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July is savings month – a great time to start investing and benefiting from the power of compound interest

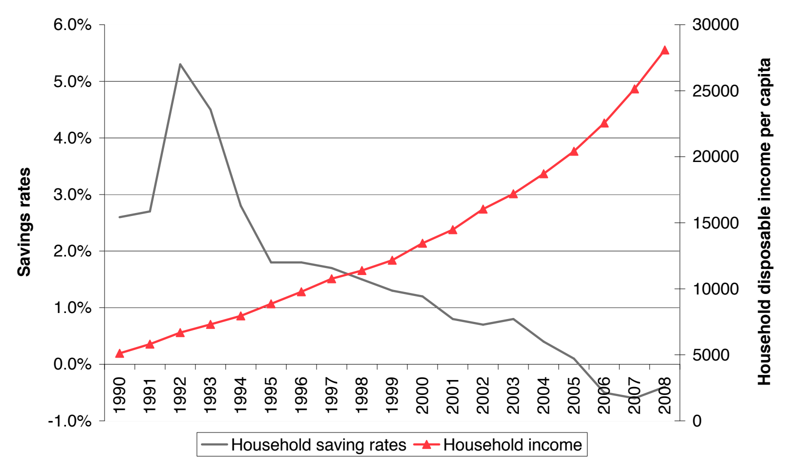
If you invested R10 000 in 1974 in the FTSE/JSE All Share Index (ALSI), your investment would have grown at a compound annual rate of 17.2% over 35 years; the same amount invested as cash would have grown at a compound rate of 13.1%. But the difference of 4.1% in annual compounded growth rates does not convey the scale of the difference in rand terms. Your ALSI investment would be worth R2.6m*, 3.5 times the value of your cash investment, which would amount to R747 000. This example illustrates the powerful effect of compounding interest, which in turn has three components:

1) Initial savings
2) The time for compounding to take effect
3) Real growth rates

1. Start saving

Of course, in order to benefit from compounding, you first have to set some money aside for saving. However, South Africans are notoriously poor savers. One measure of this, the gross savings rates as a percentage of GDP, presents a mixed picture. South Africa saved 15.4% of GDP in 2008, which compares poorly with India at about 30%, Brazil at around 25% and Australia at 22.5%. However, it is in line with the US at 13.1%, UK at 15.6% and New Zealand at about 16%. But gross savings includes corporate, government and household saving. If we look at households the picture is far worse. **Graph 1** shows that South African households were saving, on average, about 5% of disposable income in 1992. However, this has steadily decreased and currently households are no longer saving but actually spending capital. This is in sharp contrast to an increase in household disposable income over the same period.

Graph 1: Household saving as percentage of disposable income

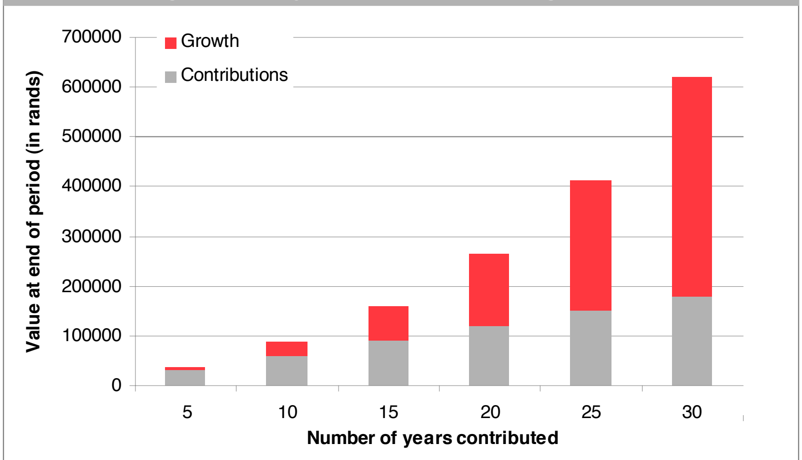


Source: South African Reserve Bank

2. Give your money time to work for you

The effect of time can be seen in **Graph 2**. As the time allowed for compounding increases, so the amount of growth, relative to the contributions, increases exponentially. The sooner you start saving, the longer you will have to benefit from what Albert Einstein referred to as the eighth wonder of the world, compound interest.

Graph 2: Average real equity returns* when investing R500 per month



* 7.3% based on South African Equities from 1900 - 2005
Source: Triumph of the Optimist

3. Look at wealth creation in terms of real growth rates

Obviously, the higher the returns, the more pronounced the compounding effect. That said, this is not the full picture, as the case illustrated in the first paragraph shows figures in nominal terms and does not take account of the effects of inflation. The true picture of wealth creation should be considered bearing inflation in mind, to get the value in real terms. The inflation rate since 1974 has averaged 10.5% per year. Thus, an investment of R10 000 would have to be worth R333 125 today for it to have kept pace with inflation. Accounting for this, the ALSI investment created 5.5 times the amount of real wealth, compared to the cash investment.

* An investment in an Allan Gray share portfolio at the same time would have grown at a compounded growth rate of 27.9% and be worth R55.6m

Commentary by Rob Formby, deputy director of retail operations, Allan Gray Limited