The Power of Compounding

Compounding is the financial equivalent of a snowball rolling downhill. With each revolution, the snowball gets bigger because it picks up even more snow every time around. Compounding produces a snowball effect with money because the earnings each year contribute a little more to earnings the following year. As time passes, the earnings contribute more and more to the total value of an investment.

The longer the period of your investment, the more you accumulate, because of the power of compounding... which is why it makes sense to start investing early.

The secret is to start early

Meet Sachin and Sehwag. Sachin invests Rs.5 OOO while Sehwag invests twice as much. As illustrated in the table below, even though the amount invested by Sachin is half of what Sehwag puts , his investment final amount is becomes twice as much as Sehwag's, simply because he started earlier - a clear instance of the benefits of compounding. This is the power of compounding.

Compounding Favours the Early Starter

	Sachin	Sehwag
Investment Amount	Rs.5,000	Rs.10,000
Investment Duration	20 years	10 years
Final Amount	Rs.81,833	Rs.40,456

Assumed annual rate of return - 15% with dividends and capital gains reinvested. For illustrative purposes only

The key therefore lies in starting earlier, and giving your investments a longer time to grow.

Reinvest earnings and put your money to work

You may have noticed that our example assumes that dividends and capital gains aren't taken in cash. Reinvesting your distributions increases the value of your portfolio which, in turn, increases the amount of interest earned each year.

Just like our snowball growing larger with each roll, the value of the investment increases by a greater amount each year as the earnings are put back in. As time passes, earnings generated by the reinvested interest can rival or surpass the earnings that come from the initial investment alone.

The longer you have, the better compounding works

Money starts multiplying, more towards the end, as can be seen in the following graph:

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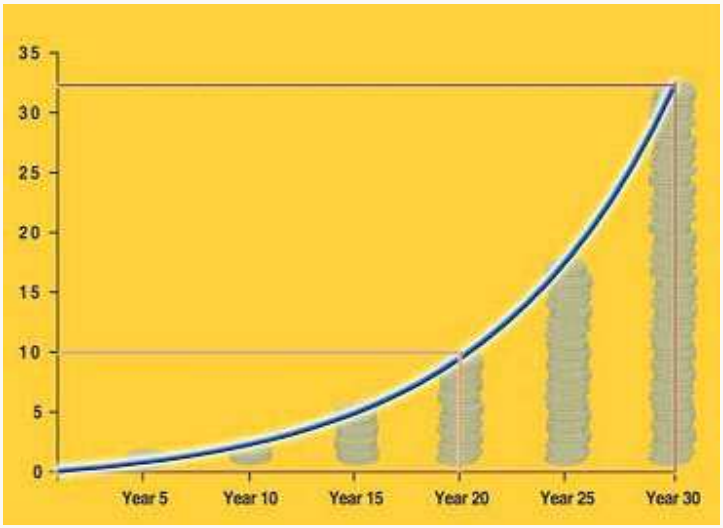
Growth of a monthly saving of Rs.1000 over a 30 year period

(Total savings: Rs.3.6 lacs)



Assumed rate of return - 12% For illustrative purposes only

Growth on top of compounding

The basic principles of compounding apply to any mutual fund. Namely, reinvesting earnings (dividends and capital gains for non-money market funds) over time can lead to potentially large increases in value.

If a fund's share price rises, your initial investment grows independently of the effects of compounding. Although there's no guarantee that a fund's share price will increase, coupling this kind of growth potential with compounding has been an effective strategy for many long-term investors.