Savings Rate or Rate of Return?

Christopher Koopman *Contributor*: *PowerPassionProsperity*

So, the stock market is good these days. Account balances have been increasingly moving up over the past 10 years. Life is good! However, have you ever given thought to what is more powerful…your rate of return, or your personal savings rate?

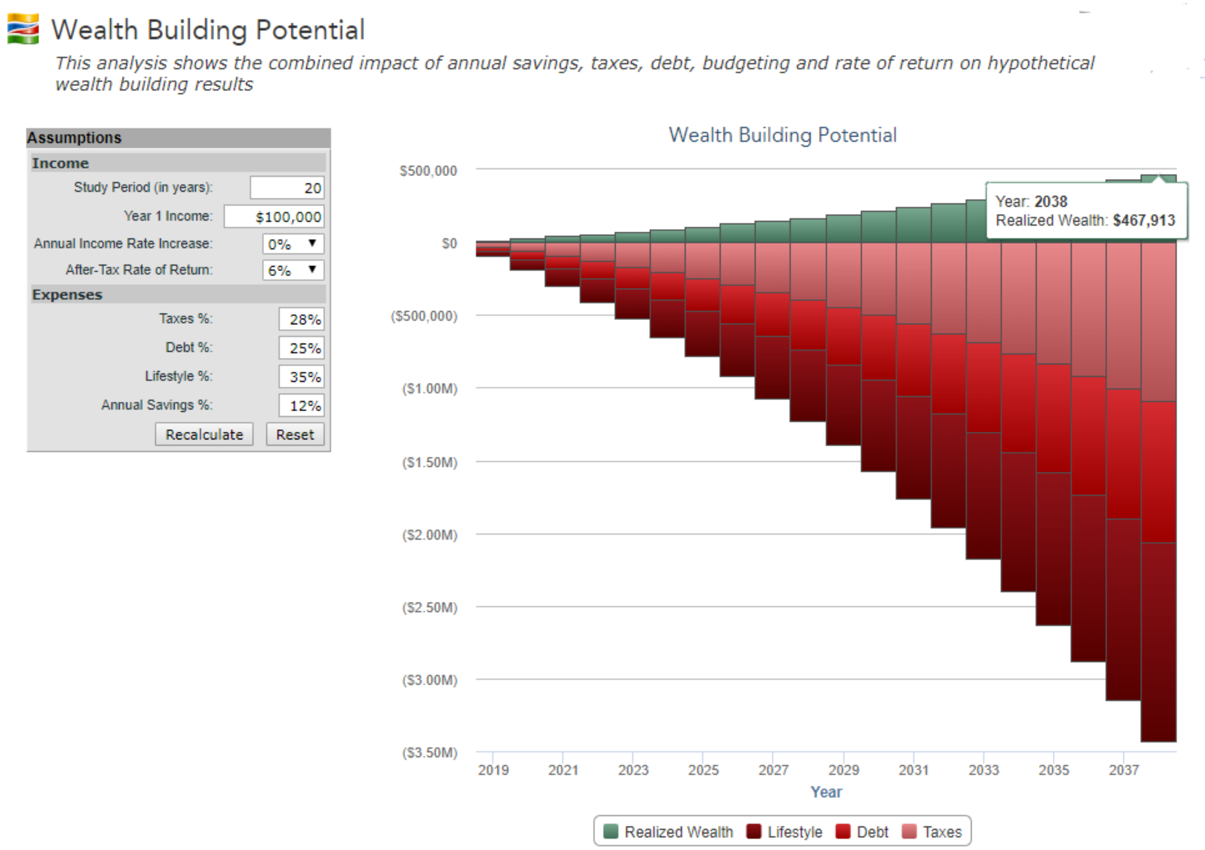
Over the last 16 years of practice in the financial space, hands down the most common misconception that my clients have when we first consult is that creating more wealth and increasing account balances has everything to do with your rate of return. I will not argue that ROR (rate of return) is a part of the process of creating wealth, but it certainly is not the main driving force. Most of us have been led to believe that the fastest way to getting wealthier is by chasing a higher rate of return in your investment accounts, bank accounts, etc. Einstein once called the 8th wonder of the world the magic of compound interest. If you understand compound interest and how it works, it almost looks like magic.

For example, let's say you invest $1,000 a month and can earn 6% for 20 years. If you do this, and each year you experienced a 6% rate of return on your money, your account balance would be worth $467,913. It would look just like this graph below, year by year, only going up.

However, this graph does not represent the reality of investing or the reality of life. Typically, account interest earned is different each year, and you do not get a "linear" rate of return.

