

Time as a Friend, Time as a Foe



How time matters to investors; facing up to the realities of time limitations; the magic of compound interest; the Rule of 72



Jack clearly has his work cut out for him now that he has resolved to get his financial affairs in order but he's not alone in finding himself at a crossroads. Next, we'll see how young Kate is well positioned to benefit from the magic of compound interest. As well, we'll further explore how time matters to investors, and learn how Jack faces the realities of time constraints ...





Kate the go-getter has set her alarm clock to go off early and is eager to get ahead start on the day. She's got her automatic coffee maker dripping away, her freshly pressed suit is laid out ready for wear and already, in the first moments of another work day, she is beginning to focus on a busy morning's worth of appointments. After a brisk shower, she allows herself a moment to munch on a slice of toast while she checks out the business section of the morning newspaper.

Kate drives an older car but likes her coffee strong and has an aggressive approach to life. She has the drive to succeed in the world of sales, and at the age of 25 she has the most important asset needed to excel in the world of investment planning as well - time.

Among our three characters, Kate is in the best position to accumulate wealth simply by letting her investments build over time. We say that Kate is in "accumulation mode" and will be

for perhaps 35 years. Not only will the investments she now makes grow over that long period of time, but since she is also earning employment income, she is able to pay for her current living expenses without touching her investment capital.

Compare her to, Clive and Jack in that respect. If Clive sells his business, he may have a sizable nest egg but he loses his major source of income and thus will have to live off his investment earnings, or possibly eat into his investment capital. Jack, meanwhile - still earns a decent paycheque from the plant but since he only has 10 or 15 years left in the work world, his investments have less time to grow than Kate's do, and he is that much closer to retirement age and having to live on his accumulated earnings.

As a career woman Kate gets excited when her monthly sales numbers start to add up, and she frequently pulls her calculator out of her briefcase as she takes stock of her tally. And now,

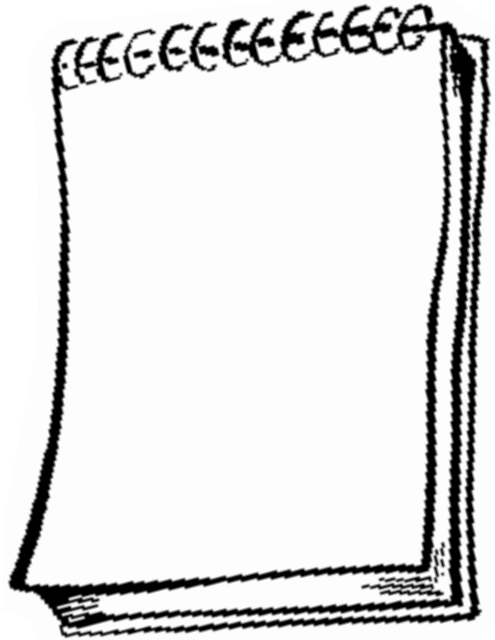
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as she contemplates embarking on an investment plan, she has a new reason to grab her calculator - to determine how compound interest will work in her favour over the long run. That wondrous but simple mechanism will be a great ally as she accumulates wealth.

Most people understand the principle of compound interest but many have difficulty determining dollar values over time. A useful rule for calculating the growth of an investment is the Rule of 72, which tells the investor how long it will take an investment to double based on an assumed rate of return. Here's how it works: take 72 and divide it by the actual interest rate or assumed rate of return and that's the number of years it will take the investment to double. If the interest rate is 10 per cent, the doubling period is 7.2 years. If its 6 per cent the doubling period increases to 12 years.

The Rule of 72 is handy for both Kate and Jack as they plan their portfolios in that it gives them a specific set of time periods to focus on. Kate uses the rule as a guideline for anticipating a series of doubling periods over the rest of her working life. If we assume a rate of return of 10 per cent per year, then she may well be looking at four or even five doubling

periods while she is in accumulation mode. - Take a second to do some calculations for yourself and you'll see how the combination of time and compound growth is a huge asset for Kate. (A 10 % return over time may be realistic in this case given Kate's situation, but this will be covered later in this story.)



People often refer to the "magic" of compound interest as if there is some secret involved. There is no mystery, it is just simple arithmetic.

Consider the old story about the emperor and the beggar. The two sit at a chess board and the emperor, feeling generous for the moment, lets the beggar start

off with a piece of gold and then promises to double it for each of his successive squares on the board. The beggar takes one, two, four, eight, 16, 32, 64, and so on over 32 squares. After 31 doubling periods the final total would have been 18 million trillion gold pieces - the power of compounding is enormous.

For Jack, on the other hand, contemplating the Rule of 72 brings home the urgency of his situation. He may only have two such periods if he works until he is 64, using the 10 % interest-rate assumption. However 10% may not be a realistic return for him as we'll discuss later; and this could further complicate his retirement picture.

The Rule of 72 will force Jack to face the reality of how different investment vehicles with different growth rates will affect how quickly his capital builds. Jack is naturally cautious and would prefer to put his money into GICs or bonds, but he is faced with the hard truth that the lower the yield of his investments, the longer it will take his money to double in value. Jack has some tough decisions ahead of him.

