Simple vs Compound Interest: What's the difference?

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Know the difference to help you build wealth over time.

Most of us will be familiar with the term "interest". But what is it exactly? In the simplest terms possible, interest is the price of borrowing money. In other words:

You pay interest when you borrow money (e.g. taking out a home loan)

• You receive interest when you lend money (e.g. the bank pays you for putting money in a fixed deposit)

You may also have heard of more advanced terms like simple interest and compound interest. So, what's the difference?

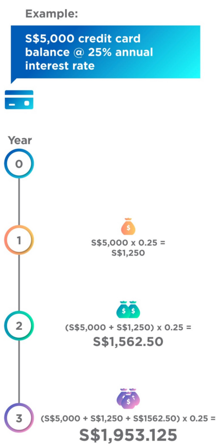
What is simple interest?

Simple interest is calculated annually as a fixed percentage of the principal amount. This means that the amount paid or received each year does not change.

This applies to investments too. For instance, buying a $10,000 bond with a 3% coupon rate pays you $300 per year.

What is compound interest?

In contrast, compound interest is calculated by adding the accumulated interest to the principal amount. This causes the amount of interest to snowball and grow bigger with each passing year.



As you can see, the interest payments can get quite big, quite quickly!

However, this same compounding effect can work in your favour when it comes to investments, helping your money to significantly multiply over time. It's important to note that any withdrawals made from your principal sum (or interests earned) will reduce this compounding effect - which is why you should stay invested for as long as possible to maximise your potential returns.

Which is better?

You want to earn as much interest as possible on your savings but not pay more than what you have to when you borrow. In summary:

- Take loans with simple interest to minimise the amount of interest paid
- Avoid owing compound interest on debt as it can snowball quickly
- Use the effect of compound interest to invest and grow your nest egg for retirement