The Wonderful World of Compound Interest

When dealing in business and financial matters, our community has often followed the adage, "cash is king." This has been a guiding philosophy for generations, and it makes sense on paper. If you have cash, you can take advantage of good business opportunities, invest in real estate, and have buying power. However, the phrase was incomplete. While cash may rule, what we do with that cash is even more important. We must always make sure our cash is working for us, 24 hours, 7 days a week. You can only work so long, but compound interest doesn't stop working for you.

Benjamin Franklin had arguably the most simple explanation for compound interest when he said, "money makes money. And the money that money makes, makes money." So let's explain it: compound interest is simply when you earn interest on a savings or investment account you own. That interest earned is then reinvested into your account, earning you more interest the following period, thus compounding on itself. For example, if you have $100 in an account giving you 10% interest in a year, you would end the year with $110. After the second year, you would have $120 dollars. Did I trick you? Because you would, in fact, have $121 in your account. Thanks for the extra dollar, compound interest!

That one dollar may not seem like much now, but compound interest is absolutely crucial for long-term investments and savings options such as retirement. All of us have a finite amount of time that we can work. Most of us will work until we are about 65-70. We are also living longer lives. We must think about long-term savings for our retirement, and doing so as early as possible can mean a difference of millions of dollars. If you are 40 years old, and plan to work for 30 more years, how much would you have saved upon retirement if you invested $100,000 at 10% annual interest? The answer is roughly $1.7 million. This assumes no added investment. If you instead started that same account at the age of 30, you would have roughly $4.5 million upon retirement. That is a difference of almost $2.8 million, just by getting a head start. Starting a decade later means missing out on an entire round of doubling your money.

The beauty of compound interest is a big reason retirement accounts are so popular. Whether you have a Roth IRA, 401(k), or a brokerage account, long-term investments for your retirement is key for a good quality of life after we retire. We know the events of life can get in the way, and not everyone has $100,000 to park in an account for 30+ years, but it starts with developing good habits and setting aside something for a retirement account to start compounding. Luckily, most financial institutions don't have account minimums and various charges, so you can make sure your money works for you.