

Power of compounding How to let your savings build wealth for you

Many people consider stocks to be a risky investment and avoid them. Interestingly, retail stock investors, who do invest in stocks, often choose small and mid-cap stocks which are relatively riskier. As a result, their personal experience with stock investing is often not positive.

Despite this, investing in equity mutual funds is becoming more popular, as seen in the growth of SIP inflows. Mutual funds mostly invest in large cap stocks, which you might expect individual investors to prefer, but only certain kinds of investors do.

Successful retail investors know they don't have the knowledge or skills to pick winning stocks, especially small cap stocks which are more volatile and not well researched. So, what do they do to grow their money?

They rely on the power of compounding, which means earning interest on interest. Most people understand this concept from fixed deposits. But how does compounding work in stock investing? Let's understand the power of compounding and then figure out how to invest in a way that makes it work for stock investments.

Here's how you build wealth from your saving and investing.

Wealth building is influenced by three crucial factors: savings/surplus, returns and the time you stay invested.

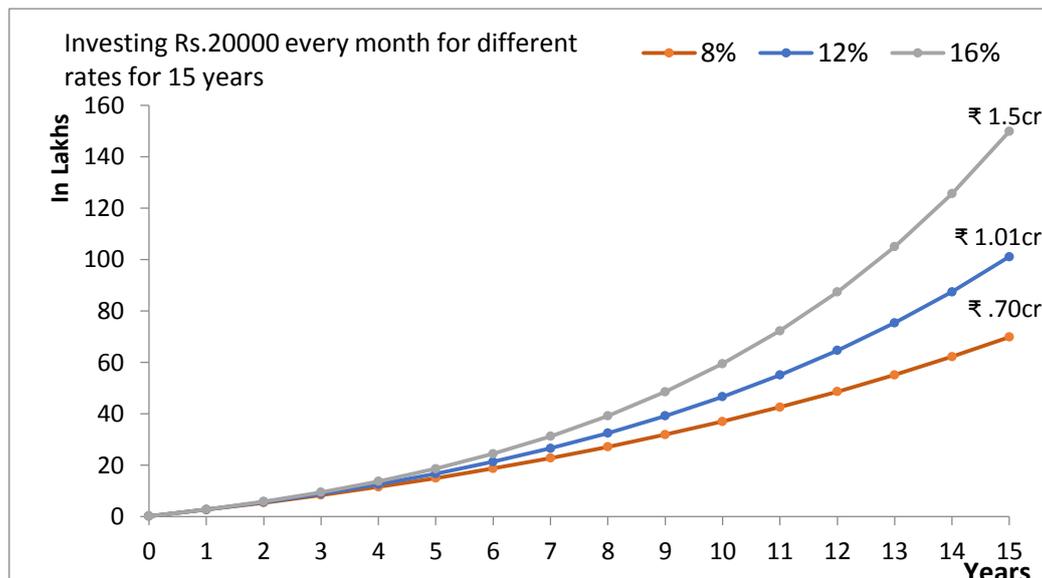
$$\text{Wealth} = \text{Surplus} (1 + \text{returns})^{\text{years invested}}$$

These variables play a pivotal role in shaping one's investment portfolio. It is essential to recognize that wealth maximization should be the ultimate goal, and a holistic approach encompassing all three variables is required.

How does a change in returns affect your Wealth creation?

Let's say you systematically invest (SIP) Rs.20,000 per month, how much will you end up with if you earned 8%, 12% or 16% CAGR? (compounded growth per year). The graph shows that after 15 years you will have about Rs.70 lacs, 1cr or 1.5cr respectively. The difference is significant at each level.

What is the significance of the returns we have chosen? 8% CAGR over 15 years is the returns you can hope to earn if you invested predominantly in Debt Funds or Fixed Income assets. Higher than this requires you to invest in equity (which is higher risk). Going from 12% to 16% CAGR over many years requires being a savvy and disciplined equity investor.



