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Why you should invest

For many people, investing in the stock market is your best hope of achieving financial freedom - providing it is done with a sensible approach and a long enough time horizon.

Unfortunately for people in their 20s and 30s today, there are several reasons why financial security may be harder to achieve than it was for your parents.

Why?

- People are living longer
- House prices have outstripped earnings growth for decades
- Most pensions are now paid based what you contribute, rather than a proportion of your final salary

Living within your means and saving a proportion of your salary every month is the most important starting point. The earlier you start setting money aside - the more you will have in later life.

But if you leave your money in a bank account, you risk eroding its value in real terms. This happens when the interest paid on the account is lower than the rate of inflation - as it has been for years.

By investing your savings into the stock market, you open up the potential for much greater returns. But you must also psychologically and financially prepare yourself for a bumpy ride. In their excellent book *Investing for Freedom*, Ben Carlson and Robin Powell suggest thinking of investing as a place where you can invest in human ingenuity. It's the simplest way of owning a stake of the business world.

"Stocks can be thought of as a way to ride on the coattails of intelligent people as they continue to innovate and grow," Carlson & Powell, 2021.

Author: Mary McDougall

What's in this guide?

P2. History of stock market returns

Big disparity from year to year

P4. How compounding can grow your wealth

"He/she who understands it, earns it"

More from this series

Guide to getting started

Guide to tax-efficient investing

Guide to investing in funds



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History of stock market returns

You need a long time horizon when investing to boost your chances of growing wealth - experts suggest around five years.

You can turn to indices to gauge broad stock market performance. The S&P 500 index more or less tracks the largest 500 companies in the US, while the FTSE 100 tracks the largest 100 companies listed in the UK. MSCI World Index is a popular barometer for the global stock market.

Their annualised return rate for the past 30 years is as follows:

MSCI World Index - 8.1 per cent

S&P 500 Index - 10.8 per cent

FTSE 100 Index - 7.3 per cent

Source: Morningstar, to 01.11.2021, data total return

But from year to year, there is a huge disparity in returns.

Here's how the annualised returns vary across shorter time frames.

Index (total return)	Base Currency	5 Yr Annualised %	10 Yr Annualised %	20 Yr Annualised %	30 Yr Annualised %
S&P 500	US Dollar	18.93	16.21	9.77	10.76
MSCI World	US Dollar	15.45	12.19	8.30	8.08
FTSE 100	Pound Sterling	4.82	6.71	5.63	7.34

Source: Morningstar, to 01.11.2021, total return

While these returns are all positive, this will not be the case year to year, or sometimes even over multiple years.



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As Carlson and Powell point out in their book, between 1926 and 2020, in any one year, there was a one in four chance of the S&P 500 Index return being negative.

S&P 500: 1926 - 2020

Time frame	Positive	Negative
Daily	56%	44%
1 year	75%	25%
5 years	88%	12%
10 years	95%	5%
20 years	100%	0%

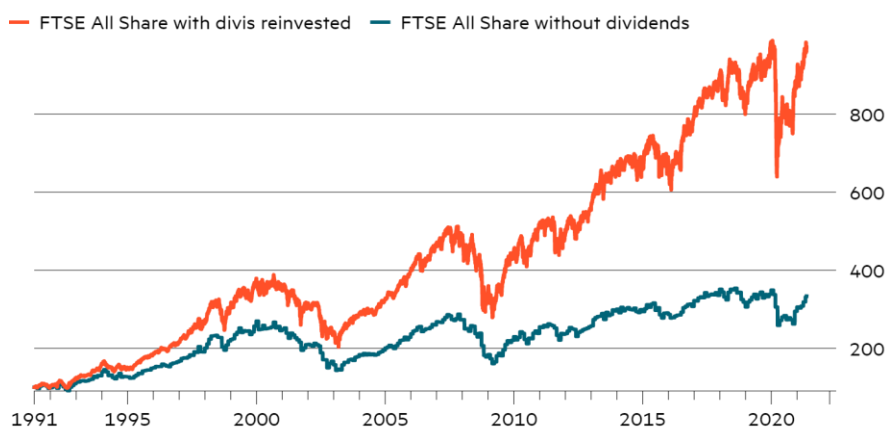
Source: Dimensional Fund Advisors, via *Invest your Way to Financial Freedom*

Reinvest dividends

There are two main ways of making money when investing in the stock market - share price capital growth and dividends. Where possible, reinvest dividends and let them compound (more on this in 'Investing in Shares' guide). Performance shown as 'total return' includes dividends reinvested.

