

Strategy 1

Compound returns: the essential ingredient

When investing for long-term goals, you should consider re-investing your earnings and giving your money time to grow.

What are the benefits?

By using this strategy, you could:

- 'Compound' your investment returns, and
- Accumulate a larger amount.

How does the strategy work?

This strategy involves two essential parts.

1. You need to **re-invest the earnings** you receive from your investment rather than spend the money on other things. This enables you to convert your earnings into capital so you can earn even more money in the future.

For example, if you invest \$1,000 at 10% pa, you will earn \$100 in the first year. If you then re-invest the earnings, in year two your investment will be worth \$1,100 and your earnings will increase to \$110 (and so on).

This simple investment principle is called compounding and it can work effectively with a range of investments, including unit trusts.

2. To get the most out of compounding, you need to **give your money time to grow**. This could involve starting your investment as soon as possible and/or keeping it going for as long as you can.

Over several years, compounding can make a big difference to your wealth. For instance, if you invest \$10,000 at 8% pa until age 65, the table below shows how much your investment would be worth depending on your age when you first invested.

Age when you invested the \$10,000

20 yrs	30 yrs	40 yrs	50 yrs
\$319,204	\$147,853	\$68,485	\$31,722

Note: This example ignores the impact of tax on investment earnings and inflation.

By simply investing 10 years earlier (and re-investing your earnings) you could more than double your money!

The rate of return can also make a big difference if you leave your money to compound over longer time periods (see case study).

Case study

Twin sisters **Anna and Ingrid** both started contributing \$2,000 a year into a unit trust at age 25 and re-invested the income distributions.

Anna chose an investment option that favoured shares and property and earned 8% pa. However, she stopped contributing after 10 years and left her money to grow until she reached age 65.

Ingrid, on the other hand, continued investing \$2,000 a year right up until age 65. But she chose a more conservative investment option that favoured cash and bonds and earned 5% pa.

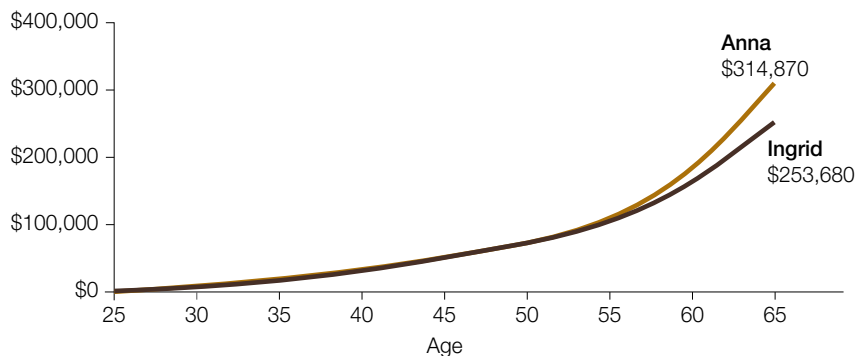
Who do you think ended up with the most at age 65? Anna who only contributed \$20,000 or Ingrid who contributed \$80,000?

Summary

	Anna	Ingrid
Amount invested	\$20,000	\$80,000
Years invested	40	40
Annual return	8%	5%

You would think Ingrid would end up with more money by investing an extra \$60,000. But, as the graph below shows, Ingrid and Anna's investments grew to \$253,680 and \$314,870 respectively. That's a difference of \$61,190 in Anna's favour.

Anna vs Ingrid (over 40 years)



Note: This example ignores the impact of tax on investment earnings and inflation.

The reason Anna had a greater account balance was the compounding effect of earning an extra 3% on her investment each year. If Anna had also contributed \$2,000 a year for 40 years, she would have an account value of \$559,562.

Tips and traps

- Before making an investment, it's important to seek financial advice to ensure the assets you choose reflect your financial objectives, investment timeframe and attitude to risk. It's also a good idea to review your financial plan regularly.
- Investing on a regular basis can enable you to reduce the impact of market fluctuations – see Strategy 4.
- Most managed funds allow you to automatically re-invest the income distributions that are paid on a regular (usually quarterly) basis.
- The income distributed by a unit trust is taxable, regardless of whether the amount is received directly or re-invested to compound your returns. To minimise the amount of tax payable, you could consider holding the investment in the name of a low-income spouse (see Strategy 5) or using a discretionary trust (see Strategy 7).