Also, one must consider that most people have some level of debt, and need to service lifestyle costs. Let us now bring that into the conversation! Assume you earn $100,000 and are saving $12,000 a year. Your annual savings rate is 12% of your income. Most people have some level of debt payments (for items like mortgage, student loan debt, car loans, credit cards etc). Lastly, the last time I checked; lifestyle is not free! So there are lifestyle costs that need to be considered.

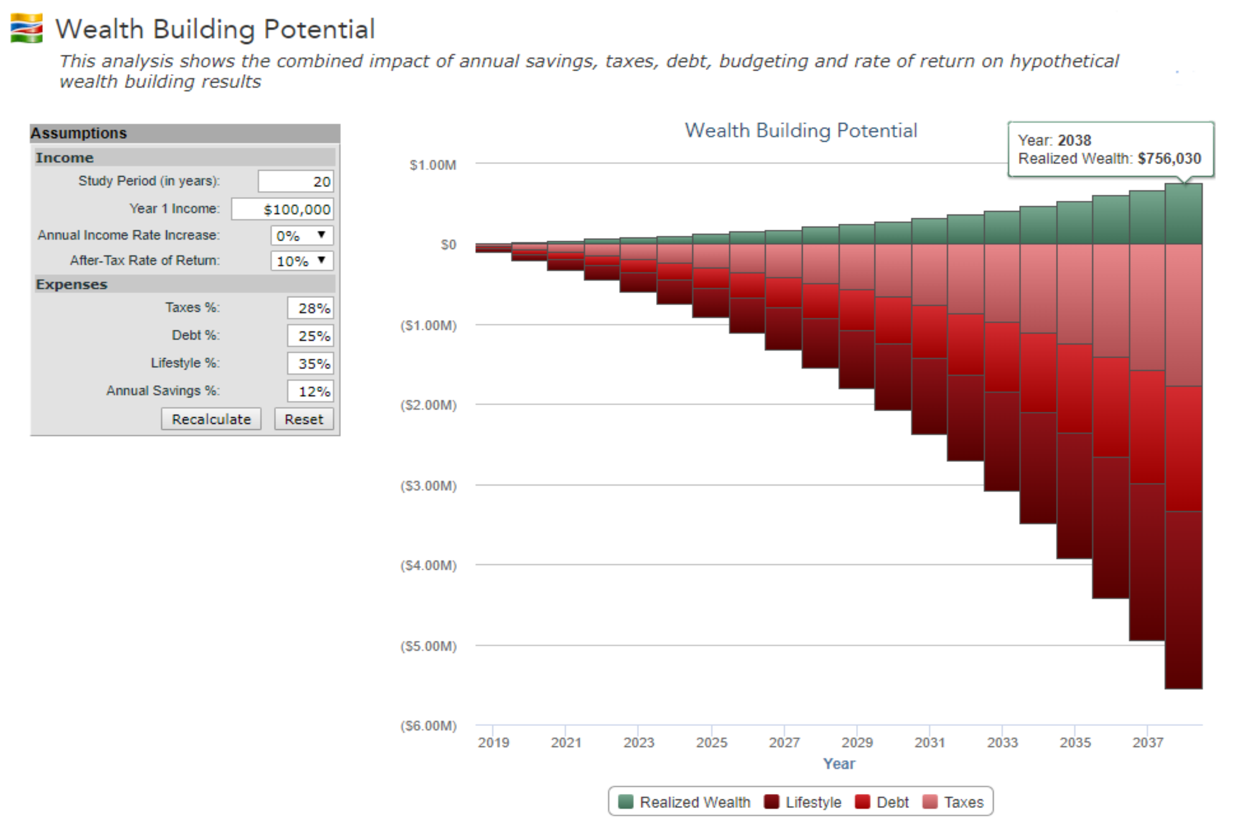
When those costs are examined in more detail, for most that I consult with, debt payments account for 25% of earned income. This means that for every dollar earned, about 25% is being used to service some form of debt payment. Lifestyle costs typically equate to 35% of what people earn annually. NOW…. let's examine what this looks like. Please digest this graph below, as it's a powerful one!



You may notice that most of the wealth we have the potential to create, is eroded away due to taxes, debt and lifestyle costs. If you have been a PowerPassionProsperity blog reader, you should now know that there is Lost Opportunity Costs that are eroding away wealth building potential in that graph above in RED.

So, what do most people do? In my years of practice, I find the that most will attempt to chase a higher rate of return. Simply put, earn more interest, and you will have more wealth. Well, let us study exactly that. In this next graph below, I adjusted the rate of return earned from 6%

in the previous graph up to 10%. You can clearly see that more wealth is created over 20 years, totaling $756,030.

