WILL THE RULE OF 72 WIPE OUT YOUR SAVINGS?

A quick answer to this question is possibly yes - unless you do something about it! In the case of some of the long-time British expatriates in Bali living on a frozen UK state pension the answer is that the rule of 72 has already wiped out most of their hard-earned pension and for them there is little they can do other than hope that a future UK government changes the rules. Could be a long wait.

The Rule of 72 can also work very much in your favour - if you make the right decisions early enough.

So what exactly is this 'Rule of 72'?

You are probably thinking this is one of those complicated new financial terms invented to confuse ordinary people and make financial experts look very clever. In fact the first recorded reference to it goes back to a paper written by mathematician Luca Pacioli in Venice in 1494.

The rule of 72 is a method used in finance to quickly estimate the doubling or halving time of an investment through compound interest or inflation respectively. To forestall any e-mails from mathematicians pointing out that 69.3 would be a more accurate figure to use or even a figure higher than 72 if we were dealing with annual inflation rates in excess of 20% I would add that 72 is accurate enough for the range of inflation rates we are likely to see in the financial markets. 72 has been chosen as the most practical figure for mental calculations or when using a basic calculator. This is because 72 is divisible by 1,2,3,4,6,8,9 and 12.

So how does it work?

Let's say you have an investment that grows at 4% per annum with the interest rolled up. If you divide the magic 72 by 4 the answer is 18. Therefore you can say that your investment will double in 18 years.

If you are fortunate to have an investment that grows at 12% per annum then 72 divided by 12 gives you 6. Therefore your investment would double in value in just 6 years. You can also see why cash is currently a poor option for the long term. If you are getting say 0.5% interest on your USD or GBP deposit account it will take you 72 divided by 0.5 = 144 years to double your money at current rates!

The rule also shows the impact of inflation

Now let's say you have left your money in the bank (or under the mattress) and it is not earning interest at all. If inflation is running at say 3% the purchasing power of your money would be halved in 72 divided by 3 = 24 years. If rampant inflation returned to say 12% (as we have seen in the past) the purchasing power of your money would be halved in 72 divided by 12 = just 6 years.

What has impacted long term British pensioners in Indonesia (and many other countries including Australia and most of Asia) is the wildly fluctuating rate of inflation over three decades and its impact over time on their pensions which were frozen from the day they left the UK. In some of the worst cases pensioners have lost up to 90% of the value of their pensions. Locally there is nothing they can do other than support an active group in Bali that through international affiliations continues to lobby and shame UK politicians.

Taking growth of an investment and the impact of inflation together it is possible to come up with a more realistic estimate of how your savings can grow. So if, for example, your investment is growing at a net 5% per annum and inflation is running at 2% then the 'real' growth is 3% and you would consequently double the 'real' value or spending power of your savings in 72 divided by 3 = 24 years.

No-one of course can accurately predict future growth or inflation rates but the formula at least gives a clear picture of potential outcomes and is a useful planning tool.

The impact of low interest rates in recent years

Inflation has not been a major issue in the years following the Global Financial Crisis as interest rates plummeted to support efforts to stimulate economies. This was good news for anyone on a fixed income or for those borrowing money from the banks. It was not good news though for retirees accustomed to living on income from deposits as that income has almost dried up. Low interest rates have also impacted returns on most forms of investments since 2008. Where financial investments such as portfolio bonds or savings plans are concerned a hidden impact has been that of charges which have not reduced in line with lower returns so it has not been a good period for investors.

But changes are on the way, good for some, bad for others. Led by the drive for growth and infrastructure investment and the fall in unemployment in the US we are likely to see a gradual return to more 'normal' rates of interest and a certain increase in inflation.

This is not good news for retirees living on frozen pensions or annuities as they will see no growth in their income whilst they will see a sharp rise in the cost of living. It is bad news also for those who have borrowed large sums of money at very low interest rates as those rates are likely to rise and even a small percentage rise can have a big impact on one's budget.

On the other hand it is good news for investors as they are likely to see better returns from their financial investments and faster growth in their savings plans. Property values should also rise although this will vary from country to country and according to supply and demand.

What actions can be taken?

Reducing loans, particulary mortgages, should be a priority before interest rates rise and start to bite. Credit card debt with its outrageous interest charges, even during times of low bank rates, should be eliminated in the shortest time possible.

The Rule of 72 demonstrates how quickly you can double your money if you have investments that grow. It also shows how quickly your money can evaporate if your savings are stagnant. The aim therefore should be to build up a capital sum that can continue to grow in real terms (above inflation) on retirement, even after taking regular withdrawals. The sum required to do this effectively can be quite staggering, but the earlier you make a start, the sooner you can get the Rule of 72 to work for you rather than against you.

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