Simply put…

THE QUIET MAGIC OF COMPOUNDING INTEREST

This is not a unique piece and the research is abundantly available.

At certain times in life you are reminded of some simple concepts that parents, school, or experience first taught. Compound interest is one such idea that seems to work magic in investing - something that is a good reminder for individual, corporate, and institutional investors. I will admit that I too was recently reminded by some close college colleagues when embarking on a new investment opportunity. I also would like to touch briefly on the impact of fees especially if they are unjustified (emphasis on the unjustified), inflation and taxes. For individuals, even if you think you are not ready, you should know that the magic is more powerful the earlier you start saving at compound interest. I thought I would share some thoughts.

Here is the Summary (if you don't feel like going through the entire letter):

1. Start Early (but there is no bad time to start)
2. Understand the Fees that you are paying (fees erodes wealth)
3. Be aware of Taxes and Inflation
4. Be disciplined or at least take the time to review yearly and add to your investments/savings

Let's start with fees

Before getting into the magic of compound interest, it may be better to start with what I mean by unjustified fees. Fees have the potential to erode the magic of compound interest and unless it is justified (either for convenience or outperformance) then you need to look elsewhere.

Let's take a simple example. If you invest in an investment product (savings account, certificate of deposit, mutual fund, or have an investment advisor) you need to know what you are paying for.

If an investment product that has certain risks earns a Gross Return of 4% but charges fees of 2%, then you only actually get 2% with little or no compensation for the risk. If there is an alternative or safer product such as a savings account or a certificate of deposit that earns 2%, that for the sake of argument is "safer," then the fee on the riskier product may not be justified.

Here's another example of an unjustified fee: could an investor have received a better return if they simply invested in a low fee product that tracks a benchmark? For instance, some investors have exposure to the US Equity Market. The S&P 500 gave a total return of 17.88% in 2020. If the investment product uses the S&P500 as a benchmark and for the sake of argument earned 17.88% but charged fees of 3%, providing a net return of 14.88%, - still a great return in this current environment of low yields! - you might as well have just invested in the benchmark directly. To me, this would be an unjustified fee.

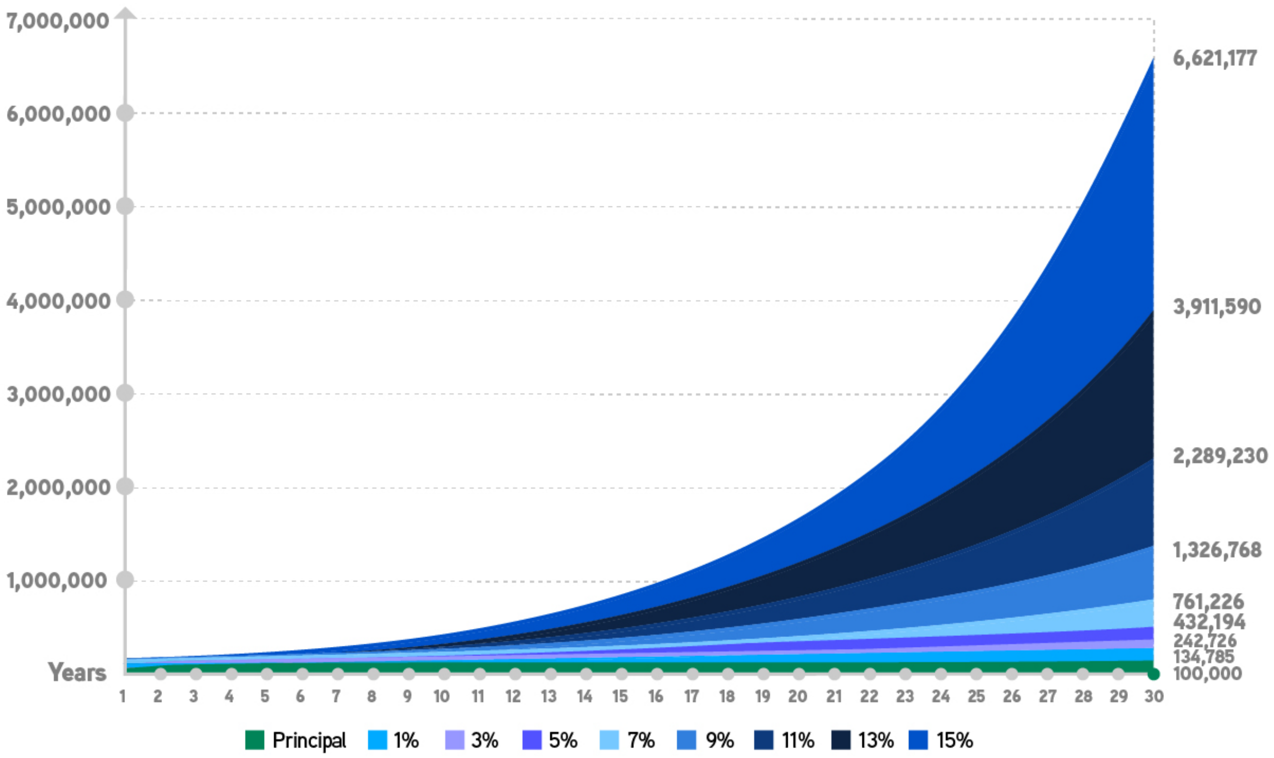
Bottom line: make sure you are getting value for the fees that you pay because fees are a real cost to long term capital appreciation.

