Alex’s Financial Tip: The Awesome Thing About Compound Interest

Compound interest, that’s a fun term that is used in my industry. If you use that high-powered computer in your pocket and go to the Google machine, it will tell you that compound interest is “*the addition of interest to the principal sum of a loan or deposit over time*”. Let’s break that down and do a real-life example that a lot of you may have to deal with. In plain English, compound interest is interest earned on interest. You are compounding the interest by reinvesting the interest. Now, why is that important and why should you always be compounding?

The real-life example that a lot of you will have to deal with is the inheritance from the death of a family member, probably a parent or grandparent. Yes, I realize that I am somewhat speaking from a place of privilege and some of my readers won’t ever receive any inheritance. One of my future articles will be about the importance of building family wealth and our desire as humans to leave a legacy.

I have been a Financial Advisor for over 6 years and over that time, I have had hundreds of clients. Most of the time I have been working with middle-income hardworking Americans. Most of my clients over the years that made it to retirement age had between $400k and $900k of invested assets. This is the money that they worked their whole lives to accumulate with the goal of maintaining their standard of living during retirement and to leave a little money to their loved ones.

So this brings me to the point of this article. Why is compound interest important and why should you always be compounding? Let’s say that you are 40 years old and your second parent passes away leaving you and your sibling each an inheritance of $250k. You decide to invest the whole thing. Your sibling decides that they need to spend a lot of it on things like a new car, a new roof on the house, and their children’s education. Plus, they are a little scared of the market, so they put the rest into their savings account. They do decide to start investing around $1000/month from their nest egg savings account. They figure that over the next 20 years, it will be worth close to the same as the $250k that you invested…

With a present value of $1,040 and monthly investment of $1,040 for 20 years at an annual interest rate of 7.5%, the future value would be

$580,519

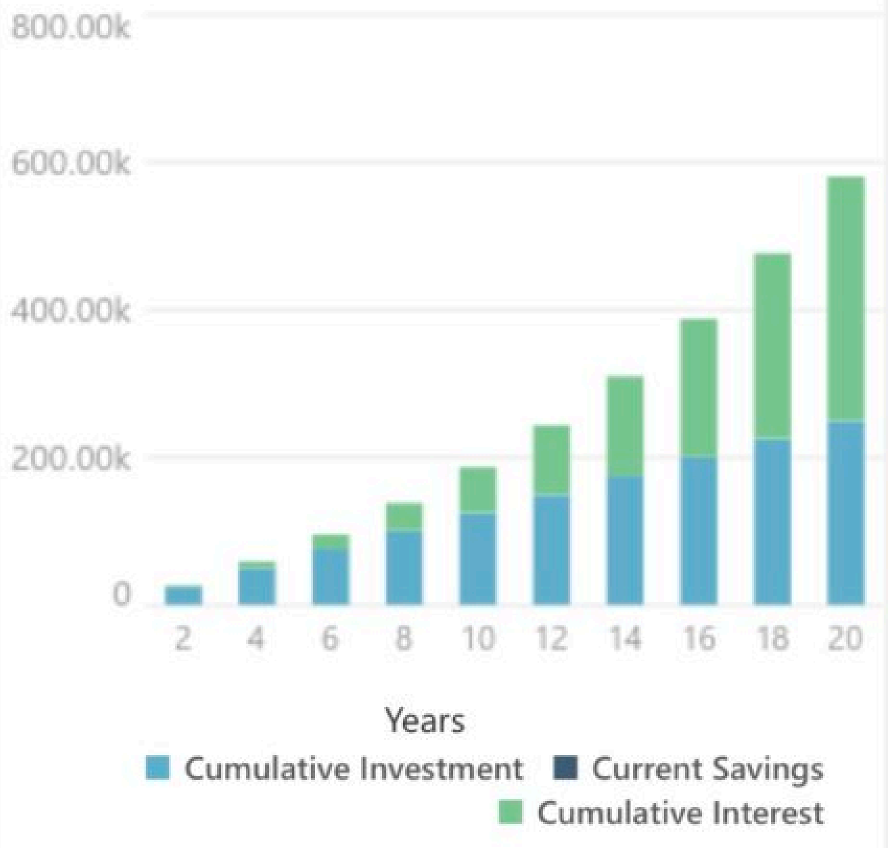
Cumulative Investment

$250,640

Cumulative Interest

$329,879

Chart Cash Flow



Your sibling’s investment result

With a present value of $250,000 and monthly investment of $0 for 20 years at an annual interest rate of 7.5%, the future value would be

