

The Miracle of Compounding

Outstanding winners of the investment game often have something in common: their ability to keep their gains and make further gains on those initial gains and so on - over a long period of time. As they do this, they have a simple math on their side called the Power of Compounding. It simply says that if you put your money in an investment with a certain return - and then reinvest the income from that for further gains, the returns keep accumulating at an accelerating rate leading to unimaginable wealth over the long term. Compounding is a miracle that allows you to turn a measly rupee into thousands of rupees if you leave it invested long enough.

Suppose you are 28 and you decide to put Rs 1000 every month into an investment with an 8% annual return. After Year 1, you will have Rs 13,533. If you leave your wealth to earn another 8% next year, rather than take out the Rs 800, on Year 2 your wealth would rise to Rs 27106. This does not look all that great - until after a few years. The longer you leave your money in, the faster it



begins to grow in the later years. By the time you are 58, your money would have grown to Rs 15.01 lakh! And that is only at a compounding of 8%. If your returns are 15% a year, the amount would be Rs 70.10 lakh only by saving Rs 1000 a month.

Clearly, the longer you leave your money invested, and the higher the rate of return, the faster your wealth will grow.

This is something that the most successful investors and entrepreneurs understand instinctively many of whom had to start from scratch to build wealth. Either directly or indirectly they follow the power of compounding, an automatic method of building wealth. You too can make the power of compounding work for you by automatically setting aside a specific amount each month for a good mutual fund or a basket of blue-chip stocks of your choice. Your wealth grows very fast for three reasons: one, you are adding to your account every month; two, the growth assets increase your growth and three, dividends and distributions are automatically reinvested.

Understanding Uncertainty

What's Volatility

Volatility is a measure of fluctuation in the price of a stock, market index or value of any asset. If the price of a share rises to a high of Rs 27, falls to a low of Rs 17 within a day and finally closes at Rs 20, its volatility for the day is 50%. Generally it is taken to be proxy for risk: the higher the volatility, the riskier the investment in that asset. But higher risk, caused by high volatility, does not always mean lower return. On the contrary high volatility can co-exist with high returns, and the reverse can also be true.

What causes Volatility

Globalisation : On 28 February stock prices went into a freefall following the fall in the Chinese stock markets. A few days later a rise in the yen's value created panic in the market. Effects of globalisation - largely good but not always hunky dory.

Interest rate : A fall or rise in interest rates affects returns from debt investments, which become more or less attractive. This can have a domino effect on stock investments too. If debt is less attractive, more money will go into equity or vice versa.

Events : There are predictable events like the Union budget or a company AGM that could trigger market volatility. Then there

are unexpected political events or just a statement by a global leader that could set off a market frenzy overnight.

Checking Volatility : Volatility can't be prevented but it can be moderated to some extent. Stock exchanges have circuit breakers

for certain types of shares which means that trading is suspended in the stock for a specified period if it falls by a pre-defined percentage. The percentage varies across different categories of stocks and is also extended to the market indices.

Fall : No copy book definition, but a drop in the indices (Sensex and Nifty) over the previous day's closing value can be termed a fall especially if it recovers lost ground the next day.

Crash : Again no fixed definition, but a crash is a huge and sustained fall. The 565 point (11%) fall in the Sensex two days after the UPA government took over in Delhi in May 2004 was a crash that suspended trading. It's better to look at percentage rather than absolute fall - to distinguish a fall from a crash

Correction : A short, measured fall in prices, especially one that shaves off some gains from a continued rally is a correction. It is considered good because during a correction, the ownership of shares from weak hands (short-term investors) to strong hands (long-term investors).