

Compound interest

Handout 5-4

Interest

- When we put our money in a savings account, we are lending our money to the bank. The bank pays us interest for the use of our money.
- Interest is a percentage of the money, usually based on a yearly rate.

Simple interest

- The bank pays the same amount of interest every year, as a percentage of the money we put in.

Compound interest

- The amount of interest we earn grows each year because the bank pays interest on what we put in, plus the interest we earned. Of course, it grows even faster if you keep putting more money in!
- Compound interest can make a big difference to our savings over the long term. The earlier we start saving, the more compound interest helps our money grow. A little bit can turn into a lot!

Example:

You have \$10,000 to invest for 3 years in a guaranteed investment certificate (GIC) that earns 2.5%, compounded annually (meaning your return is added to the investment at the end of each year).

Here's what happens in the 3 years:

Year – Starting balance \$10,000	Value at the start of the year	Interest earned	Investment value at the end of the year
1	\$10,000.00	\$250.00	\$10,250.00
2	\$10,250.00	\$256.25	\$10,506.25
3	\$10,506.25	\$262.25	\$10,768.90

* figures in table can be calculated using the compound interest calculator on the Ontario Securities Commission website www.getsmarteraboutmoney.ca