New Investor? If You Do Nothing Else With Stocks, Learn This Lesson

Description

First published on Fool.com. All monetary figures are in U.S. dollars.

There are lots of investing best practices floating around. Some are more time tested than others, but since there’s no cookie-cutter strategy perfect for every type of investor, most of it can be helpful to someone. But it can also become overwhelming to take in so much information.

Investing doesn’t have to be complicated, nor should it be. If you’re looking to tune out the noise and learn the one thing that will help you build wealth in the stock market, it’s that time reigns supreme.

Using “the Eighth Wonder of the World”

One of the most magical phenoms in investing is compound earnings.

Compound earnings occur when the money you make from investments begins to make money on itself. For example, if you receive 10% returns on a $5,000 investment, you’ll make $500. If you reinvest the $500 and receive another 10% return, you’re now earning it on the original $5,000 and the $500 you earned last time, giving you a total return of $550 instead of $500. Another 10% return would now earn you $605. It’s a lucrative cycle.

There’s a reason Albert Einstein is often credited with calling it the “Eight Wonder of the World”: It’s extremely powerful. For compound interest to work its true magic, though, it needs time. The more time, the better because it can often do the heavy lifting for you when it comes to building wealth. Most people don’t have six-figure lump sums they can invest to make $1 million-plus, but a lot have time.

Time rules all

To see the power of compound earnings, let's imagine you invested $1,000 monthly for a different number of years. Here's roughly how much you'd have at different points if you averaged 10% annual returns:

Years Invested	Total Value	Amount Personally Invested	Capital Gain
20	$343,650	$120,000	$223,650
30	$986,964	$180,000	$806,964
40	$2.65 million	$240,000	$2.41 million

Data source: Author calculations.

As you can see, with each 10-year gap, the amount you personally invested only increased by $60,000, yet the increase in your capital gain was over $583,000 and $1.6 million, respectively. Thanks to compound earnings, the more time you have, the larger the gap between what you invest and what you can gain. It's how most people become millionaires while investing much less than that.

Here's how many years it'd take you to cross the $1 million threshold based on different monthly contributions, averaging 10% annual returns:

Monthly Contributions	Years Until $1 Million	Personal Contributions
$500	31	$186,000
$750	27	$243,000
$1,000	24	$288,000
$1,500	20	$360,000
$2,500	18	$432,000

Data source: Author calculations.

Trying to reach $1 million only by saving without investing is next to impossible for most people. Even if you had the ability to put away $25,000 annually, it'd take 40 years. But in each above instance, attaining at least $1 million was doable without investing even half of that amount, thanks to compound earnings. The more time you have, the less money you need to invest to reach specific financial goals.

It's all about consistency

Time is the most important factor in how effective compound earnings can be for you, but consistency is also extremely important. Investing shouldn't be something you do occasionally; it should be a regular part of your financial life. The easiest way I've found to do this is by incorporating dollar-cost averaging.

When you dollar-cost average, you choose a set amount, put yourself on a fixed investing schedule, and stick to it no matter what. Stock prices down? Invest. Stock prices up? Invest. Stock prices flat? Invest. Whatever schedule you put yourself on — whether weekly, biweekly, monthly, or whatever else fits you — the key is to stick to it.

Dollar-cost averaging keeps you consistent and helps prevent you from trying to time the market(which is virtually impossible to do consistently). It’s easy to remain consistent when stock prices andyour portfolio are rising, but it’s much harder when they’re dropping. By remaining consistent and usingtime to your advantage, you’ll be sure to keep the engines of compound earnings running smoothly.

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Date
2025/06/27
Date Created
2022/12/04
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