

The Gift of Compound Interest

If young people understand the power of compound interest, they have a great incentive for starting to save money at an early age. (Albert Einstein called compound interest the eighth wonder of the world.) It's not a hard concept. Once a person grasps the implications, huge financial opportunities await. The sooner one learns about compound interest, the larger financial difference it can make.

Studies show, however, that most of us don't get it. The majority of Americans have a very poor grasp of how this simple concept applies to real money management.

So here are three questions to test your understanding.

- 1) Suppose you put \$100 in a savings account and the interest is 2% per year. After 2 years, how much do you think you would have? a) less than \$102, b) exactly \$102, c) more than \$102.
- 2) Suppose a person puts \$100 a month into an investment account for 10 years (that's a total of \$12,000) and the account earns simple annual interest of 5%. At the end of the time, how much money is in the account? a) \$12,000, b) around \$12,600, or c) more than \$15,000.
- 3) What's worth the most? a) \$10,000, b) \$1,000 per day for 30 days, or c) a penny doubled every day for 30 days?

More than half of Americans cannot correctly answer these questions (not even the first simple one). In each case the answer is "c," and the magical power of compounding is at work. Interest is being earned each period, then interest is earned on interest, and the end result is way more than what one might guess.

Of course, the problem is that the first few periods of compounding are not impressive. In the first question, even after compounding for two years, you have only \$104.04. Four "free" dollars are good, but in our "get-it-now" society, waiting two years for anything is too long.

It's when compounding periods reach 15 to 30 years that the dollars really start to add up. In question two, continuing the \$100 per month contribution, at 15 years there's more than \$26,000 and at 30 years more than \$82,000. Now the free money (interest and interest-on-interest) amounts to a whopping \$46,000, all earned from \$36,000 contributed! And that penny doubled every day 30 times equals \$5,368,709.12. Wow – that's really magical!

So here's a "gift" suggestion for the young people you love. First, learn how to demonstrate the power of compound interest. Get out your electronic device and search for compound interest calculators. There are many available online. A couple favorites are www.econedlink.org and <http://apps.finra.org/Calcs/2/Savings> because they have graphs and charts that show progress over the savings period.

Once you've mastered a calculator, demonstrate it to some young person whose future well-being is important to you. Follow up with a recommendation or a gift of a book. *The Young Investor* by Katherine R. Bateman is a good choice for kids, and *Automatic Millionaire* by David Bach is great for teens and beyond. Your gift will truly be the one that "keeps on giving" in powerful ways for many years.