FTSE ALL SHARE 30YR TOTAL RETURN VS CAPITAL ONLY

Rebased (%)



Source: FactSet



The magic of compounding

Investing isn't just about how much money you have to invest. It's also about how much time you have to invest it. That's because of the power of compound growth, which can create a snowballing effect.

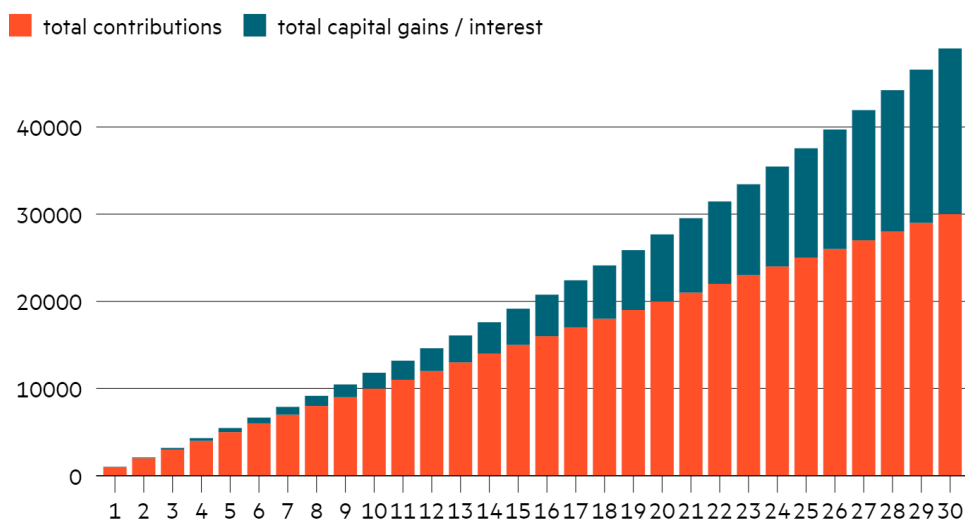
Here's how it works. Say you invest £1000 in a company in 2010. Let's say in the first year it grows 5 per, at the end of year 1 that investment will be worth £1050.

Here's the important bit: that extra £50 you have made on your investment stays invested in the company. That means that in year two, the growth rate will be applied to the £1050 investment, rather than the initial £1000 investment.

Here's why that matters. Say the company grows another 5 per in year 2. Five per cent of £1000 is £50, but 5 per cent of £1050 is £52.50. By leaving your money invested in the company you will be adding an extra £2.50 to your returns by doing no work at all.

HOW COMPOUNDING INTEREST CAN GROW WEALTH (£)

Chart shows £1,000 annual contributions compounding at 3% per annum over 30 years



Source: Investors' Chronicle



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Sensible investing is about the steady accumulation of wealth, not the chasing of blue-sky shares. Over long periods the magic of compounding will accelerate the growth of your portfolio.

Albert Einstein is purported to have once described compound interest as the "eighth wonder of the world," saying, "he who understands it, earns it; he who doesn't, pays for it."

The rule of 72

There's also a nifty shortcut for getting your head around how compounding returns can grow wealth, known as the rule of 72. If you divide 72 by your rate of return, you'll find out how fast your money will double in value. For example, if you had £1,000 that was earning a 6 per cent return, it would grow to £2,000 in 12 years.

Of course - compounding will also work against you if the value of your assets are falling. If you don't put your savings into productive financial assets, your money is going to lose its value.

Case study

Let's say Josh, aged 20, invested £1,000 today and didn't touch it until he retired aged 70. The investment, left untouched, compounded at 4 per cent annually, would be worth over £7,000 50 years later.

With regular payments this can accumulate to a substantial sum. If Josh paid in £1,000 every year for 50 years, and the returns compounded at 4 per cent per annum, At age 70 his returns would be worth over £165,000 - multiples more than the total £50,000 paid in.



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Before you start

Before you start investing, make sure you've paid off any credit card debt. The interest you pay on it tends to be higher than what you receive on savings.

And make sure you have enough emergency money in an instant-access cash account - at least enough to cover three months' worth of essential outgoings. This should tide you over should you lose your job - or if any significant house expenses crop up.

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