



Compound Interest

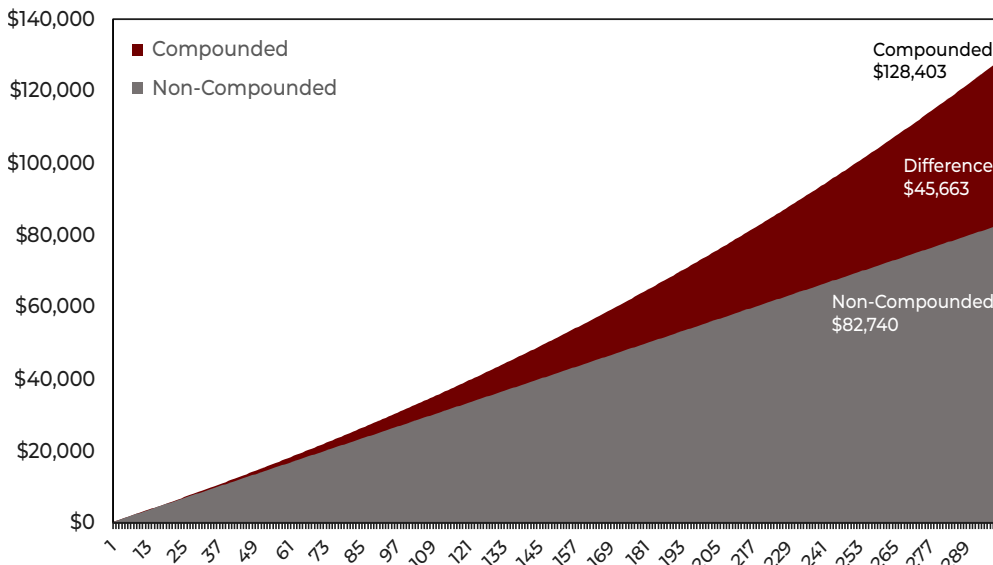
Albert Einstein is said to have stated that “compound interest is the eighth wonder of the world. He who understands it, earns it; he who doesn’t, pays it.”

In a world where news disseminates faster than what feels like a blink of eye, investors and individuals alike can be prone to information overload. In investing, this overload can translate into underreactions or overreactions in market movement. In turn, those underreactions or overreactions can lead to a heightened sense of uncertainty surrounding the market, even in the face of all-time equity market highs (as measured by the MSCI All-Country World Index closing price on 2/29/2024 since Index inception on 12/31/1987 (MXWD Index)).

At the height of uncertainty in either the equity or bond market, we believe that it is always crucial to remember in what our opinion is one of the most important financial principles: the power of compounding interest. Compounding interest is essentially generating interest on interest and the longer the process remains undisrupted, the more powerful the process becomes.

Below we illustrate the impact of the monthly compounding of \$100,000 using the 25-year average of the 10-yr. U.S. Treasury yield as of 2/29/2024 (3.31%) vs. a non-compounded \$100,000. The ending balances differ by more than \$45,000.

Chart 1. Compounded vs. Non-Compounded Interest Example



For illustration purposes only. Based on the average yield 3.31% for the 10-yr. U.S. Treasury for the 25 year time period ending 2/29/2024. Past performance is not a guarantee of future returns.

For purposes of this article, we are using the average monthly 10-yr. U.S. Treasury yield as we believe investors can view the 10-yr. U.S. Treasury yield as the market’s “risk-free rate.” The risk-free rate of return is the interest rate an investor can expect to earn on an investment that carries zero risk. The risk-free rate is commonly considered to be equal to the interest paid on a 10-year U.S. Treasury note. However, the risk-free rate is a theoretical assumption since technically all investments carry some form of risk even if extremely safe.

Currently, as of February 29, 2024, the 10-yr. U.S. Treasury yield sits at 4.25%, a more attractive yield than the 25-year monthly moving average seen in Chart 2. (See following page.)

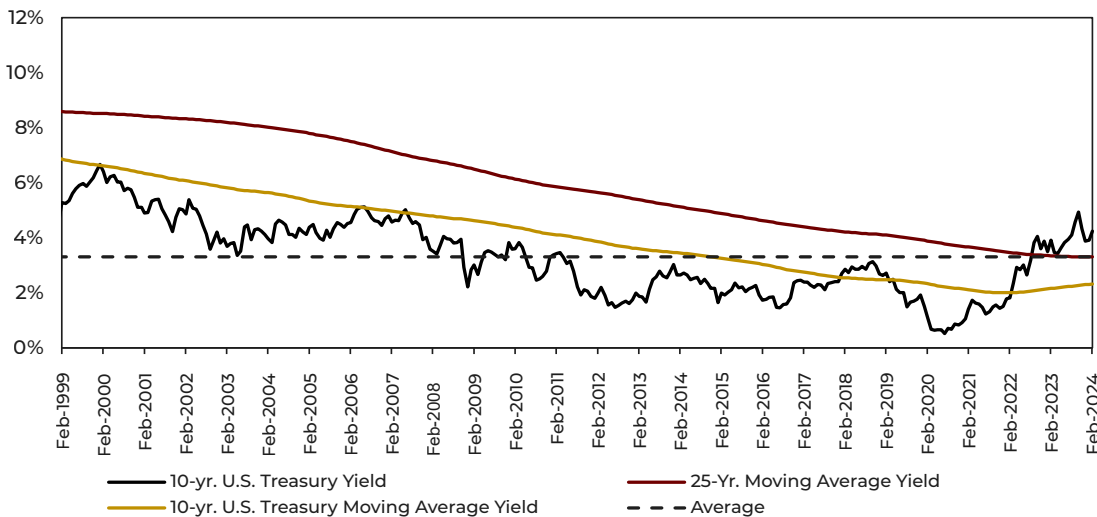
In today’s climate, the compounding process ensues. Indeed, interest, dividends, and portfolio rebalancing are all currently capturing what is thought to be an elevated 10-yr. U.S. Treasury yield based on the Federal Open Market Committee’s December Dot Plot showing projections of at

