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Chapter 10 Money and Banking

This article from the October 2001 *Wall Street Journal Classroom Edition* explains how the value of money can grow over time. “The Power of Compounding” illustrates one of the basic economic principles that makes saving and investment worthwhile. Compound interest can turn a small initial investment into a substantial sum of money over a period of many years.

Before reading the article below, you may want to look up the following terms: *balloons, corporate profits, doldrums, mitigated, relentlessly, volatile, and wager.*

Behold the “power of compounding.” It’s the principle that makes money worth investing. It goes like this: If you put your money in an investment with a given return—and then reinvest those earnings as you receive them—the snowball effect can be astounding over the long term.

Suppose you have \$10,000 in your bank account and decide to put it into an investment with an 8% annual return. Over the space of the first year, you earn \$800 on your investment, giving you a total of \$10,800. If you leave those earnings alone, rather than pull them out to spend, the second year would deliver another \$864, or 8% on both the original \$10,000 and the \$800 gain. Your two-year total: \$11,664 and climbing.

As you can see, compounding produces modest—if steady—gains over the first few years. But the longer you leave your money in, the faster it begins to grow. By year 20 in our example, your money would have almost quadrupled to more than \$46,000. If you had invested \$20,000, it would have soared to more than \$93,000.

Of course, the power of compounding works for savings accounts, too. But if you adjust the interest rate downward to 4% (a typical return on a cash account), you’ll see what you’re giving up: Your 20-year return on that \$10,000 drops to around \$22,000. Now dial the interest rate up to 11%, the

average historical return of the stock market. At that rate, your \$10,000 investment balloons to a rich \$80,623.

The longer you leave your money invested and the higher the interest rate, the faster it will grow. That’s why stocks are the best long-term investment value. Of course, the stock market is also much more volatile than a savings account. But given enough time, the risk of losses is mitigated by the general upward momentum of the economy.

To understand how, consider the investment returns of the stocks in the S&P 500 index over the past seven decades. While the line zigzags up and down from month to month and year to year, the trend is relentlessly upward. If you had invested \$100 in these stocks in 1929, you’d be sitting on more than \$165,000 today (assuming you rein-

vested all the dividends).

Those long-term gains are all the more remarkable when you consider that the 71 years in question included the Great Depression, the market doldrums of the early 1970s and the two market crashes that punctuated the 1980s. The 10-year periods with positive returns far outnumber those in which investors lost money.

Why is that?

Corporate profits are the key to understanding

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the investor’s edge. Buying a share of stock gives its holder an ownership claim on that company’s earnings. If those earnings go up, then the stock price will usually rise as well. So ownership of a company that has higher earnings should be worth more than ownership of a company that earns less.

An investment in the stock market comes down to this: It’s a “bet” that corporate profits will rise. Based on the historical evidence, it’s a pretty good wager. Not a guarantee by any means, but one where you hold pretty good odds.

Maybe you’re saying to yourself that just because corporate earnings rise in most years doesn’t mean there aren’t years in which they fall. True enough. But over the last 200 years, business profits in the

U.S., Western Europe and Japan have increased in far more years than they have decreased. And that’s because the economies in the developed countries have expanded at a fairly steady pace with only an occasional setback from recessions.

According to the Bureau of Economic Analysis data, corporate profits, on average, represent 9.2% of the gross domestic product. The ratio fluctuates from year to year (partly because some corporate profits come from overseas operations and thus depend on foreign economies). But over long periods of time, you can expect profit growth will match the growth in the economy.

And that means stockholders with a good mix of companies are more likely than not to make money.

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QUESTIONS FOR DISCUSSION

1. What two factors are important to making the principle of “compounding” work?

2. What evidence indicates that corporate profits will rise?

3. **Making Comparisons** If the average historical return on a stock market investment is 11%, why doesn’t everyone put their money into stocks rather than into a savings account?

4. **Analyzing Information** Agree or disagree with the statement: Stocks are the best long-term investment value. Why?
