

The Chatterbox



How Compound Interest Works

Albert Einstein called compound interest the eighth wonder of the world and the most powerful thing he had ever encountered. It is the very way that the rich get richer and how many ordinary people create great wealth over time despite earning only modest incomes throughout their lives.

Compound interest works over time because it allows an individual to earn interest on not only the original amount that they invested, but also they earn interest on the interest they earned from that original investment. Over time this interest on interest creates a snowball effect, picking up momentum and size as it goes.

Having your money work hard for you rather than you having to work hard for your money is one of the secrets of the wealthy. They know the best way to accumulate and increase wealth is to have their money work hard for them at all times. They have learned to use the power of compound interest. Compound interest example: If you take \$100 and earn 10% annually, at the end of year one you have \$110. At the end of year two you have \$121. That is because you earn not only 10 more dollars on the original \$100, but another \$1.00 on the \$10 interest you received in year one. That's the magic of compound interest.

Now let's look at \$1,000 invested and earning 10% interest for 40 years. In the first example let assume that there is no compounding of interest. In the second example we will assume that interest is compounded on an annual basis. How much would a person have accumulated after 40 years in each example?

Example 1

At the end of 40 years the \$1,000 invested at 10% without any compounding would have grown to \$5,000.

Example 2

At the end of 40 years the \$1,000 invested at a 10% annual compound interest rate would have grown to \$45,259. That's \$40,259 or over 9 times more than had there been no compounding of interest.

That's the magic of compound interest!