# [Compound Interest: A Main Component of Financial Planning]

Speakers: Tom Mullooly and Brendan Mullooly

Brendan: Hello and welcome to the Mullooly Asset Management podcast for January 10, 2013. This is Brendan and today Tom and I are going to continue talking about the building blocks of financial planning. We're going to cover compound interest today.

Last week we were talking about saving money and how if you have money saved up it can your decision making for the better. So, you know, getting into compound interest, we want to talk about how it can really help you and hurt you, so do you want to talk about that, Tom?

Tom: Yeah. It really does change your decision making when you have some money in your pocket or in the bank when it comes to laying out for big expenses. And we're going to talk about how compound interest, when you owe money, compound interest can really kill you.

But we can also talk about how when you have money investing for you, earning interest, compound interest can really be your best friend.

So let's talk about some of these big cash outlays. Like suppose you're going to go and take a big trip. Let's say you're going to take a big cruise with your family and say it's going to cost $5,000, or some big trip where you're going to really, you know, really splurge. If you don't pay cash for that trip, if you put it on a credit card, like most people do, if you carry that balance at suppose, let's say 12.9% interest, you're going to find that over six years of paying that off, that $5,000 cruise, when you add in all the interest payments that you've made, it really adds up to $7,100. And so your $5,000 cruise, which is a big event, has really become 40% more expensive just because you're financing that trip instead of, you know, trying to pay as much as you can in cash.

Another big event where people wind up paying way more than what they originally anticipated is when they are buying a car. The easiest way to figure out what you're actually paying for a car is to add up all of your payments, whether they're over 48 months, 4 years, or 60 months, 5 years, or whatever your payment period is, just take your monthly payment and multiply it by the number of months you pay, plus the money that you paid up front to get the car, and you can figure out what a car actually costs.

But with cars being so expensive, Brendan, now people are looking at leasing more and more. And when you lease a car, you know, you have to put a, usually a couple thousand dollars down, up front when you start the lease. And then you've got say three years of say $325 a month, I mean, you've paid nearly $12,000 for a car and then at the end of 3 years, guess what? You don't have an asset that you can trade in, you're basically back at the beginning point again where you've got to put a couple thousand dollars down again and start a new lease payment or get into a car loan. So it becomes really, really expensive when you start to look at how much things cost if you have to finance them.

Brendan: Yeah. And I mean, we just talked about a vacation and a car, but it could be something a lot less expensive, like a new refrigerator from Sears. I mean, that could cost you around $1,200, but if you take one of these deals that they're throwing out, like $47 a month, over 3 years that could cost you as much as $1,700.

Tom: That's a lot more than $1,200.

Brendan: That's $500 more.

Tom: Right.

Brendan: Or you could pay it off in less than 2 years, 23 months, interest free and that's $52 a month. That's only $5 more a month and you're going to save a couple hundred dollars by doing it.

Tom: That is really where I think people drop the ball because when you finance these things on a store credit card, a lot of times you're paying 20, and sometimes 29% interest, and if you just do the match and say, hey, if they've got a 12-month interest-free financing, or 24-month interest-free financing, well, just figure out what you need to do to get it done in 23 months instead of 24 months and like you said, Brendan, the difference was only $5 more a month.

Brendan: Yeah.

Tom: That's $500 in interest. That's huge.

Brendan: Yeah. And you save a lot of money by doing it, as well.

Tom:  Right.

Brendan:  It just makes sense.

Tom:  Yeah.

Brendan:  So those are some examples of how compound interest can really hurt you.  Do you want to talk about how it can be helpful?

Tom:  Sure.  There's a big difference between simple interest and compound interest and I want to walk through some numbers.  Suppose you have $10,000 that you could invest at 5% for 5 years, and right now with interest rates so low, Brendan, 5% actually sounds pretty attractive.

Brendan:  Yeah.

Tom:  But if you had something, like say a tax-free bond that pays interest twice a year, there's not much compounding going on there.  So simple interest on something like that would be just whatever the rate is times the investment.  So with simple interest, if you're earning 5%, you get $500 per year, after 5 years, that's principle plus interest, $12,500.

But suppose this were compounding, using monthly compounding.  If this were compounding over 5 years, at 5%, the actual number is not 12,500, you actually pick up another $300-plus in additional interest just because this money is compounding, and the numbers get even bigger the further out you go.  For example, this is for 5 years, if you were to compound this money at 5% for 10 years, this would grow, the 10,000 plus interest would grow to $16,470.  After 15 years, it would grow to over $21,000.  I mean, this is a huge, huge gap between what you would earn simple interest versus compound interest.

And so on the one side, if you're borrowing money, compound interest can really hurt you.  But if you're investing money, compound interest really can be your best friend, and we want to be your best friend when it comes to investing, so we want to just remind you that none of the securities that we mention in any of these podcasts or videos represent a past specific recommendation of Mullooly Asset Management.  And this video is not a recommendation to buy or sell any of the securities that we mention here.

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Brendan: All right, that's all we have for this week on the podcast. Hopefully you learned something about compound interest and how it can hurt or help you, depending on what you're doing. And thanks for listening.

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