least three rate cuts in 2024, with more potential cuts in 2025 and 2026.

Simply put, interest and dividends are currently being reinvested at more attractive “risk-free” yields when looking back 10 years. All the while, earnings yields measured by the price-to-earnings ratio in the MXWD Index continue to converge with the current “risk-free” 10-yr. U.S. Treasury yield and sit at levels not seen since before the 2008 Financial Crisis as shown in Chart 3. (See following page.)

What does this all mean? For fixed income only portfolios, organic compounding can look something similar to our theoretical \$100,000 investment in Chart 1. However, with equity earnings exposure yielding about 1% above the 10-yr. U.S. Treasury, we would expect to see a slight acceleration to compounding especially as broad equities measured by the MXWD Index continue their drift into all-time highs from index inception.

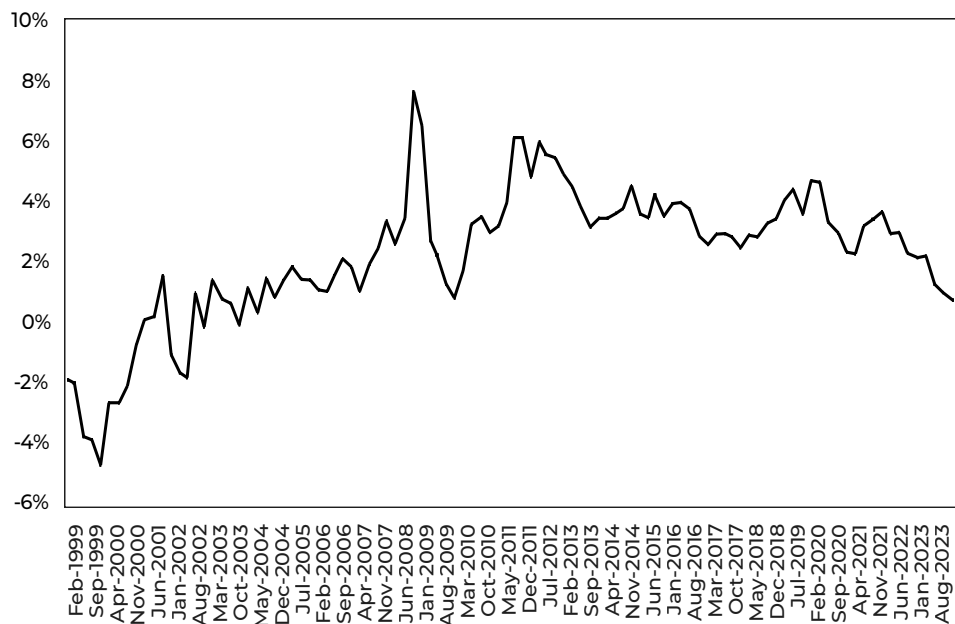
Chart 2. Monthly 10-yr. U.S. Treasury Yield



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However, we believe it is very important to make note that balanced portfolios should be regularly rebalanced to adjust for market movement. As broad equities have moved higher, bond prices have remained grounded due to higher for longer monetary policy. This is where tight account management is warranted. Trimming overweight equity exposure and reinvesting into historically high “risk-free” yield is a welcome occurrence in our opinion, especially when considering all the geopolitical events that have transpired since the Covid-19 Pandemic.

Chart 3. Equity Risk Premium



Bloomberg Finance, L.P. The equity risk premium is an excess in return that investing in the equity market provides over a risk-free rate. In the above example, it is the difference between the earnings yield of the MXWD Index vs. the yield of the 10-yr. U.S. Treasury for the periods indicated. Past performance is not a guarantee of future returns.

Reiterating from earlier, the longer the compounding process remains undisrupted, the more powerful the process becomes, not to mention the conservative positioning an investor can have on the fixed income portion of a balanced portfolio if broad equities face a pullback or intermediate downtrend.

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Sources: Bloomberg Finance, L.P., RBC Wealth Management

Index Definition: The MSCI All-Country World Index captures large and mid cap representation across 23 Developed Markets (DM) and 24 Emerging Markets (EM) countries. With 2,920 constituents, the index covers approximately 85% of the global investable equity opportunity set as of 12/31/2023. Data provided by Bloomberg Finance, L.P.



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