The Power Of Compound Interest And Why It Pays To Start Saving Now

Have you ever wished that you could have more money, without all the effort? Or are you concerned you won't have enough saved for retirement or your child's education?

Luckily, there's actually a simple way to accomplish those things if you're willing to learn how to put your money to work for you. It's called compound interest, and it can help you exponentially grow your wealth.

WHAT IS COMPOUND INTEREST?

When people think of interest, they often think of debt. But interest can work in your favor when you're earning it on money you've saved and invested.

Compound interest can be defined as interest calculated on the initial principal and also on the accumulated interest of previous periods. Think of it as the cycle of earning "interest on interest" which can cause wealth to rapidly snowball. Compound Interest will make a deposit or loan grow at a faster rate than simple interest, which is interest calculated only on the principal amount.

Not only are you getting interest on your initial investment, but you are getting interest on top of interest! It's because of this that your wealth can grow exponentially through compound interest, and why the idea of compounding returns is like putting your money to work for you.

WHY IT'S IMPORTANT TO SAVE NOW

The magic ingredient that makes compound interest work best is time.

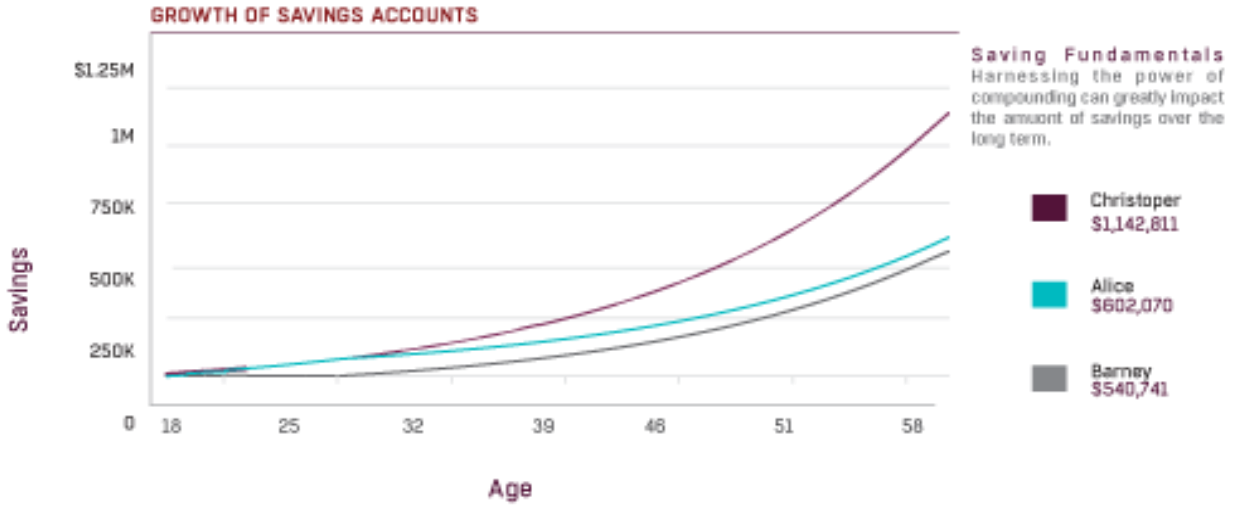
The simple fact is that WHEN you start saving outweighs how much you save.

An investment left untouched for a period of decades can add up to a large sum, even if you never invest another dime.

Let's see how compound interest works with an example. Below, Alice, Barney and Christopher experience the exact same 7% annual investment return* on their retirement funds. The only difference is when and how often they save:

- Alice invests $5,000 per year beginning at age 18. At age 28, she stops. She has invested for 10 years and $50,000 total.
- Barney invests the same $5,000 but begins where Alice left off. He begins investing at age 28 and continues the annual $5,000 investment until he retires at age 58. Barney has invested for 30 years and $150,000 total.

- Christopher is our most diligent saver. He invests $5,000 per year beginning at age 18 and continues investing until retirement at age 58. He has invested for 40 years and a total of $200,000.



(Click for larger image)

Barney has invested 3 times as much as Alice, yet Alice's account has a higher value. She saved for just 10 years while Barney saved for 30 years. This is compound interest: the investment return that Alice earned in her 10 early years of saving is snowballing. The effect is so drastic that Barney can't catch up, even if he saves for an additional 20 years.

The best scenario here is Christopher, who begins saving early and never stops. Note how the amount he has saved is massively higher than either Alice or Barney. Is it so astounding that Christopher's savings have grown so large? Not necessarily – what is most remarkable is how simple his path to riches was. Slow and steady annual investments, and most importantly *beginning at an early age*.

Compound interest favors those that start early, which is why it pays to start now. It's never too late to start — or too early.

If you are early in your career, it can feel like there are a lot of things competing for your money between student loans, saving for a house, retirement and more. However, saving now can give you a huge edge on your finances so you can retire stress-free. Also, if you are saving for your child's education, the power of compound interest surely applies. Start saving when they are in diapers and not as they are starting their college search.

GET STARTED

If you want to easily accumulate wealth and take advantage of the magic of compound interest, it's important to start early and be consistent. As you can see in the example above, it's possible for your money to grow to a large sum with a small initial investment. If you consistently save and invest, you'll have a nice nest egg by the time you retire.

To get started, you can:

- Max out your Roth IRA ($5,500 limit in 2015 and $6,500 for age 50 and older)
- Contribute to your employer-sponsored 401(k), especially if there is a match (that's free money!)

- Contribute to an account like a SEP IRA if you're self-employed; while you may not get a match from an employer, these contributions are tax-deferred
- If education is your goal, max out a Coverdell IRA ($2,000 limit) or contribute to a 529 plan (limits vary by state but are much higher).

The key is to start now and contribute what you can! It may seem like it's not worth it, but even small contributions of $25-$100 per month add up over time.

Time is your best friend and the one thing that makes compound interest so effective. Saving now and starting early will pay dividends in your future and help you accumulate extra money. That's the power of compound interest and why it pays to start saving now.

Windgate does not provide tax advice. Consult your professional tax advisor for questions concerning your personal tax or financial situation.

*A 7% annual return is hypothetical. Past performance is no guarantee of future results. (Even if the hypothetical annual return was reduced, the outcome would still be the same. Alice would still have more savings than Barney, and Christopher would still have the most savings available.)