On to Compounding Interest

Simply put, it comes from your principal (let's say 100,000) plus the interest earned being reinvested over a period of time. Interest on the interest grows your fund exponentially.

Best to see an example of what 100,000 compounded over 30 years look like with zero fees, and with fees.

Gross returns on **$100,000** after **30years** at various returns



100,000, compounded at 1%, - for all of you hoarders of cash 😊 or those keeping money in a chequing account (under the mattress 0% does not count) - after 30 years with zero fees will get you to 134,785 (not bad for 100,000 without factoring inflation). Under your mattress you will still only have 100,000.

If you moved up into a product earning a higher yield such as a savings product or certificate of deposit that earns 3%; with just 2% more over 30 years, your investment would be 242,726, almost double what you would have if the return was 1%. If you go up the scale to 5%, the value of your investment would now be 432,194.

Why did I include columns for 9% all the way up to 15%? This is to illustrate that if you do it yourself (or with the help of an advisor), the power of compounding can work wonders (this also applies to real estate). But like all things, risk and return are linked and maybe this will be covered in another letter: what approach do you need to earn higher returns—with obviously no guarantees.

More about fees

Just to touch on fees again, let's say this same investment product earned 3%, but charged you 2% in fees, providing a return of 1%, you would notice that over 30 years, you earn the same as if you invested in a savings product. Or worse yet, let's say you decided to take risk and earn 9% gross, but paid 3% in fees. Over the 30 year period those fees would have cost you 752,419 in compound interest that could have been yours!

