Simple vs. Compound Interest — Video Transcript

When you save or invest, your return depends in part on how interest is calculated.
Two common methods are simple interest and compound interest.

Simple interest is calculated on the original amount of money you invest, or the principal.
Simple interest offers consistent growth, but it does not build upon itself.

For example, if you invest $1,000 for five years at 5% simple interest each year, after one year, you'd have $1,050 – you could earn $50, which is 5% of $1,000.

For each year after that, you'll earn $50 because the interest is calculated on the original $1,000.

By the end of year five, you'd have a total of $1,250 – your original $1,000 plus $250 in interest over those five years.

Compound interest works differently.

Compound interest is calculated on both the original principal and interest earned from prior periods – meaning interest earns interest. That means more growth potential than simple interest.

Using the same example, after one year, you'd have $1,050 with compound interest – the same as with simple interest. But in year two, interest would be calculated on that larger balance, for a total of $1,102.50. Your investment would grow in the same way for the remaining years, so by the end of year five, you'd have approximately $1,276.

With simple interest, your investment could grow to $1,250. With compound interest, it could grow to $1,276 – about $26 more over five years.

The difference in this example is small. But over decades, and with larger investments, compound interest may noticeably help increase your investment return.

Knowing the difference between the two types of interest may help you improve your financial decision-making and perhaps build or increase your wealth over time.

All investing involves risk, including the possible loss of principal, and there is no guarantee that any investment strategy will be successful.