

Good Habits Help Build a Lifetime of Investment Success

We often talk about good habits for health like exercising or eating more fruits and vegetables, but what about good habits for your investment portfolio?



One healthy financial concept is using the benefits of compounding as you invest regularly over a long period of time. Unlike a healthy diet where each day is a new challenge to avoid that piece of chocolate cake, compounding has the potential to build upon itself like a snowball rolling down a hill and grow into an avalanche of savings over time. That building effect is the foundation of the compounding principal where your initial savings grows, and that growth is added to your savings balance so the new balance grows even more.

If you only have a single sum to invest and want to know how long it will take your money to double without adding any more to it, you can apply the “Rule of 72” – take the interest rate you are earning and divide it into 72. For example, if you have \$1,000 to invest and your interest rate is 5%, it would take you 14.4 years to double your money from \$1,000 to \$2,000.

To illustrate the effects of compounding, consider this question. If you were starting a new job and could receive either \$1,000,000 for 30 days of work or a penny on the first day, doubled every day after for 30 days, which would you choose? If you chose the \$1,000,000, you might be surprised that the penny doubled every day for 30 days would give you \$5,368,709.12. While you will probably not get a job offer like this, it demonstrates the power of compounding.

The longer you are able to save, the more substantial the benefit is, but don’t get discouraged if you can’t save a huge amount initially. By starting early with even a smaller amount, you are getting the benefit of multiple decades of growth on those funds. You can use different types of accounts for savings. It usually makes sense to start with a tax-deferred account such as an IRA, Roth IRA or 401(k) plan through your employer because the tax-deferral feature of these types of accounts allows the funds to grow more than they would if they were taxed each year.

Financial Planning

Let's review an example. Assume you start saving \$5,000 annually (about \$13.70 a day) when you are age 25. If you earn 7% per year in a taxable account, that \$5,000 annual amount will grow to over \$642,000 by the time you turn 65. If you instead save in a tax-deferred account, that same \$5,000 annual savings will grow to \$998,000 at age 65, a 36% increase. Keep in mind that depending on the type of retirement account, you may owe taxes when you distribute the funds. If you withdrew all of that \$998,000 at age 65 and were in the 37% tax bracket, you would end up with \$628,740. The cost of delaying the saving habit can be dramatic. Let's say you don't start saving that \$5,000 until you are 30. In that case, your tax-deferred total would only be \$691,000, a 31% difference for delaying savings by 5 years.

Another benefit to a regular savings habit is that you aren't trying to pick the best time in the market to invest. Instead, you are regularly investing during both good and bad markets and over time, this gradual approach will allow you to take advantage of market fluctuations, buying more shares when the market is down and less when the market is up.

In sum, this is a simple strategy where you can start early and small, but it has the potential to make a huge difference in what you can accumulate over your lifetime. Here are a couple of tips to remember:

1. **Start Early.** As you saw from the example above, even a small amount of regular contributions can grow to a substantial amount over time. The impact of waiting a year or two can result in a significant reduction to the amount you accumulate.
2. **Stick to your plan.** This concept won't work if you don't commit to keeping the savings going, even when it is difficult to do so, such as when poor market conditions exist or when you would rather spend the money on a beach vacation. One way to make it a bit easier is to set the savings up as a payroll deduction through your employer. That way it will come out automatically and will be more difficult to stray from your plan.
3. **Increase your savings amount over time.** As you progress through your career, you will receive raises and possibly bonuses. Consider allocating a portion of each of those increases to your savings plan. The New York Times has a 1% more savings calculator that illustrates the powerful benefit of increasing your savings amount by just 1%. Check it out to see for yourself the benefit of gradually increasing your savings. ■

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