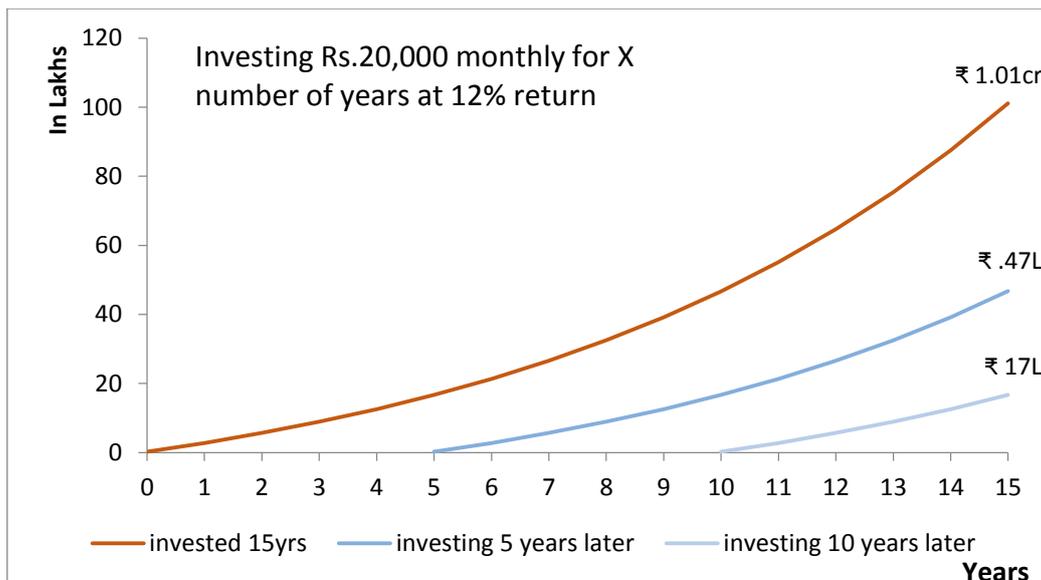
$$\text{Wealth} = \text{Surplus} (1 + \text{returns})^{\text{years invested}}$$

Why not higher than 16%? The simple truth is that if you try to maximize returns you expose yourself to very high risk which prevents you from keeping your entire surplus to work and staying invested for long. In short high risk-high returns way of investing does not work well for retail investors.

Start early

If you invest Rs.20,000 per month at age 25 for 15 years and it compounds at 12%, by age 40 you can build an enormous Rs.1 Crore corpus. In case you start 5 years later, investing from age 30 to 40; you would get Rs.46 Lakhs, and 10 years later just Rs.16.7 lakhs.

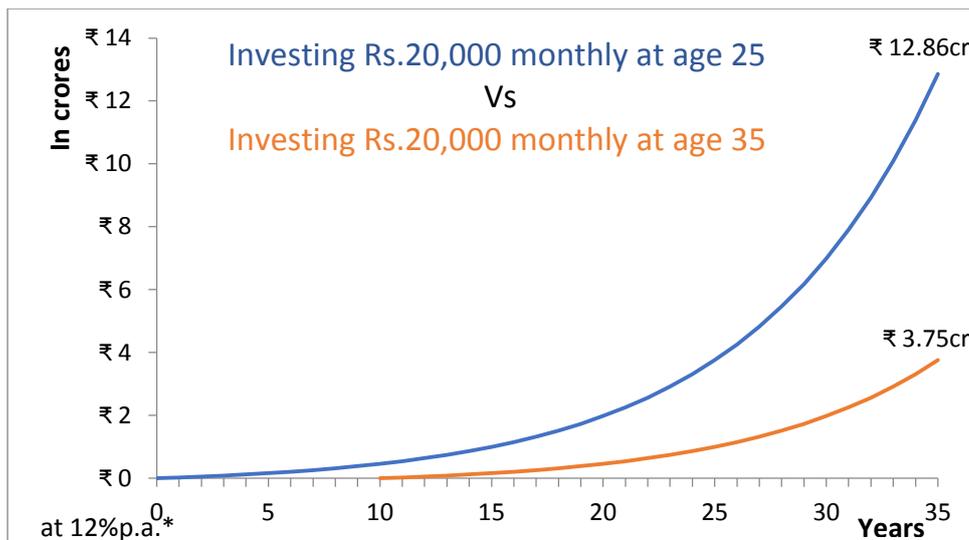
By starting early you allow compounding to do most of the heavy lifting. With a pretty decent income and sizable savings in your earlier years, you can make a noticeable change to your investments.



