

The Myth of Compounding Interest

Many financial strategy recommendations and actual wealth building strategies rely on the compounding or reinvestment of interest earned on a financial asset in order to achieve a variety of financial objectives. The practice of “compounding” is commonplace in most financial circles and has been largely held in high esteem by both consumers and professionals alike.

With the discovery of the Exponential Curve, mathematicians were able to calculate how long it would take for a sum to double. Also known as the Rule of 72, one can simply divide an assumed interest rate into 72 to determine how many years are required for the final number to be twice as large as the original number. For example, if a number were to be compounded annually at a 6% rate, it would take 12 years to double (72 divided by 6 equals 12). If that same number were to be compounded at an 8% rate, it would only take 9 years to double (72 divided by 8 equals 9).

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If a person knows the value of his money today, and chooses to employ an interest rate assumption, then calculations can be made quite easily as to how that money might grow over time.

Consider a person who has \$100,000 in the bank today and expects to earn 6% in interest each year. With these assumptions, that individual can predict that by compounding, the bank account will grow to be worth \$200,000 in 12 years (72 divided by 6 equals 12). If that same person continues to compound for second 12 year period, the account would be worth \$400,000 after 24 years, then \$800,000 after 36 years, and so on.

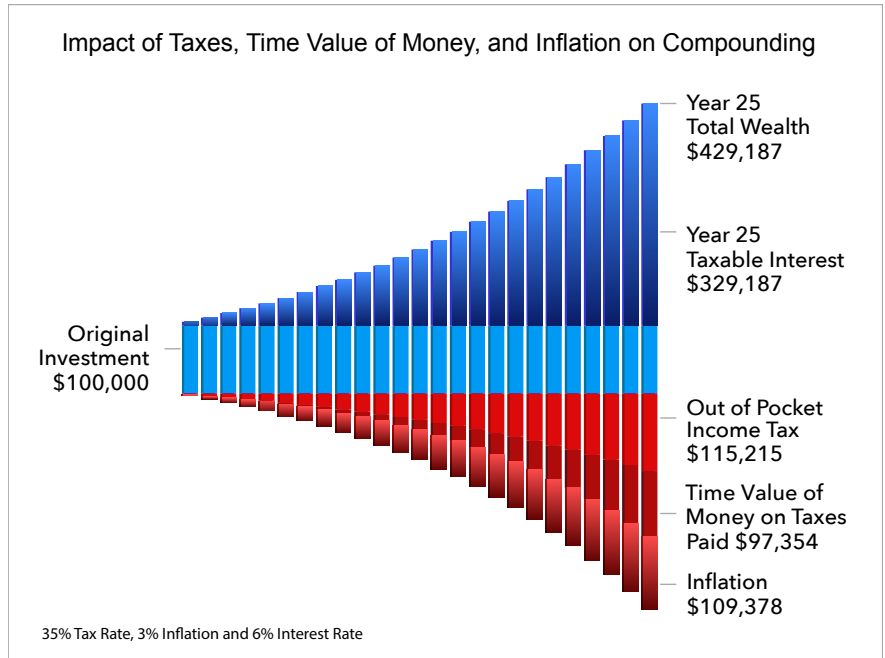
Accumulating Wealth is More Than Just Math

Money is also affected by inflation, taxes, lost opportunity, fluctuating interest rates, penalties, fees, and other costs. It is possible that the combined impact of these eroding forces may dilute, or even offset completely, the expected profits derived from compounding. Therefore, these factors should be considered carefully when deciding if, or for how long, this compounding principle can be relied upon.

Compounding Taxes

In both taxable and tax deferred accounts, the strategy of compounding interest can lead to a compounding income tax. In taxable accounts, as interest is credited each year, the account balance will grow – which is good. However, as annual interest increases, so too will the annual income tax increase that is due on that account. If a taxable account is building wealth at a compounded rate of 6%, then the annual out-of-pocket income tax liability is compounding (or increasing) at the same 6% rate.

With tax deferred accounts, the same compounding tax is occurring. However, as opposed to increased taxes being paid out of pocket each year, deferred accounts postpone the tax until distributions are made. Either way, the impact of compounding income taxes triggered by compounding wealth building strategies can be significant.



This is a hypothetical example and does not represent the performance of any particular financial product.

Alternative Strategies

In many cases, the “redeployment” or movement of earned interest from one financial account to another may lead to improved financial outcomes.

For example, interest previously left to compound might be redeployed to purchase life insurance, thereby helping to potentially lower taxes over time and bolstering protection benefits. Or, instead, this interest may be used to pay off high-cost consumer debt, which may result in a cash flow savings that could be used for other asset building purposes.

There are a limitless number of strategies that exist for the use of the interest earned on financial accounts. Consideration of the options or use of earned interest should occur regularly and become part of a person’s financial review process. In doing so, improved benefits and wealth building results may occur.

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