

Total Cents Podcast Lesson 5

Educate Them on Compound Interest

Topic Overview

The goal of this lesson is to give your kids a firm understanding of what compound interest is and why it's important. One dollar stashed under the mattress is not worth one dollar ten years from now. In fact, it's worth a lot less. Examples like this one demonstrate how inflation ends up ravaging one's purchasing power. Those who understand compound interest are motivated to develop the habit of saving, which is exactly the kind of knowledge and mindset you want your children to have.



Your Intro Discussion With Them:

Tonight we are going to talk about "The Miracle of Compound Interest." It was Albert Einstein who made compound interest famous when he said:

"Compound interest is the eighth wonder of the world. Those who understand it, earn it ... Those who don't understand it ... pay it."

Step 1

Go BIG picture

Compare your answer to your child's to the question: What is inflation?

Kids Likely Answer:

Inflation causes things to cost more every year.

Parents Likely Answer:

Inflation is the increase in the prices of goods and services over time

Why is it important to have a solid understanding of inflation?

- The inflation of the value of the dollar affects how much purchasing power consumers have.
- Historically, our purchasing power has decreased year to year, meaning that 5 years from now \$100 won't buy as much as it can now.
- This also means that the return you get from any investment needs to be at least more than the inflation rate, otherwise your money will lose its value over time.

The Pizza Slice Example:

In 1972 a slice of pizza cost \$0.92. In 2022, the same-sized slice of pizza costs \$3.

Step 2

Earn rather than pay interest to beat inflation

As it pertains to money, what is interest?

Interest is the reward for saving—and the cost of borrowing.

What's the difference between earning and paying interest?

Earn Interest: *You can earn interest when you put your money into a savings account at the bank. You will get paid extra money on top of your deposit in return for allowing the bank to use your cash. Interest is paid as a percentage of all the money you put in the account.*

- If you deposit \$100 into your savings with an interest of 4% then you will receive \$4, which would be your interest rate. The longer you leave money in your account, the more interest you earn.

Pay Interest: *This system works both ways and while it's great when you're saving, it's not so great when you're borrowing. That's because you'll have to pay someone interest for using their money.*

- *If you borrow \$100 with a 4% interest, you will owe them \$104.*

What are the two types of interest?

Simple

- *Example: $\$100 > 10\% = \10*

Compound

- *Interest on the interest*
- *Example: $\$100 > 10\% = \10next year.... $\$110 > 10\% = \121*

Step 3

Get to the important relevance

Why is interest important?

- *Interest fights inflation.*
- *"Allows you to make money while you're sleeping."*

Step 4

Make it Fun

What's the Rule of 72?

- *The Rule of 72 is a tool used to estimate how long it takes your money to double. It reinforces the compound interest concept.*

Here's the rule:

- *If you take 72 and divide it by the intended interest rate, you'll calculate the number of years it will take to double your money. Sticking with 10%, if you divide 72 by 10 you will find that it takes you 7.2 years to double your money.*

Step 5

Turn it into a game

This might help reinforce certain principles, while also encouraging critical thinking skills.

"Quick! Rule of 72—how many years would it take for your money to double at a rate of 4%?"

Here are some reference points to help keep these top of mind:

- *1% = 72 years*
- *2% = 26 years*

Conversation Wrap Up

Remember, inflation robs—but compound interest helps protect against inflation. Now, what did Albert Einstein say? "Compound interest is the eighth wonder of the world. Those who understand it, earn it. Those who don't understand it, pay it."