

Counting the cost of interest

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There is a very old story about a king and a trader. The king liked to play chess and collected rare and fine chessboards. One day a trader approached the king with a particularly ornate chessboard and offered it to him. The king was enraptured by the piece and asked the trader to name his price. The trader replied that he would give the board to the king for no price but, as he was hungry, he would value a little rice.

The king agreed and the trader asked for one grain of rice on the first square of his chessboard, followed by two on the second, four on the third and so forth until the chess board was filled. The king, amazed at such a low price for a such a prized possession, readily agreed.

Who got the better of the deal: the king, or the trader? Answer at the bottom of the page.

According to a recent report by the “All-party parliamentary group” (APPG) for financial education, it was found that two-fifths of teachers did not know that it is now a legal curriculum requirement to teach financial literacy in school and, indeed, it has been since 2014.

Ironically, the reasons given for this lacuna is the lack of budget resources to fund the relevant teaching. There is a deeply entrenched misunderstanding in the public sphere of the contrast between revenue expenditure and capital expenditure. Investing in the financial understanding of children may well yield significant returns in the future.

What is clear is that many people do leave school and progress through life with an often foggy understanding of basic financial facts surrounding saving, investment, banking, lending, life assurance and general insurance.

Inevitably this opens the public to, at best, higher costs than necessary and, at worst, exposure to the endless financial scams and “get rich quick” schemes that seem to populate the airwaves and the internet. Some basic financial knowledge, particularly for young people, can go a long way to securing their futures as they progress through life.

Regular readers will know that an oft-quoted maxim of ours belongs to the eminent economist, JK Galbraith: “the only magic in finance is the magic of compound interest.”

There are two sides to the interest question: the first relates to costs and the second relates to returns.

It is now quite clear that the years of “free money” are decisively over. Quantitative Easing has morphed into Quantitative Tightening meaning that interest rates, whilst still low by historical standards, are set to remain far higher than young households have come to expect.

Around 1.8 million mortgages this year will move off sub 2% discounted rates to standard rates of more than 5%. Given the scale of borrowing young borrowers have had to accept to get a foot on the housing ladder, that represents a sizeable chunk of household budgets (and household demand).

Understanding interest, APRs, loan terms and other “non-interest” costs is crucial in managing household budgets where, for most people, every penny counts.

At the same time, a rise in interest rates has an impact on returns across all asset classes. Over the course of last year, most assets, including ultra-long dated index gilts, returned very poor results.

The more substantive point is that many financial markets have suffered a reset but that forward expected reinvestment rates have risen substantially particularly for lower risk assets, particularly gilts.

To return to Galbraith's point about compounding, it is worth noting that the first five years of contributions to an investment scheme are worth five times the last five years on a forty year time frame. Compounding is also, it might be observed, a young person's game.

Whilst young people have better things to do than think about long-term saving, setting up an ISA, for example, is a hugely valuable thing to do for young people even with small amounts of money that can then compound over many years, tax-free, far into the future.

It is also worth noting that the fiscal consequences of Covid, war in Ukraine, and to some extent Brexit, are coming home to roost, so some knowledge of the tax system will also be rather valuable as we navigate our way through the rough seas of these challenging times.

The answer to our question: to fill a chessboard with rice would take 18,446,744,073,709,551,615 or 18 quintillion grains of rice or 210 billion tonnes. The conman/trader was victorious.

However, there was a sting in the tail. Although, as a child, the King had absconded from his lessons on compound interest, he was no fool. He agreed to give the conman his grain, as long as he counted everyone.

We understand he is still counting; such is the magic of compound interest.

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