4 Ways to Accelerate the Power of Compound Interest

[This is a guest post from Michael Episcope, co-founder of [Origin Investments] which provides real estate equity funds to individuals. Origin Investments has been a paid advertiser on this site, however, this is not a sponsored post.]

The secret to growing wealth is not only making wise investments but also putting earnings to work to generate even more earnings. Money grows faster over time. When interest, dividends and capital gains on investments are left to accumulate, they grow exponentially—earning interest on not only the original investments, but also the accumulated earnings.

Calculate Compound Interest with the Rule of 72

A useful shortcut to help calculate the rate of compounding at a given interest rate or expected investment return is the rule of 72. By taking the interest rate or the expected return and dividing it by 72, the result is the number of years it will take to double your money. Using this formula, a 9% return will double every 8 years. (72 divided by 9=8)

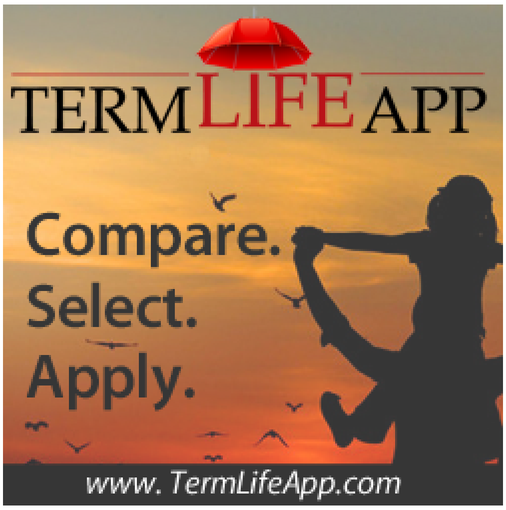
Even a single percentage point more in annual returns add up to big dollars when you do the math. For example, over 35 years a $1 million investment portfolio generating gains of 6% annually will be worth $7.69 million, while a 7% annual return will generate a portfolio value of $10.68 million. That's a difference of 39%.

Albert Einstein is said to have called compounding the eighth wonder of the world. Whether or not that's true, it's clear that keeping your money working at all times and making money on your money is the key to getting and staying wealthy. By making a few portfolio tweaks or managing cash more effectively, nearly every investor can find a way to generate another 1% to 2% annually on their portfolios. It requires discipline, but the steps are simple:

4 Ways to Accelerate the Power of Compounding

#1 Focus on asset classes with high expected returns

Portfolio optimization is a tool used by virtually every wealth manager to create risk-adjusted portfolios, but it comes at a cost by trading volatility for return potential. That's because portfolio maximization doesn't focus on maximizing long-term wealth, but rather minimizing long-term loss—For that reason, many portfolios are "over-diversified" with asset classes that are included to lower volatility.



David Swensen, CIO of Yale University's endowment—the world's second largest according to the New York Times, focuses the school's investment dollars on alternative asset classes with high return potential. Very little of the Yale portfolio is in bonds or cash. Why? While bonds are a great tool to smooth the ups and downs of a portfolio, they don't earn significant returns. And what's the point of having bonds in a portfolio if you have a 25-35-year investment time horizon? Over that period, odds are you will achieve the long-term historical average of any asset class. So why not invest in an asset class with a high expected return?

Instead, Yale's endowment has assets in both the public and private markets to optimize returns. To be clear, the Yale portfolio is highly diversified across various asset classes, each with the potential to generate sizable returns. It's this strategy that has helped Swensen achieve annualized rates of return in excess of 12% over the last 30 years. Alternative investments such as real estate and venture capital played a key role in generating these returns.

#2 Scrutinize every fee

Investors pay fees directly to wealth managers or investment accounts, and indirectly to managers of the underlying assets. The fee for wealth managers today is somewhere between 0.3% and 1.0% on assets under management. To find lower management fees, consider re-negotiating or using a robo-advisor. Robo advisors such as Betterment and Wealthfront provide similar asset management services as traditional advisors but for a fraction of the cost.

Moving beyond advisory fees, pay close attention to investment vehicles and how their fees are structured. Passive investing has proven to beat active investing time and time again, but finding the lowest cost provider is essential. Are you in a Vanguard index fund paying 0.1% or a mutual fund paying 0.6%? Switching is simple and easy.

It's often the hidden fees we don't see that are the ones that destroy returns the most. The race to low fee or no fee solutions has forced companies like Robinhood to find other ways to fee customers. No one works for free and companies must make money so beware of these marketing tricks. Don't penalize a company for putting their fees up front and center. A 1% fee can sometimes be a lot less expensive than free.

#3 Manage cash appropriately

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Cash is king, but too much of it can stink up a portfolio's return potential. Cash in an investment portfolio can drag portfolio returns down substantially because it earns next to nothing. If 20% of a portfolio is in cash, then the other 80% must work even harder to achieve your portfolio return goals. Determine how much cash you need and make sure the rest is invested appropriately, even if it's just in an overnight money market account earning 1 or 2%. If your cash is sitting in your checking or savings account, chances are that you are earning less than 0.25%.

The biggest mistake investors make when committing to closed-end funds is setting aside their commitment in cash. In many cases, it can take years for the manager to call this capital and that's a lost opportunity. This commitment needs to stay invested until it's called. Over the short term, you may realize some downdrafts, but the potential funding shortfall can be easily managed by maintaining a healthy cushion in your liquid portfolio. On the back end, make sure distributions are immediately invested instead of just sitting in your bank account. In the long run, managing money in this way will reap the greatest portfolio benefits.

#4 Invest for the long-term – Set it and forget it

It's not about timing the market but how much time you are in the market that matters. Generating a steady 7% return and managing your capital in a tax efficient manner is far better than chasing short term returns or throwing darts at the wall trying to guess the daily ups and downs of the market.

Consider this: from 1998 to 2017 the stock market generated a 7.2% annualized return. If you missed the 20 best days of those 20 years, your return would have been only 1.15%. That's the difference between having $1,256,950 and $4,016,943. No one knows when those best 20 days will happen, which is why staying invested matters.

No portfolio grows at a steady 7%, but over the long run, the right assets managed appropriately can be optimized for a predictable expected return. The danger in optimizing a portfolio, though, is to focus on minimizing long-term loss rather than maximizing long-term wealth. Wealth managers often diversify away risk so much that they also diversify away the ability to make any real wealth. If you have a 30-year time horizon, why are you investing in bonds? Moving that money into alternatives with high return potential is a far better solution so long as you can identify the right funds.

By combining traditional assets with high potential alternatives, investors can make long-term plans that give them the best options for appreciation. An adviser may have 50 to 100 relationships but you have only one. Stay on top of your portfolio and don't be afraid to challenge the status quo because it's your nest egg that's on the line. The job of the advisor is to not lose you money, but the absence of loss is not gain. Work with them to craft a plan that not only preserves your wealth but also affords you the ability to build wealth. Finding that extra 1-2% in returns is fairly easy if you follow some of the steps outlined above and can pay huge dividends down the line.

Do you agree with these recommendations for increasing investment returns? Why or why not? Comment below!