$$\text{Wealth} = \text{Surplus} (1 + \text{returns})^{\text{years invested}}$$

That was compounding just for 15 years, imagine what compounding does in the long run. If you invest from the age of 25 till you retire, just Rs.20,000 per month at 12% returns, your portfolio will have amassed Rs.12.8 crores by age 60. Which, by any standard is sufficient for retirement.

But what if you started investing later, say around age 35. Then you would have accumulated just Rs.3.75 crores in comparison. An insane Rs.9 crore difference that an additional 10 extra years of investing can do to your wealth over the 25 year time span compared to the investor who started at age 35, that's the power of compounding.



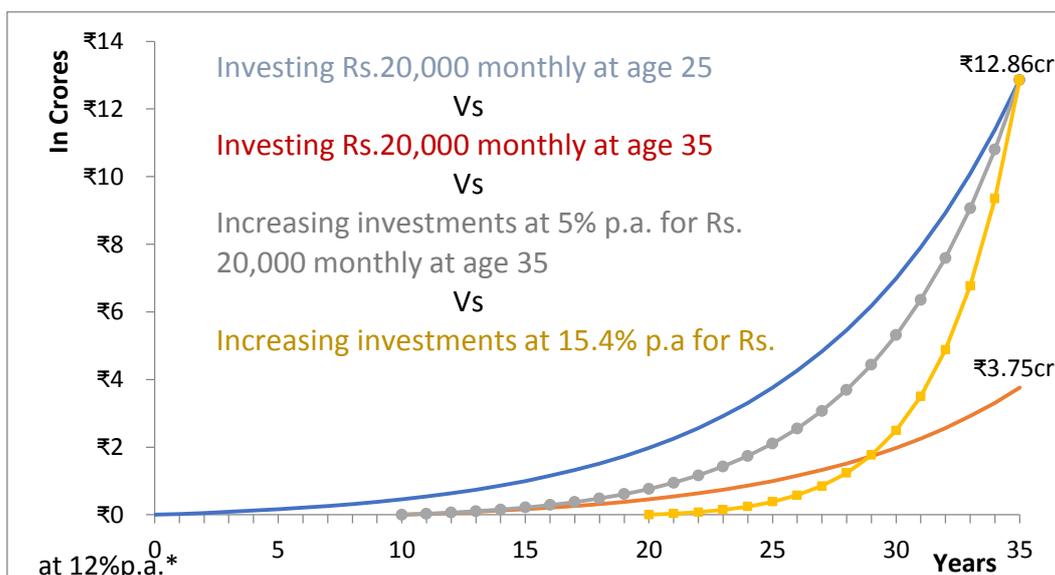
A baffling 9 crore difference; this staggering difference highlights the profound impact an additional ten years of compounded investing on wealth creation.

Late to the party; fear not.

Some of you might be thinking 'I am doomed, I should have started investing a long time ago, I'm at the point of no return and starting to invest now seems a bit useless'.

Late investors need not lose hope; they can still achieve their financial goals by increasing their investment surplus every year. An yearly increase of 5% in investment can help mitigate the impact of lost time. By proactively increasing their investment commitment, late investors can gradually catch up and boost their wealth accumulation over time.

Those who have not invested until age 45 can catch up by investing Rs.20,000 monthly in stable and resilient stocks, generating a return of 16% and by increasing their investments at 15.4% every year, can still build a wealth of Rs.12.8 crore.



