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Season 2. Building personal wealth

Episode 3.

Cutting the cost of your long-term goals

Hi there, Jason here. And in this Money Insight we'll look at how you could seriously cut the cost of your longer-term goals by using the magic of 'compound investment returns'. But before we get into that I just need you to be aware of a couple of points. First, this Insight is not a recommendation to you to invest your money in the stockmarket or anywhere else. The right investments for you will depend on your unique personal circumstances, and these include your attitude to investment risk and your capacity to take it on each of your financial life goals.

These are important issues to understand when looking at investments and we will come back to them later in this season. Also, to make this Insight easy to understand, we're going to compare just two of the many choices you have for saving and investing your money over the long term. We'll compare ordinary bank savings accounts with Stockmarket-based investments. As ever, we will come back to explore a much wider range of investments later in this series. For now, let's just see how the potentially magical returns of long-term, regular investing could dramatically cut the cost of your bigger financial goals.

Now, we're going to talk here about total and real returns on your money. And in a nutshell, here's what those terms mean. Your total returns are what you get by adding any income from your investment to any capital growth it produces. So, this means accumulating the interest that's paid on a bank account or reinvesting the dividends on Stockmarket-based funds. Real returns is simply the term used to describe by how much, if anything, your money is growing above inflation. And it's important to plan your money in 'real' inflation adjusted terms, because inflation will obviously make what you want to buy more expensive in the future.

Okay, so let's now see what real returns have actually, been produced in the past, both in ordinary bank savings and in the stockmarket, using data going back more than 100 years. And what we find is that bank savings accounts generally delivered total returns that just kept up with inflation over that time. In some decades bank savings have produced returns that are a little bit above inflation, whilst in others, like the 10 years up to 2018 they've produced a bit less. But in general terms it's reasonable to assume that you'll just about keep pace with inflation with ordinary bank savings. And, remember that in the short term, your money in the bank is safe, provided that you don't deposit more than the compensation limit with any one banking group. You can learn more on bank compensation limits in the resources area of the Salary Finance website.

Now, by comparison the total returns from major world stockmarkets, like those in the UK or the USA, have tended to beat inflation by around 5% a year on average over the past 100 years. However, the difference with Stockmarkets is that the returns in each decade have varied a great deal more than the returns on bank savings. For example, in a very good decade the UK Stockmarket delivered real returns of more than 15% a year. And that really is quite extraordinary as it equates to a doubling in value in less than 5 years. However, in a few other decades, like that from 1967 to 1977, the Stockmarket produced a little less than inflation. Although you'd have still fared worse with savings in the bank over the same period. But the Stockmarket is no place to invest for short periods of time, say, less than 10 years, because prices can fall a lot over short timescales.

So, whilst there's more to learn here, a simple rule to follow is to consider bank savings for your shorter-term financial goals and Stockmarket based funds for your longer-term goals. Also, as we're looking at regular savings, it's worth noting that investing regularly for the long term reduces your risk of picking a bad time to get into the investment markets. Indeed, any big falls in market prices early on in your savings journey could work in your favour, because you then pay lower prices for your shares with your future payments. Once again, we'll explore this idea in more detail later in this season.

For now, let's just take a close look at the big extra returns you could enjoy in the long term, from what seems like a small extra return from investing. And let's assume that by regularly investing, you earn on average just 3.5% a year extra on your money, when compared to bank savings. This is lower than the long-term historical average, but it's best to be prudent and work with a cautious assumption. How much bigger do you think your funds could be by investing regularly over time? Well, the short answer to this is that regular investing is unlikely to add much extra to your funds in the first few years of your savings journey. But it is likely to add a lot extra to your funds over the long term. And here are the numbers.

An extra 3.5% average annual return might add about 10% extra to a regular savings pot over a 5-year term. And with the risk in stock markets most people would say that regular investing over such short periods is not a good idea. However, when you look over longer terms the picture changes dramatically. Over 15 years, your funds could be around 30% higher because of investing. Over 25 years you might enjoy 60% extra on your money. And if you saved over 35 years, as many do in their pension, you might double your fund value compared to bank saving, simply by achieving that extra return of 3.5% each year. Here's the magic of compound investment returns in a picture.

And what you can see here are the sorts of funds that you might build up over time by saving £100 per month. Which is just £3.33 each day by the way. Obviously, if you can afford to save £6.66 a day or £200 per month, you can double the numbers you see on this chart. The green line shows what funds might be accumulated by regularly investing your money over time. And the dotted amber line shows what you'd likely accumulate by saving your money in the bank.

Now, whilst these compound return charts are interesting we only achieve our financial planning magic when we turn them upside down. And, if it makes sense for you to regularly invest your money to achieve a financial life goal, and you assume some modest extra growth on your money each year, you will dramatically cut the amount you need to save. So, over the long term you might cut your costs by 50% or more, and your comfortable nest egg could be yours for a lot less than you thought.

Of course, these are only rough numbers and to get a personal estimate of how much you need to save - for any of your financial goals. Check out the links to the savings calculators from the Salary Finance Website. And ask your employer what calculators they have available to help you check your pension funding too.

In the next money Insight we're going to explore the options you have to adjust your financial plan, if you need to get yourself on the track you want. Or to improve on a good plan if you already have one. See you back here when you're ready for that. All the very best.

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