Compound Interest Mind Bend

“Compound interest is the eighth wonder of the world. He who understands it, earns it… He who doesn’t, pays it…” – Albert Einstein

Compound interest means earning interest on your interest. It’s a powerful concept in saving and investing.

How to make the most of compound interest: 3 Strategies + Takeaways

Strategy 1: Saving the interest vs. spending the interest

What happens if you withdraw your interest as you earn it?

- Investor A makes a $1,000 initial deposit with a 5% annual return and doesn’t touch his account. Total interest earned after 35 years is $4,516.
- Investor B makes a $1,000 initial deposit with a 5% annual return and spends the interest every year. Total interest earned (and spent!) after 35 years is $1,750.
- By leaving his investment alone, Investor A earned 2.5 times more interest than Investor B.

The takeaway: Interest withdrawals-—even if they are small—keep compound interest from doing its thing.

Strategy 2: Starting earlier vs. starting later

How much difference does a head start make?

- Investor A starts saving when he's 25 and makes a $1,000 initial deposit followed by $1,200 deposited annually with an average 5% annual return.
- Investor B starts saving when he's 35 and makes a $1,000 initial deposit followed by $1,200 deposited annually with an average 5% annual return.
- At age 60, Investor A will have contributed $42,000 and earned $70,900 in interest on those deposits.
- At age 60, Investor B will have contributed $30,000 and earned $29,659 in interest on those deposits.
- Investor A contributed $12,000 more than Investor B but earned $41,241 more in total interest!

The takeaway: Time is money when it comes to compound interest. The longer you wait around, the less interest you'll earn.

Strategy 3: Monthly compounding vs. annual compounding

What difference does the compounding frequency make?

- Investor A deposits $100 per month into an account that compounds monthly.
- Investor B deposits $1,200 per year into an account that compounds annually.
- Both start saving at the same time.
- Both have an initial deposit of $1,000.
- Both get a 5% annual return.
- Both contribute $1,200 a year.
- After 35 years, Investor A will have earned $76,343 in interest while Investor B will have earned $70,900 in interest.
- Even though all other variables were the same, Investor A earned $5,443 more than Investor B.

The takeaway: Smaller, more frequent contributions are better than larger annual contributions when it comes to monthly compounding.

Investing can be risky: Not all investments are guaranteed—some investments carry the risk of losing money, even when made through a financial advisor or financial institution.