TERM
COMPOUNDS THE INTEREST

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IMAGE **THINKSTOCK**

A MAJOR PROJECT for this financial year should be to ensure the money you have in superannuation is working for you as hard as it possibly can. But first you need to understand the way compound interest works.

To put it simply, how much you will have at the end of a given period depends on the time the money is invested, and the rate you can achieve. If the term is short the rate matters little, but as time lengthens it matters enormously.

Suppose a person invested $1000 a month toward their retirement. If they started at age 25 they would have $6.3 million at age 65 if they could achieve 10 percent per annum. However, the final sum would be just $2 million if they only achieved six percent per annum.

If a person waited until they were 45 to start the program, and still managed to invest $1000 a month, at age 65 they would have $760,000 at 10 percent and $462,000 at six percent. Because the term is much shorter, the lower earning rate does not have such a dramatic effect.

I regularly receive emails from young people whose superannuation is all in the capital stable or balanced area. This is totally inappropriate for anyone under 50.

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To make matters worse, the majority of self-managed super funds have no exposure to international funds. Obviously the trustees have never bothered to check out funds such as Magellan (Global Fund) and Platinum (International Fund). Over the past three years they have returned 23.5 percent and 16.4 percent per annum respectively (after fees).

But the importance of rate of return is not just for people who are still working. Thanks to rising life expectancies, a person who retires at age 65 may have 30 years of living ahead of them. If they retired with $1 million in superannuation and withdrew $60,000 a year indexed for inflation, their funds would be gone at the age of 84 if they achieved five percent a year on their portfolio, but would last until they are 99 if they could achieve eight percent.

Once again, the importance of rate fades as time reduces. Think about a person aged 80 with $300,000 in superannuation who wishes to draw $45,000 a year. The money would be fully expended at age 86 if they earn five percent, but would only last one year longer if they earned eight percent.

A major finding of the Cooper enquiry into superannuation was that 80 percent of Australians were "disengaged with super". If you find yourself in that 80 percent, my advice to you is to start getting engaged. You've just seen how a small difference in the rate of return can make a huge difference to the amount you will have when you retire and how long your retirement funds will last. ■

Noel Whittaker is the author of *Making Money Made Simple* and numerous other books on personal finance. His advice is general in nature and our readers should seek their own professional advice before making any financial decisions.
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