GRAYISSUE

It is worthwhile starting to save early – a little can go a long way

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You can substantially improve your financial situation if you start saving sooner rather than later and you will be a step closer to being financially independent when you retire. A little really can go a long way.

It is interesting how most of us are reluctant or unable to make the sacrifices needed to save more than 10% of our salaries towards retirement, yet we expect the amount we save to be able to pay us 75% of our final salaries – often for as many years as our saving years. Sadly there are no genies waiting in lamps in this lifetime; the only way we can hope to achieve this replacement ratio is through long-term commitment, decent returns and sensible investor behaviour.

Time and commitment

If you start early and save consistently over long periods, less of your total investment will be from your contributions and more from growth – this is why it doesn't usually pay to leave your money under your mattress. Based on very long-term equity returns in South Africa, with 30 years of saving, more than two-thirds of your total investment would have come from returns and compound growth, as shown in **Graph 1**. As the time allowed for compounding increases, so the amount of growth, relative to the contributions, increases exponentially.

Warren Buffet refers to compound interest as the 'eighth wonder of the world'. The power of compounding is about the power of making your money work for you: earning returns today on the returns you earned yesterday. It also holds the key to financial security for most of us as we live longer and need to save more for our retirement.

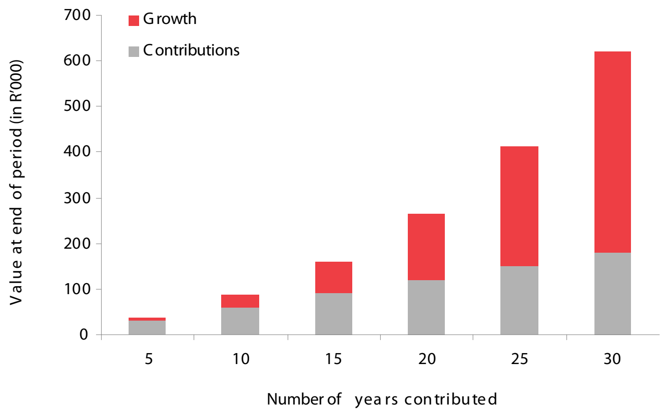
Your first 10 years of contributions are more important than your last 10 years as the money has that much more time to grow. **Graph 2** shows an interesting comparison, again using long-term real SA equity returns. Investor 1 contributed a consistent amount of R1 000 per month for 10 years (i.e. R120 000) and then stopped contributing, but remained invested for another 30 years. Investor 2 delayed starting for 10 years, and then contributed R1 000 a month for 30 years (R360 000). At the end of the 40-year period the two investors were on a par at the same return. This just goes to show that starting to save just a small amount is really worth the sacrifice in the long term.

Factor in inflation into your return expectations

Time is also an enemy because it erodes the value of your money in the form of inflation – over time you are able to buy less with the same amount of rands. Therefore, the returns on your investment should be at least enough to compensate you for the length of time that you invest so that the value of your money is maintained. If the rate of inflation is 6% per year, for example, your investments have to grow by more than 6% each year before you achieve any real return.

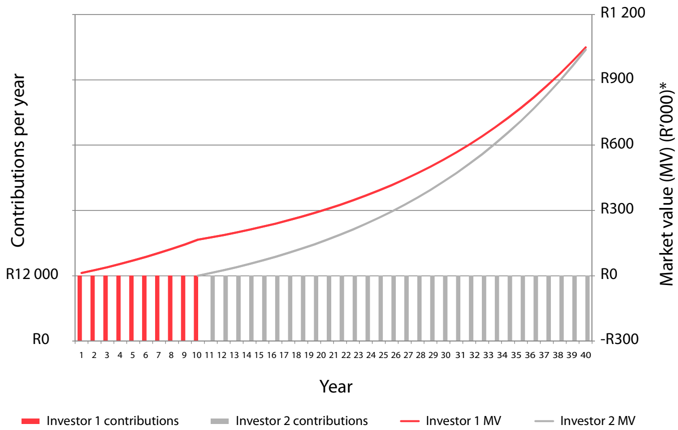
Asset classes with the potential for greater returns come at the cost of increased risk of capital loss, as well as increased short-term volatility. However, this volatility does smooth out over time. Depending on your personal circumstances, if you have a long-term time horizon you may be better able to tolerate volatility and thus benefit from equity exposure over time.

Graph 1 | Investing R500 per month into equities* over time



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

Graph 2 | The first 10 years are more important than the last 10



Source: Allan Gray research

Sensible investor behaviour

We have often commented on our investor returns research, which shows that the average investor earns much less than the funds they are invested into. The main reason for this is that, on average, investors make poor decisions about when to buy, sell and switch between funds. Investment performance does not come in a straight line. Investors who are taken by surprise by a period of short-term underperformance and sell their investments at the wrong time often miss out on a substantial part of the return in our unit trusts. Changes in your personal circumstances and capacity to take risk should encourage you to rethink your investment strategy, not short-term market fluctuations.

Commentary by Jeanette Marais, Director of Distribution and Client Services, Allan Gray