

Column: A simple explanation for how interest works

December 2, 2024



Interest is a familiar concept to all of us. While often associated with debt and loans, interest is more than just a cost of doing business. It's a powerful tool that can incentivize savings, investment, and consumption. Let's explore what interest is and how it works.

Interest is the cost of borrowing money or a reward for saving money. When you save money in an interest-bearing account, you earn interest, essentially receiving a reward for deferring consumption and lending your funds to others, including to your bank. Conversely, when you borrow money, you pay interest as a cost for using someone else's funds. This interest rate helps to balance the demand for loans with the supply of available funds.

Interest rates influence our economic decisions. High interest rates can discourage borrowing and spending, potentially slowing economic growth. And, low interest rates can encourage borrowing and investment, stimulating economic activity.

Let's take a deeper look at the two primary types of interest: simple and compound.

- **Simple interest:** This is calculated based on the principal amount borrowed. It remains the same throughout the loan term.
- **Compound interest:** This is calculated on both the principal amount and the accumulated interest. It grows exponentially over time, making it a powerful tool for both saving and investing.

Here is an example. Let's compare an investment of \$100,000 over 10 years. The \$100,000 deposit receiving 5 percent simple interest annually would earn \$50,000. The same deposit, with a monthly compound interest rate of 5 percent, adds up to about \$64,700 in interest.

So, what factors influence interest rates? Here are a few to consider:

- **Risk:** The riskier the loan is for the lender, the higher the interest rate. For example, a loan to a business with a history of financial instability will likely have a higher interest rate than a loan to a stable government.
- **Market conditions:** Economic factors like inflation and interest rate policies set by central banks can affect interest rates.
- **Term:** A longer loan length often comes with higher interest rates to compensate the lender for the increased risk of the loan.
- **Credit worthiness:** Your credit history and credit score play a significant role in determining the interest rate you'll pay. A good credit score usually leads to lower interest rates.

Interest is a fundamental part of our daily lives. Here are some of the ways it can directly impact you:

- **Saving:** If you're saving for a goal like retirement or buying a house, compound interest can work to your advantage to help maximize your returns.
- **Debt:** Paying attention to interest rates on loans and credit cards can help you make informed decisions about borrowing and repaying debt.
- **Investing:** Understanding the concept of interest is crucial for investing, as it's often used to calculate returns on investments like bonds.

By understanding how interest works, you can take control of your finances and make better decisions. If you have any questions or need more information, reach out to us. Our team is here to help.

Need help with financial goal setting and accountability? Learn more about our Inspired Wealth program here: <https://www.liveinspiredwealth.com/offer>.

Julia Carlson is a registered representative with and securities and advisory services offered through LPL Financial, a registered investment advisor. Member FINRA/SIPC.

Information in this material is for general information only and not intended as investment, tax, or legal advice. Please consult the appropriate professionals for specific information regarding your individual situation prior to making any financial decision.