

Compound Interest and Time:

Two key components when saving for retirement

By Tim C. Lee

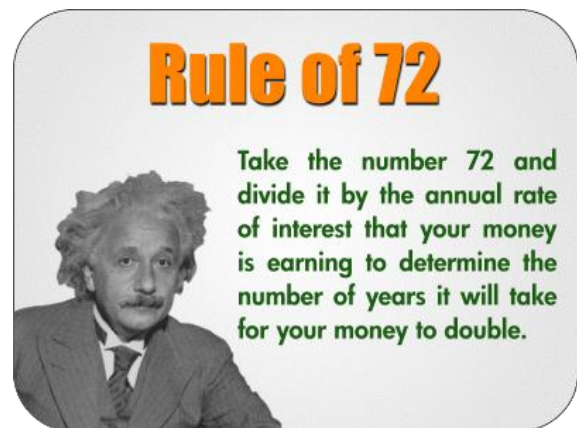
When saving for retirement, there are two terms that everyone needs to understand. **1) Compound Interest** can be defined as interest earned on the principal amount and on the accrued interest that is being earned. Albert Einstein described it best, *"Compound Interest is the 8th wonder of the world. He who understands it, earns it...he who doesn't, pays it."* **2) Time** is essential in making your money grow and work for you. The sooner you begin to save for retirement, the more time your money will have to benefit when earning compound interest.

To simplify this more clearly, let me give you an example. There are two friends, Harry and Mike, who have just turned 25 years old and are interested in saving for retirement at a very young age. Harry wants to get started immediately with an initial investment, but Mike decides to prolong his initial investment until later.

Harry, at the age of 25, decides to contribute \$200 per month (\$2,400 annually) towards his retirement. He continues this allocation for the next 15 years to the age of 40; which is when he decides to discontinue any future contributions. Overall, Harry has contributed \$36,000 towards his retirement savings. At this point, he decides to let the money stay in this retirement account earning compound interest over a period of time. At the age of 65, after contributing only \$36,000 over a 15 year period, Harry has accumulated an incredible \$917,860.13 based on a 10% average rate of return.

Mike, who wanted to prolong his initial investment, decided to start at the age of 35 to contribute the same amount of \$200 per month (\$2,400 annually) towards his retirement. He continues this allocation for

the next 30 years to the age of 65; which is when he decides to discontinue any future contributions. At the age of 65, after contributing \$72,000 over a 30 year period, Mike has accumulated only \$437,754.15 based on the same 10% average rate of return.



So, how is it possible for Harry to have accumulated more than twice of his friend Mike when they reached the same age of 65?

Even though Mike contributed double as much as Harry (\$72,000 versus \$36,000) in twice the amount of time (30 years versus 15 years), Harry, at the same age of 65, still earned more than double that of Mike (\$917,860.13 versus \$437,754.15).

One very important factor is, Harry started saving ten years earlier than Mike; which gave his money more time to grow using compound interest. In finance terms, this can also be described as "The Rule of 72." This rule is a simplified way to determine how long an investment will take to double. By dividing 72 by the compound annual interest rate, you can get a rough estimate of how many years it will take for the investment to duplicate itself.

So, how many times do you want your money to double? The sooner you start saving, the greater chance you will have in

reaching your retirement goal financially. Remember, compound interest and time, are your two key components

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