It's naive to think that stock investing will automatically give you high returns that beat inflation. Many people see the Nifty 50 or Sensex going up and delivering 10 to 15% CAGR, and think any stock they invest in will do the same.

But what should you look for to make sure your investments can compound at a rate of, say, 12%, which is well above the inflation rate? Knowing this will help you decide which stocks to invest in.

The answer lies in understanding how the market arrives at the price of a stock. The investing Guru *Benjamin Graham* answered this very nicely.

“In the short run, the market is a voting machine but in the long run, it is a weighing machine”. - Benjamin Graham

In the short term, stock prices are determined by current supply and demand like a voting machine. If more people want to buy a stock than sell it, the price goes up until supply matches demand. This is what traders look at when making decisions.

But there's also the weighing machine side of the market, which involves assessing the worth of a stock and determining a fair price. If you want to earn 12% CAGR, the stock price should increase at the same rate.

If you're not relying on the supply and demand side of the market, the intrinsic value of a stock should increase at the same rate as your desired return. The intrinsic value of a stock depends on its ability to generate increasing profits without needing more investment.

For example, if a company has built a strong brand and distribution network, it can grow its sales and profits with lower marketing costs as a percentage of its revenue, benefiting from its past investments.

A growing company usually keeps some of its profits and reinvests them to earn more in the future. This leads to compounding growth in its profits and earnings per share (EPS). To see if a stock is a good investment, look at its EPS over time and check how fast it's growing. You can trust the market to correctly assess the stock's worth and price it so you earn a good return.

For example, Hdfc bank had an adjusted EPS growth of 18.9% in the last 9 years. Its share price delivered a return of 17.1% for the same time period. The short term growth rates may mismatch but over the long term the relationship holds.

CAGR ⓘ CAGR Colour Code Guide ⓘ

	9 Years	5 Years	3 Years	1 Years
Net Interest Income	19%	17%	14.6%	11.6%
Total Income	16.3%	14.3%	10.6%	7.6%
Adj EPS	18.9%	18.1%	18.7%	18.8%
BVPS	21.5%	20%	16.4%	17%
Share Price	17.1%	8.9%	14.2%	17.2%

Bajaj Finance had a successful run over the last decade and evidently there's a strong relationship in EPS growth and its share price growth.

CAGR ⓘ CAGR Colour Code Guide ⓘ

	9 Years	5 Years	3 Years	1 Years
Net Interest Income	27.4%	23%	14.4%	28%
Adj EPS	31.5%	31.6%	27.9%	61.7%
BVPS	29.9%	25.2%	17%	22%
Share Price	48.4%	25.9%	31%	27%

Over the course of a significant time span (i.e. 9 years), the increase in share price can be seen as a reflection of the growth in earnings per share (EPS)

Challenges in selecting good stocks:

Now that we've touched upon the technical aspects, let's look at the many hurdles in finding good stocks to invest in successfully.

Information Overload: There is an abundance of information available about stocks, making it hard for investors to filter out relevant data from noise.

Company Fundamentals: Assessing a company's financial health, earnings potential, and growth prospects requires in-depth analysis.

Valuation: Determining the fair value of a stock is not straightforward and involves various valuation models.

Industry Analysis: Understanding the dynamics and trends of the industry in which a company operates is crucial.

Competitive Landscape: Evaluating a company's position relative to its competitors is essential to identify potential winners.

Risk Assessment: Assessing the risks associated with a company's operations, debt levels, and market exposure is crucial.

Finding the right stocks can be quite challenging. If you don't have the time or if you don't keep up with new information, you can lose money in the markets like how most people do.

To find the right stocks, you should have a good understanding of the company. Should time be a constraint, you can enlist the assistance of our stock analysts.

Are you ready to make your money work for you?

Our Core Superstars and Multicap 100 plans are the perfect ways to do it!

With our plans, you can relax and watch your money grow even as you sleep. We hand-pick well-researched, fundamentally strong stocks poised for growth. You can give us a call to help you get started with investing.

Click here to learn more and start investing today!

Get a list of the best stocks to invest in