"Einstein, Dividends and The Rule OF 72"

Even though Albert Einstein was famous throughout the world for his achievements in physics, such as his Theory of Relativity, the phenomenon he was most impressed by had to do with finance. When asked what he considered to be the most powerful force in the universe, Einstein is reputed to have said, "compounding interest". He went on to call this the "greatest invention in human history".

Who are we to argue with a genius? Compound interest provides a very powerful tool for amassing wealth in your portfolio, particularly when coupled with reinvesting dividends. As we mentioned in a previous article, the effect of compounding interest on reinvested dividends raised them from being 35% of overall returns over nearly 80 years, to outstripping price appreciation more than 25 times.

The "Rule of 72", (or 69), is used to determine how many years it would take an investment to double in value, with compounding interest. You simply divide 72 by the interest rate, or dividend yield, or rate of return to determine how long it will take. For example, if you're receiving 6% in dividends, divide 72 by 6, and you get 12, meaning the investment will take 12 years to double, all other things being constant.

Of course, with stocks, the price is rarely constant, so price appreciation will speed up the doubling process. Conversely, you'd expect price depreciation to always slow down this process, but when a company's stock's price declines and they maintain their dividend payout, you'll actually receive more shares when you reinvest your dividends at this lower stock price.

For example, say you own 100 shares of ABC company. If ABC pays out a steady $1.00/share dividend, this is worth 5 shares when ABC's price is $20.00 - (100 shares x $1.00 dividend = $100.00, divided by $20.00 = 5 shares). If ABC's share price falls to $10.00, and they maintain the $1.00 dividend payout, this reinvested dividend now buys you 10 shares – (100 shares x $1.00 dividend = $100.00, divided by $10.00 = 10 shares).

This faster accumulation takes some of the sting out of price declines, but it really comes into play when the stock's price recovers and goes higher, since now you own a greater number of shares.

Logically, the higher your dividend rate is, the faster the Rule of 72 can work for you. However, always look at the dividend payout ratio, which, if very high, could warn you that the dividend may not be sustainable for the company, as we've often seen in 2008-2009.

The Rule of 72 is why young people have such a great advantage when it comes to generating wealth, since they have time on their side. If parents can educate their children about the importance of saving and wealth generation at a young age, kids can put Einstein's favorite invention to work and gain some financial security sooner.

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