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JOURNEY TOWARDS FINANCIAL BLISS

RULE OF 72

The "***Rule of 72***" is a very handy mathematical shortcut for quickly estimating how long it'll take to double your money if you stay invested and reinvest your gains.

The "***Rule of 72***" is a very simple calculation. By dividing 72 by the annual rate of return, investors get a rough estimate of how many years it will take for the initial investment to double itself.

In your fixed rate investments, like Bank FDs, you already know the rate of return i.e. interest rate payable on such investments. For other investment options, like Mutual Fund units, you make an assumption as to what average annual percentage return will be on your investment. Then you divide this rate of return into the number 72. The answer will be the number of years it will take to double your money.

For example, let's assume an average 8% return i.e. current rate offered on fixed deposits of more than 2-3 years, by most of the Banks in India. At that rate, according to the "Rule of 72", it would take 9 years to double your money (72 divided by 8).

A word of caution to be added here. Above quick calculation is very handy. But what "***Rule of 72***" fails to do, is present accurately your future purchasing power.

While a 8% return will double your money in nominal rupee terms over 9 years, during this time period, it is very likely to fall well short of doubling your purchasing power. The reason: inflation.

Thus, The "magic of compounding" isn't so magical once you take account of the impact of inflation. And if you are investing in an instrument like a fixed deposit, in which the returns are taxable, even more of the magic is lost.

So if 72 isn't a good "rule" for estimating how long it takes to double your purchasing number, then what is?

Using 72 would make sense if zero inflation were assumed. Assuming a deflationary period, the appropriate number to divide by could even be below 72. Under the most probable economic and market scenarios, which assume a rising cost of living, the inflation-adjusted number for calculation purposes is likely to be well above 72.

The lesson for investors is that they may find themselves financially unprepared if they base their wealth-creation assumptions on before-inflation numbers, and on the ***Rule of 72***. Thus, advisers play an "expectation manager" role, educating their clients by illustrating the actual impact of inflation on long-term investing.

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