



5 Reasons Compound Interest Isn't What It's Cracked Up to Be

Fees, inflation, taxes, market performance and spending habits will affect your compounding interest. Financial planners want you to believe compounding interest is magic, but you should know the truth.

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To hear some financial planners tell it, compound interest is a magic carpet ride: Save early and often, and over 40 working years, your pennies will turn into millions.

That's how it was explained to Chris Browning, assistant professor with the department of personal financial planning at Texas Tech University in Lubbock. Back when he was an impressionable 25-year-old, he was dazzled by the simple math unscrolled by an enthusiastic planner.

Then reality set in. "I hate the way it's sold to people as though it's a lottery-winning strategy," Browning says. Compounding, he says, "is not as amazing as people sell it to be."

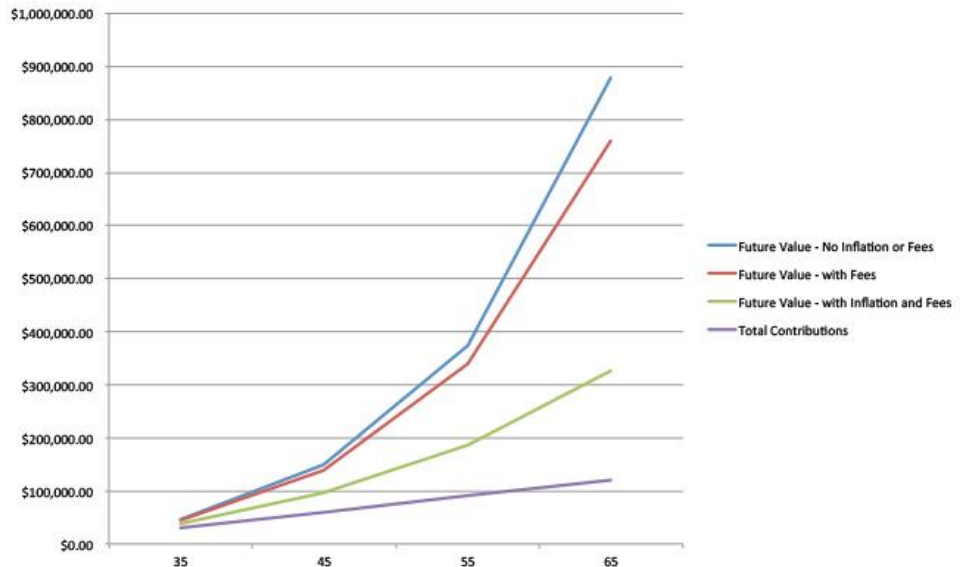
That's because the simple compound interest equation is simultaneously eroded by five factors: fees, inflation, taxes, market performance and the other ways you could spend your money.

That's great news if you are just now ramping up your retirement savings. You haven't lost out on as much as you might have feared. And if you accelerate your savings in the 20 to 25 years before you retire, you can still capture much of the power of compounding, experts say, even after real-life factors.

The fiscal fallacy in compounding. Financial planners love to hammer home the power of compounding because it does seem like magic. The basic idea is that as you save, you capture investment returns not only on the amount you save, but also on the investment returns. As your savings pile up, you get more returns on the ever-growing total.

As illustrated by the accompanying chart, simple compounding accelerates simple saving. If you start at age 25, saving \$250 a month and earning 7.5 percent annually, you'll have a gross return of nearly \$900,000 by the time you turn 65.

The chart illustrates the effect of fees and inflation on compound interest. The blue line shows how much contributions grow through simple compounding, based on a 25-year-old who saves \$250 every month for 40 years, and earns 7.5 percent. The red line factors in investment fees of 0.5 percent. The green line shows the combined effect of the 0.5 percent fees plus an annual inflation rate of 3 percent. The purple line shows the total amount contributed to the account, with no interest earned.



Except you won't.

Factor in rock-bottom investment fees of 0.5 percent annually, and you'll see more than \$100,000 evaporate from the rosy projection, Browning says. (And if you pay a planner, include those fees, too.)

Now factor in both fees of 0.5 percent and an annual inflation rate of 3 percent, and the value of your hoard is cut in half, Browning says.

It gets worse: You'll have to pay taxes somewhere along the line.

The markets, Browning says, might not cooperate with your plan and deliver a steady 7.5 percent annual return. That will affect the power of compounding.

Finally, what if your dogged stoking of the compounding engine means you don't get to pay off debt or do things that you love?

"The typical person can probably can save a million dollars over their lifetime, but they'll be unhappy doing it," says Mark Calabria, director of financial regulation studies for the Cato Institute.

Think about experiences, education and just plain having fun. Are you willing to forfeit them today so you can have a pile of money, hopefully, in a few decades? Calabria says that a healthy blend of living for today and living for tomorrow is the perspective that motivates people to meet their savings goals. Arithmetic exercises, like the classic compound-interest example, rarely inspire, he says.

How to make compounding work for you. Compounding has its place, advisors say. First, it's good to understand the concept, because it helps you make simple comparisons.

One of those comparisons should be how much you lose by paying fees, says Catherine Hawley, a financial advisor based in Monterey, California. "Fees can be thousands every year, and it's money you never see," says Hawley, who recommends that clients check out FeeX.com, which parses the real-life impact of various levels and combinations of investment fees.

Hawley also says that using one-dimensional compounding as a baseline can help you understand the factors you can control in saving and investing and the factors beyond your control. Math, taxes and the market are outside your control, but you can control fees, your saving rate and the lifestyle trade-offs you make today to save for tomorrow.

If you're getting in gear with your retirement savings in midlife, you're probably in your peak earning years, and that means you can save more and accelerate over the finish line, Browning says.

Easy tweaks to your saving schedule can juice up the power of compounding, too. Browning says you can save thousands more over your working life by simply putting your monthly contribution into your account at the first of each month, not on the last day.

And, he says, compounding yields one additional virtue: If you are interviewing financial advisors, you can thumbnail their approach to client service by asking them how they synchronize compounding calculations with your overall life and financial goals. Those who look at all the moving parts – and don't just hammer on what you don't have because you didn't make the most of compounding earlier – are likely to take the holistic approach that gets you where you want to go.