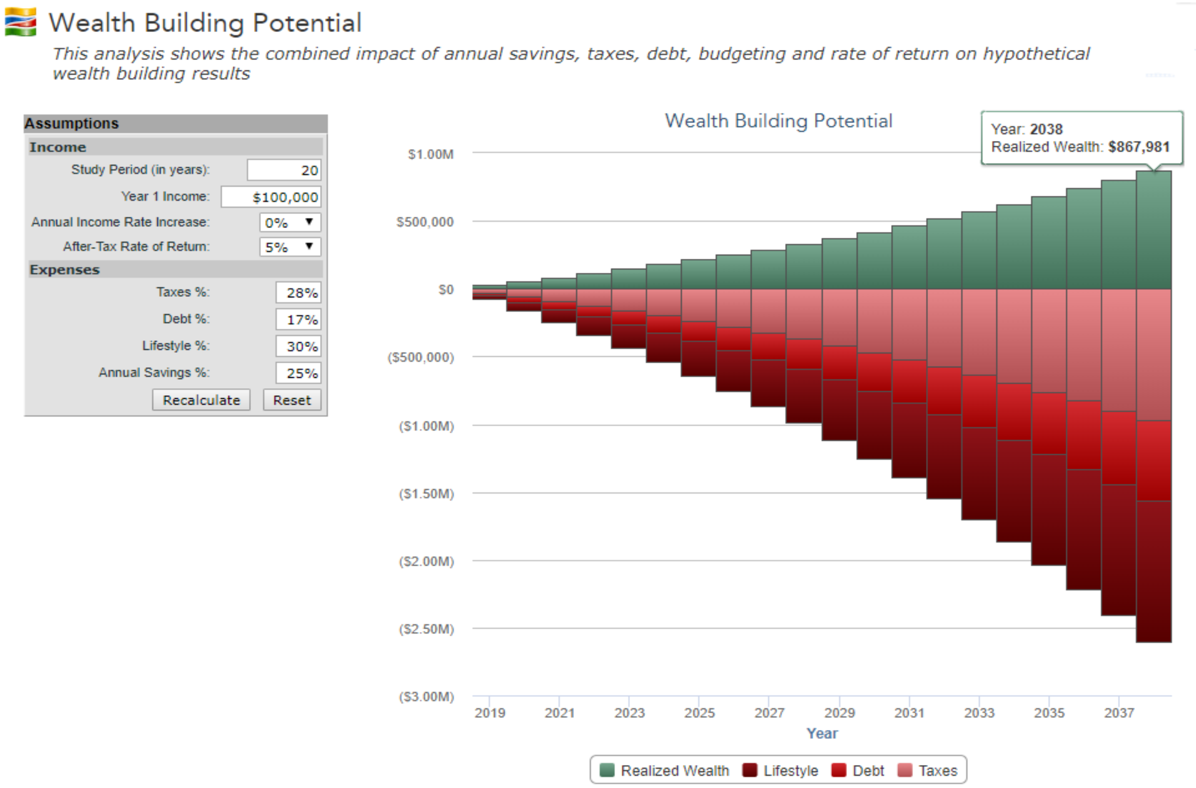


My conflict with this approach is it promotes risk and does not address the root cause of the erosion of wealth noticed in RED on the graph. Nor does it focus on other areas of critical importance such as protection, liquidity building, debt management and tax management.

What if the process of wealth creation was approached more holistically? What result could we have if we considered our savings rate as a part of our overall approach to wealth accumulation, as opposed to ONLY focusing our energy on earning a higher rate of return?

What if we could manage our debt differently for example by having increased dollars go towards savings to build up liquidity creating a higher annual savings rate, and NOT chasing a higher rate of return?

To show the power of this, in the graph below, the rate of return was decreased down to 5% (lower than the original 6%), however, the savings rate was increased to 25%. This can be accomplished by considering all financial decisions like debt management in conjunction with annual savings as well as some potential lifestyle changes such as identifying more opportunities for savings. Does becoming a world class saver have a greater impact that chasing a higher rate of return? Let us find out!



$867,981 is clearly more than $756,030. That was accomplished by not adding more risk by having to chase a higher rate of return.

I believe most people put too much unnecessary pressure on their assets to grow, simply because they are not saving enough money. They key to identifying more dollars to save is by examining your entire financial landscape in a coordinated and integrated manor. This allows for greater fluidity in your financial decisions and strategies.

Identifying the eroding factors of wealth, reducing risk, and increasing cash flow for savings, can lead to better financial results, with less effort.

I encourage you to re-examine your savings rate!

Check out [my website] and follow me on [linkedin]

Christopher Koopman

I am the president and founder of *Statera Wealth Solutions, Inc*.   We focus on sustainable wealth building solutions for those who want to grow and protect their wealth. Our modern perspective challenges outdated conventional financial wisdom, awarding our clients improved financial wellness and less financial stress.