

## A BEGINNER'S GUIDE TO MUTUAL FUNDS



Compounding is the magic of investing' said Jim Rogers, the famous American businessman and financial commentator. It is indeed one of the most powerful weapons in an investor's arsenal. The beauty of this concept lies in the fact that it is quite simple to understand. But when you put it into practice, the impact can be immense.

### What is the power of compounding?

Mathematically speaking, compounding is defined as, 'the increase in the value of an investment, due to the interest earned on the principal, as well as the accumulated interest.'

Simply put, it is a strategy that makes your money work for you. It could be regarded as a powerful tool to grow your wealth. You can use the power of compounding to plan your future goals, such as retirement.

Simple interest means you earn interest on your principal. But with compound interest, you earn interest on the principal amount as well as the accumulated interest amount over successive periods. Over time, this interest snowballs into a substantial amount.

Here's a hypothetical example to highlight the power of compounding.

Vijay and Geeta both invest Rs 50,000 each in an investment avenue that offers an annual interest rate of 10% for 10 years. While Vijay chooses simple interest, Geeta opts for compound interest (read re-invest).

At the end of 10 years, Vijay would make a total corpus of Rs. 1 lakh. On the other hand, Geeta would earn a corpus of Rs. 1.30 lakh.

This is because in Vijay's case, the interest was calculated only on the initial principal amount of Rs. 50,000. But in Geeta's case, the interest earned each year was included along with the principal to calculate the interest for the next year. This helped increase her earnings in a big way.

## Benefits of the power of compounding

One of the biggest benefits that investors can appreciate about the power of compounding is the value of time. With time, you could gain returns, and the yields on these returns could further generate returns; thus, helping to increase your investments quickly.

Saving money and earning compound interest amount every year is a good thing. But what if you were to invest a fixed amount each month? This small act could boost your returns over time. Let's find out how that is possible.

When you regularly invest over time, your returns could accumulate at a much faster pace.

Imagine you invest Rs. 5,000 every month. The interest on this amount is 10% per annum. The below table reveals how your investment returns would look like over time:

Years	5	10	15	20	25	30
Expected amount Rs. (in lakhs)	3.9	10.3	20.9	38.3	66.9	114
Amount invested Rs. (in lakhs)	3	6	9	12	15	18
Wealth Gain Rs. (in lakhs)	0.9	4.3	11.9	26.3	51.9	96

The above table is to explain the concept of power of compounding and is shown for illustration and explanatory purposes only

This example highlights the compounding effect because the wealth gain rises exponentially over five years. And at the end of 30 years, the investment capital of Rs. 18 lakhs has grown multiple times to a corpus of Rs. 96 lakhs.

If there is just one takeaway from this example, it can be this:

It is crucial to start saving and investing from an early age. And when you do this regularly for an extended period, you stand a chance to maximize your returns and benefit from the full power of compounding.

Many people wrongly assume they can begin investing only when they have large sums of money. Therefore they delay investing until they are in their mid-forties. This is not a sound investment strategy. On the other hand, when you start investing from an early stage, it doesn't matter how much you can invest. Even if you invest small amounts of money regularly, you can hope to achieve a significant corpus over time.

## Power of Compounding and mutual funds

We have talked about the benefits of investing a fixed amount regularly to benefit from compound interest. But there is a big question to be addressed. Where can an investor put his money to achieve the full benefit of compounding?

The answer is mutual funds.

As an investment avenue, mutual funds are designed in a way to magnify the benefits of compounding. This is possible through [Systematic Investment Plans \(SIPs\)](#).

Here's how it works: You can invest a fixed sum in mutual funds regularly through a Systematic Investment Plan (SIP). This can be monthly, quarterly or semi-annually. You can select the fund of your choice, use an [SIP calculator](#) to calculate the return on your investment and make a SIP payment on the allotted date. Investing regularly through SIPs could magnify your returns over time.

While you can invest in most fund types through a SIP, you may want to consider investing in equity funds for long-term goals like retirement planning. This is because equity funds have the potential to offer better returns in the long-term.

The best part about SIPs is that you can automate your payments by giving a standing instruction to your bank. You can transfer money from your registered bank account directly to the mutual fund on the specified date. As a result, you don't need to worry about missing payment schedules.

## Key rules to enable the power of compounding

### a. **Control your expenses**

The principle of compounding works in the same way whether you invest Rs. 100 or Rs. 10,000. However, if you invest a substantial amount, the interest you earn can also increase significantly.

The best way to harness the power of compounding is to raise your investments. But if you have a limited income, you can increase your savings by controlling your expenses. One way to do it is to create a budget and identify areas you can reduce your costs each month. Spending wisely and smartly can increase your savings and you can invest more. This way, you stand a chance to reap better returns.

### b. **Start early**

There is nothing like making an early start in investments. Ideally, you should start investing the moment you begin earning. But if you have already crossed that stage, the next best thing is to start investing now. Identify a mutual fund that is in line with your financial goals and start investing. When you start investing early, you can create a solid base for your funds to grow and expand in the future with the help of compounding. If you don't know how to calculate the return on investment, you can use an online calculator. There are many calculators available that tell you exactly how much you need to start investing today to future goals.

### c. **Be disciplined**

To create a healthy corpus and meet your financial goals on time, it is critical to have investment discipline. Investing regularly at the start of your investment journey can ensure discipline. It is wise not to skip your SIP payments. When you regularly invest month after month, you not only increase your savings but also develop investment discipline. This is a vital habit if you wish to achieve financial success.

### d. **Learn patience**

Most investors look to chase quick returns. But in the attempt to earn quick money, they can make mistakes that could result in big losses. As we have seen, the power of compounding magnifies over time. Hence, it can help to have a long-term approach towards investing. One must invest patiently that could reap healthy returns over time.

You don't need to be a financial expert to benefit from the power of compounding. Every investor can take advantage of this concept and put it to good use. So, start investing today to enjoy a great future.

**NEXT TO COME: MUTUAL FUND INVESTMENT GUIDE: HOW TO INVEST IN MUTUAL FUND PLANS**