

Investing: Is investing the same as saving?

Mathieu Bouville

A common view is that saving involves bank accounts whereas investing is about stocks and bonds. A criterion I find more helpful is the difference between principal and interest. If you need \$1 200 in a year (e.g. for holidays), you can save \$100 a month and get the money you need even without collecting any interest. On the other hand, if you set aside \$100 000 forty years before retirement and get a return of 5% a year, you will end up with \$700 000. In this case, the interest dwarfs the principal (i.e. the amount you initially invested): it would be much harder to actually set \$700 000 aside. I think this is the key distinction: for savers any return is icing on the cake, but it is the cake itself for investors.

It is common to insist that you must save on a regular basis, start early, etc. But, as just mentioned, the return you get is just as important. You will get more out of \$50 000 invested at 5% for 40 years than from \$100 000 invested at 3%. Figure 1 shows that the amount to be invested to have \$500 000 (roughly what it takes to buy an annuity paying \$2 000 a month after 65) after forty years depends dramatically on how much the investment yields, whereas for shorter time horizons one must set aside nearly the whole amount in any case.

Figure 2 shows that if one invests for long enough then one needs to save only a small fraction of the final sum.

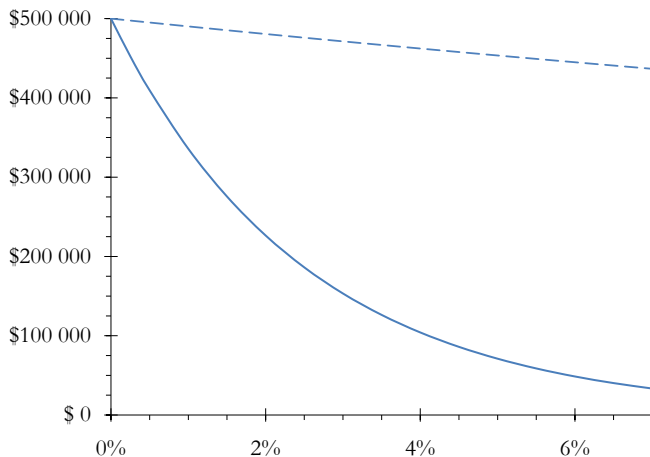


FIG. 1: How much money is needed to have half a million after two years (dashed line) and forty years (solid line) as a function of the interest rate.

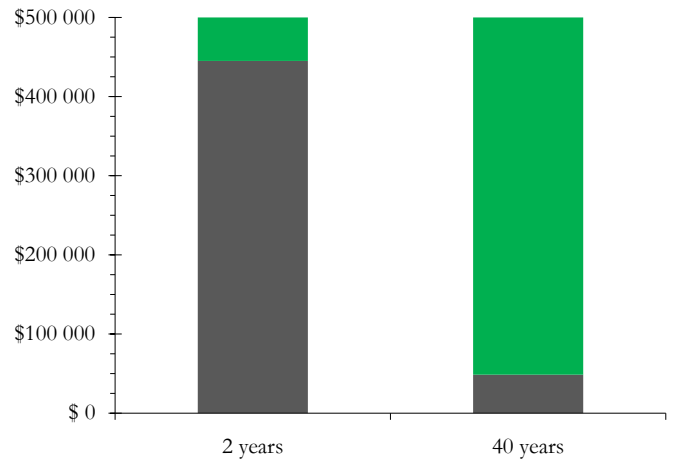


FIG. 2: Contributions from the savings (gray) and the investment return (green) at 6% p.a.

This figure basically explains why people can retire at all: if one had to set \$500 000 aside out of a gross income of \$2000 a month in order to maintain this income in retirement, one would need a saving rate of 50% (on one's gross income) for forty years! When the return on one's initial capital provides the bulk of the final capital a more bearable saving rate can suffice.