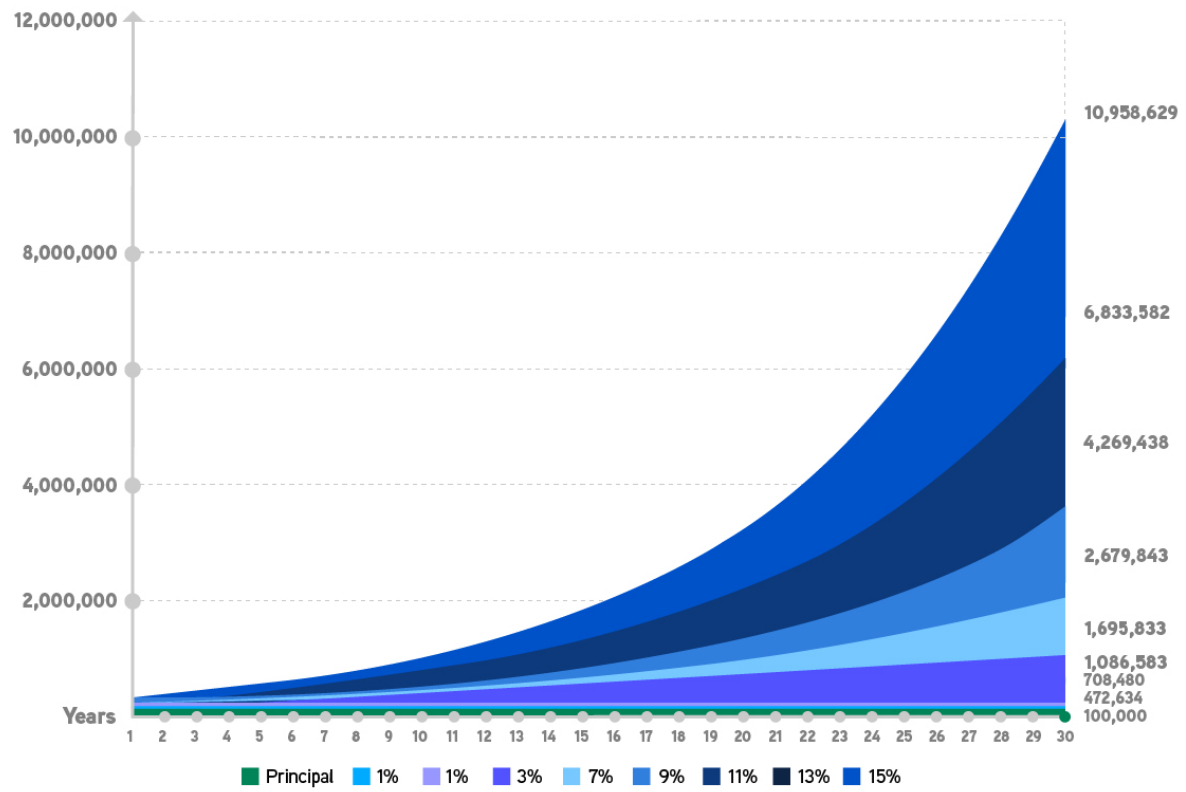
Quick Caveat and Reminder: This is over 30 years, so if the investment product has a good track record, (one or two bad years does not mean dump the product) what you need to do regularly is keep track of the performance of your investments and make sure you aren't just making someone else rich. Watch out for fees

And remember the principal invested over 30 years, with no additional savings can increase your wealth substantially at varying interest rates.

If you can add to your savings from time to time

Let's add one layer of additional savings, also being compounded. Let's take the same 100,000 you started with and add 10,000 in savings each year for the 30 years. Here is the new chart of approximate returns:

Gross return on **$100,000 Over 30years** (with **$10,000** added each year)



That 1% investment earned got you to 472,634, compared with the 134,785 if you did not add to your investments each year. And if you earned 3%, and added 10,000 each year, the value of your account is now 708,480. And well, if you did create a blend of other investments and earned 7% or 9% respectively, your account would be 1.7 million and 2.7 million respectively. Not bad.

This works whether you start with 10,000; 100,000, or more. And if you have more you should feel lucky but do not squander it. If you have more, well I hope you are also doing a lot of good for the community.

Inflation and Taxes

Lastly, let's talk about inflation and taxes. Arguably, they erode wealth just like fees. Inflation ultimately is a hidden fee. Inflation, generally speaking, is the increase in prices measured on a basket of certain goods and services. What we care about is that over time, things get more expensive. The dollar you have today buys a lot less in the future with constant inflation over time — inflation is secretly working against you.

So if inflation is 2%, and you are happy with cash earning 0%, or a savings account earning 1%, you should know that you are getting poorer by 2% per year compounded or 1% per year in that savings account.

Luckily, so far in Trinidad, interest income is not taxable to individuals; however, interest income is subject to tax for corporations. Taxes are another cost that one should be thinking about regardless if they invest in Trinidad or abroad. In the USA there are also estate taxes that apply to individual investors that are non-residents.

To recap…..

1. Start Early with a little or a lot; there is no bad time to start
2. Understand the Fees: which are helpful and which erode wealth
3. Be aware of Taxes and Inflation
4. Be disciplined and pay attention: review yearly and add to your investments/savings
5. A trusted advisor could get you started, but do you need to keep them forever?