$1,115,204

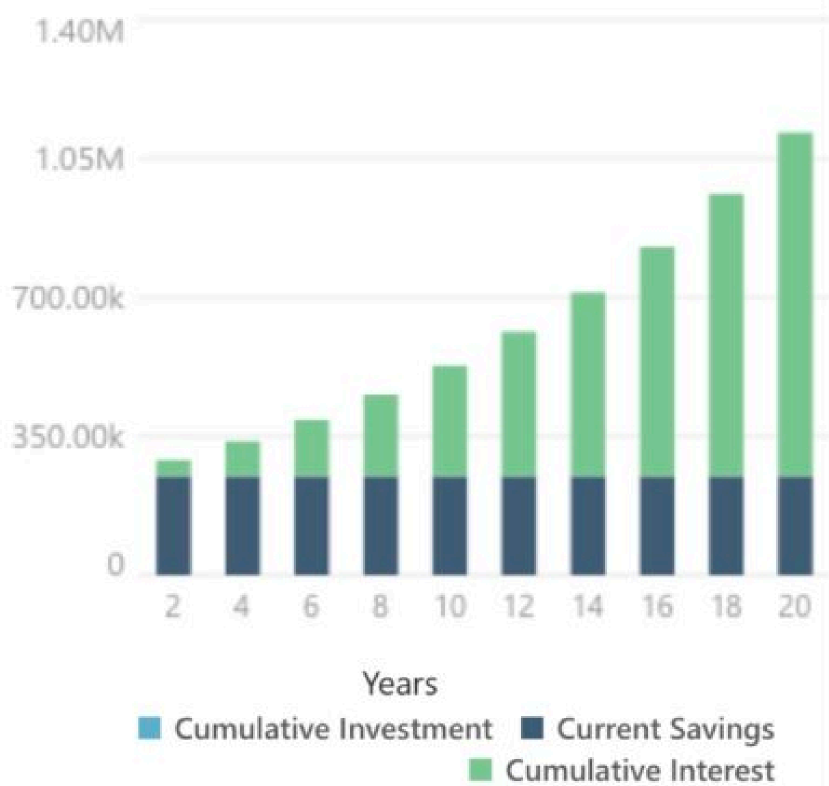
Cumulative Investment

$250,000

Cumulative Interest

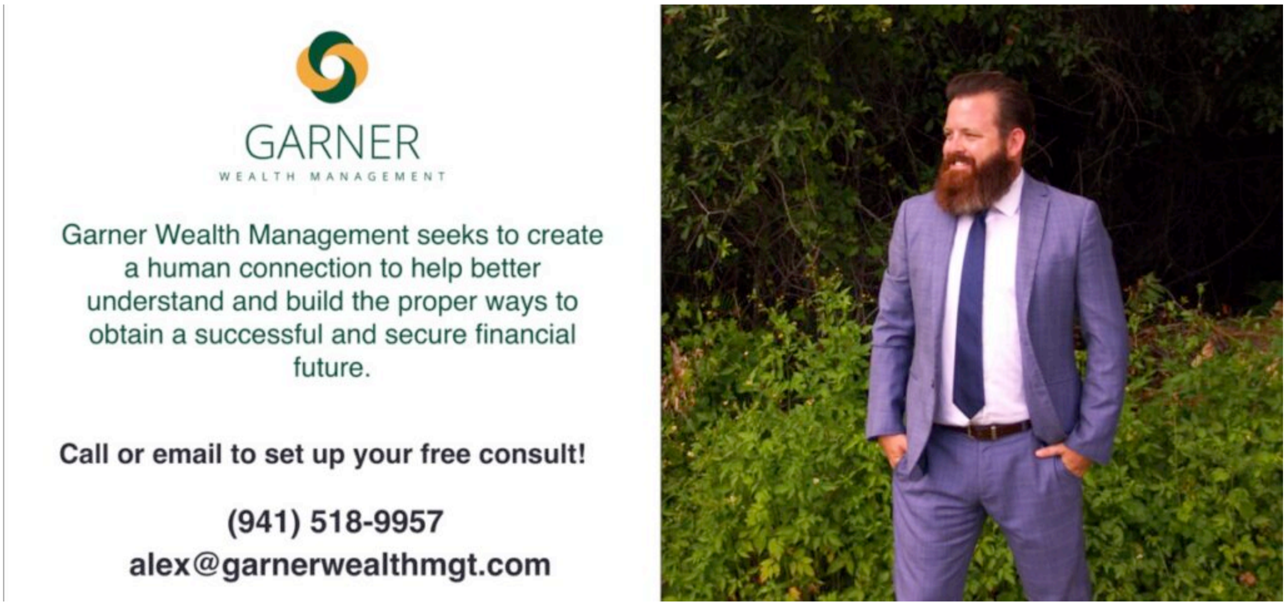
$865,204

Chart Cash Flow



Your investment result
This is just a hypothetical example, but as you can see from these two charts, they were very wrong. The money that you invested has now grown to over a million dollars, the vast majority being the interest due to compounding. Your sibling’s account is roughly half that amount. Why would that happen? What caused this? I am sure you all guessed it. Compound interest!

Compound interest is an awesome thing, and now that you have a better understanding of it, you can make smart decisions with your money. If you ever find yourself with a large amount of money from either an inheritance or winning the lottery, give your Financial Advisor a call. You will be glad that you did.



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