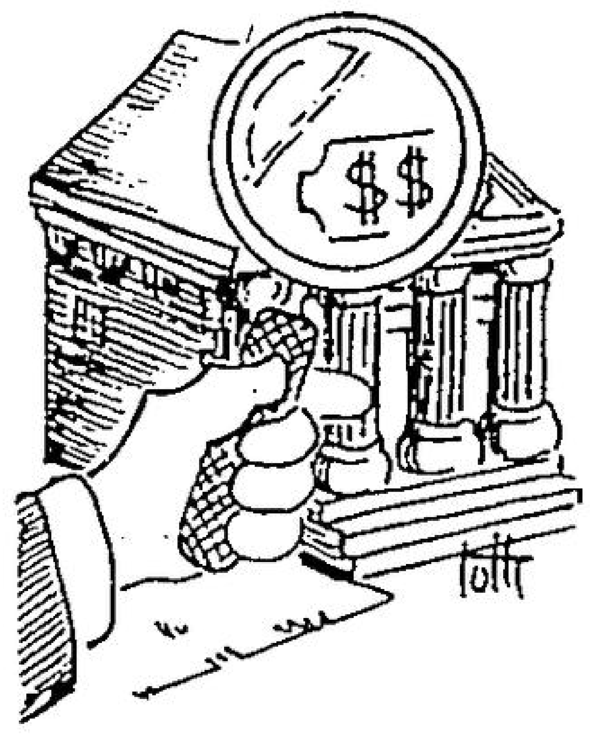
Accountants say interest rates can be deceptive

By Peggy Mulligan, C.A.

When we read a good detective novel, we're keenly aware that things are not always what they seem to be. Yet we rarely have the same awareness when we stash our hard-earned money in the bank. The fact is, however, that in banking as in sleuthing it is usually profitable to investigate beyond what seems to be the obvious.

When you open a bank account, for example, you may be told that it earns 6 per cent interest. That seems straightforward enough. But did you know that there are two ways that 6 per cent can be calculated and that one of them actually earns slightly more money than the other?

Interest can be quoted at a "nominal" rate or an "effective" rate, sometimes known as "real". If you have $100 in your bank account and it earns 6 per cent interest, compounded semi-annually, you are actually earning slightly more than 6 per cent.



Here's how the real rate works. For the first half of the year, your $100 earns 3 per cent interest, or $3. That interest is "compounded" six months after you open your account. That is, the $3 remains in your account and you now begin to earn interest on that interest. For the remaining six months, you earn 3 per cent on your $100 plus 3 per cent on your $3 of interest. At the end of 12 months, you have $106.09. This means you earned 6 per cent on your $100 ($106) and 3 per cent on the interest ($0.09); a real rate of 6.09 per cent.

By comparison, with an effective interest rate of 6 per cent, compounded semi-annually, you end up with precisely $106 at the end of 12 months. In essence, the effective rate means that the bank agrees to pay you 6 per cent on your $100 at the end of the 12 months. Therefore, you actually earn slightly less than 3 per cent interest every six months so that when the interest is compounded your earnings after the full 12 months will work out to $106.

Understand rate options

In order to get maximum earning power from your savings, it is obviously important to understand interest rate options. It is also vital to understand the power of compounding as banks offer a staggering array of compounding options as well.

Perhaps the most dramatic example of the power of compounding is one that is familiar to many — the RRSP. If you invest $1000 at 10 per cent compounded annually, in 20 years your RRSP would be worth $6,527. Invested instead at 10 per cent, compounded semi-annually, your $1,000 would grow to $7,040 over the 20 years.

If it seems to be a lot of work to wade through and compare the benefits of different types of bank accounts with different interest rates and varying compounding options, remember that you worked hard for your money, so you should make it work hard for you.

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You can start CPP benefits at age 60

Did you know you can start to collect your Canada Pension Plan retirement benefits at any time after your 60th birthday? You don't have to wait to 65.

If you declare that you have "substantially ceased employment" (which CPP interprets to mean that your annual earnings from employment or self-employment won't exceed the current maximum of $6,516.72 a year) then you're pensionable!

For each month short of your 65th birthday the pension you receive is reduced by 0.5 per cent. From then on your monthly cheque will be indexed but it won't suddenly jump to the "age 65 level" when you pass that birthday.

Incidentally, it works the other way around too, so that your pension increases 0.5 per cent for each month you don't collect after age 65, to a maximum of 130 per cent at age 70, which is the latest you can apply.

FUND	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION
INDUSTRIAL DIVIDEND FUND	31.3%	14.3%	16.4%	15.4%	16.3%
INDUSTRIAL EQUITY FUND	16.9%	11.9%	11.0%	14.2%	15.5%
INDUSTRIAL FUTURE FUND	16.5%	—	—	—	15.4%
INDUSTRIAL GROWTH FUND	26.6%	14.3%	15.3%	17.2%	17.4%
INDUSTRIAL HORIZON FUND	22.9%	—	—	—	14.0%
INDUSTRIAL INCOME FUND	11.6%	13.7%	15.8%	12.1%	11.1%
INDUSTRIAL PENSION FUND	29.9%	13.2%	14.8%	14.2%	16.5%
MACKENZIE EQUITY FUND	28.8%	13.4%	15.3%	—	15.0%
MACKENZIE MORTGAGE & INCOME FUND	12.6%	13.8%	15.2%	—	16.2%