How Much Do You Know About Compounding?

Most retirement-planning articles stress the need to keep money invested for the long term to take advantage of compounding. Take this quiz to see how much you really know about the subject.

TRUE OR FALSE

1 Compounding is the process by which the value of an investment potentially increases over time.

2 Compounding can play a crucial role in building up your retirement nest egg.

3 The Rule of 72 deals with high-scoring football games.

Answers

1. **TRUE** Let's say you invest $1,000 in a mutual fund that returns 5% the first year you own it. At the end of year one, your investment is worth $1,050—a gain of $50. In year two, the investment again returns 5%, but it's now 5% of $1,050, or $52.50. The value of your investment has climbed to $1,102.50 ($1,000+$50+$52.50). Thanks to compounding, your money may potentially grow faster and faster as each year's incremental gain is added to the previous year's total. After 20 years of compounding, your initial $1,000, assuming a 5% annual return, would have grown to $2,653.30—without your having added another cent.

2. **TRUE** The process of compounding is the process of building. The higher the return on your investments, the faster compounding can build up your money. If you are receiving a company match in your retirement savings plan, that money can also compound.

3. **FALSE** The Rule of 72 is a simple rule for estimating how long it will take compounding to double the value of an investment at a given rate of return. Say you have an investment at an 8% annual rate of return. Divide 72 by eight and you'll see that the value of your investment will double in about nine years. At a 12% annual rate of return, your investment would double in value in roughly six years (72 divided by 12).

These examples are for illustrative purposes only and do not represent the performance of any of your plan's investment options. Your results will vary.

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