

Avoid high-cost debts that snowball on you

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The secret of compounding is how you earn more money from the interest on what you have already invested. There are some rules you can adhere to for reaping the maximum benefits of compounding:

Start early and save more: The work you need to do in the beginning is often very painful and tiring, but once your the snowball is built, your wealth would attract more wealth. Establish a savings/investment budget that will enable you to save a certain amount of your monthly income (at least 20%) for investments. This will help you stick to your investment plan for the long run.

Power of compounding: The longer you leave money invested in a good investment option, the more it will grow due to the compounding effect. Say there are two individuals: Rahul and Priya (names changed). They make disciplined investments and both want to retire at 60. Rahul started investing Rs 1,500 per month when he was 25, and Priya Rs 2,500 per month when she was 30. Assuming a 10% yearly return, both — despite lower contribution by Rahul — will have at 60 almost the same corpus, at Rs 57.4 lakh.

What is compounding?

In the world of investments, compounding refers to the ability of an asset to generate returns, and then again generate returns on the original investment as well as on the return from the previous period.

When this goes on for a long period of time, in later periods the original investment grows exponentially and the total corpus becomes multiple times the initial amount.

How does it work?

You invest some money (principal), which earns interest at a certain rate (%) at the end of the first period (yearly, half-yearly, quarterly or monthly). At the end of the second period, a larger block (principal + interest) earns interest: The principal earns interest and along with it, this time, the interest you earned at the end of the first period also earns interest. The total sum that earns interest in the third period is even bigger and, as the process continues, the block of money gets larger.

You can witness this power of compounding in systematic investment plans (SIPs) of mutual funds.

Earn compounding interest, don't pay it: It's important to pay off your debts quickly. High-cost debt like outstanding on credit cards is also compounded. Do away with credit card debt as this can be your biggest impediment to wealth creation. Assuming a 27% annual interest on unpaid credit card balances, an unpaid Rs 1 lakh at the beginning of the year could turn into over Rs 3 lakh of debt by the end of the fifth year.

Stay away from the activity trap: Research done by a leading global institution on its account holders have shown a couple of stunning outcomes: Among the best

performers on their portfolio were people who had forgotten about their investments and therefore did nothing about them. Or portfolios where the account holder had passed away and thus there were no transactions that were done. Remember that excessive portfolio changes can actually take you away from your objective of increasing your wealth. So monitor your portfolio regularly, rebalance when necessary to achieve the benefits of compounding and increasing your wealth.

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