A Tale of Twin Brothers

The Incredible Power of Compound Return

There is a famous riddle that attempts to illustrate the importance of considering the long-term consequences of your actions. It goes something like this: Suppose twin brothers both enter the workforce at the age of 20. They both plan to retire 40 years later at the age of 60. The first brother adds $100 per month to his savings for 10 years, earning a return equal to the market return of 8 percent. After 10 years, he stops contributing monthly to his savings, letting his money accumulate at 8 percent per year for 30 years. The second brother adds the same $100 to his savings, earning the same return. But, he only starts adding to his savings when the other brother stops (at the age of 30). The second brother adds $100 per month until they both retire 30 years later at the age of 60.

In other words, these twins are identical in their saving habits except that the second brother starts 10 years later and makes monthly contributions to his savings for three times longer (30 years versus 10 years). The question is: which brother has accumulated the most by the time they both retire at the age of 60?

The second brother saved the same monthly amount and earned the same return as the first. However, he made monthly contributions for many more years (30 vs. 10). Naturally, many people assume that he would have accumulated more than his brother. Therefore, most people are shocked to learn that the first brother accumulated significantly more than his Johnny-come-lately brother ($200,000 vs. $149,000), despite only making monthly contributions for 10 years (between the ages of 20 to 30). The point is: it pays to start early. The long-term consequences of seemingly subtle choices can be breathtaking.

Amazingly, there is an interesting and very important corollary to this story that even the most sophisticated investors may be completely unaware of. If the first brother had actively invested his money and earned just 2 percent more per year (10 percent vs. 8 percent), his final net wealth would have been a whopping $406,000, more than twice his original $200,000!

In other words, putting off saving for retirement until he was 30 would have decreased his retirement wealth by roughly 25 percent ($200,000 vs. $149,000). But being satisfied with a market return would have decreased it by 50 percent ($406,000 vs. $200,000)!

If failing to save early for retirement is a classic example of short-sighted thinking, being satisfied with the return of an index is a less well-known but much more egregious oversight. The good news is that it is an oversight that can be corrected at any time.

Beating the market is not easy, but it is easier than many people realize. Certainly, it is much easier than working twice as hard and having to save twice as much. At the Stock Fundamentalist, we know this because we have done it. See the powerful resources available at www.StockFundamentalist.com. With them, you can accomplish the challenging but very achievable and beneficial goal of beating the market.

"The most powerful force in the universe is compound interest."

—Albert Einstein