

chapter 5 4 financial algebra

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Chapter /5, Section /4: Financial Algebra – A Deep Dive into Time Value Calculations

When it comes to mastering the art of financial decision making, the ability to quantify the worth of future cash flows is paramount. Chapter 5 of most introductory financial algebra textbooks is dedicated to the time value of money, and Section 4 zeroes in on a set of powerful tools that allow investors, lenders, and students alike to evaluate investments, loans, and annuities with precision. In this article we will walk through the core concepts, provide step by step methods, work through illustrative examples, and highlight common pitfalls. By the end, you'll have a solid foundation for tackling any problem that involves present value, future value, interest rates, and amortization schedules.

Table of Contents

- Overview of Chapter /5, Section /4
- Key Concepts Explained
- Step by Step Problem Solving Methods
- Illustrative Example Problems
- Common Mistakes and How to Avoid Them
- Practice Tips for Mastery
- Conclusion

Overview of Chapter /5, Section /4

Section /4 of Chapter /5 typically focuses on the **Future Value (FV) and Present Value (PV) of Annuities**. While previous sections might cover simple interest, compound interest, and the fundamentals of discounting, this part introduces the formulas that handle multiple cash flows occurring at regular intervals. It also bridges the gap between theoretical formulas and real world financial products such as mortgages, student loans, and retirement accounts.

In essence, Section /4 teaches you how to:

- Compute the future value of an ordinary annuity (payments made at the end of each period).
- Determine the present value of an ordinary annuity.
- Apply the formulas to both annuity due situations (payments made at the beginning of each period).
- Build amortization schedules that detail principal and interest components for each payment.

Key Concepts Explained

1. Ordinary Annuity vs. Annuity Due

An **ordinary annuity** consists of equal payments made at the end of each period. For example, a monthly mortgage payment is an ordinary annuity because you pay the lender at the end of the month.

An **annuity due** as payments made at the beginning of each period. Rent paid on the first day of each month is a typical annuity due example.

2. Present Value (PV) of an Annuity

The present value of an annuity is the sum of the discounted values of all future payments. The formula for the present value of an ordinary annuity is:

$$PV = P \times [1 - (1 + r)^{-n}] / r$$

where:

- P = payment amount per period
- r = interest rate per period
- n = total number of payments

For an annuity due, the present value is simply the ordinary annuity PV multiplied by $(1 + r)$, because each payment is effectively one period earlier.

3. Future Value (FV) of an Annuity

The future value of an annuity is the total amount that all payments will accumulate to after the final payment. The formula for the future value of an ordinary annuity is:

$$FV = P \times [(1 + r)^n - 1] / r$$

Again, for an annuity due, multiply the ordinary annuity FV by $(1 + r)$.

4. Amortization Schedule

An amortization schedule breaks down each payment into its **interest component** and **principal component**. The interest portion for a given period is the outstanding balance at the start of the period multiplied by the interest rate. The remainder of the payment reduces the principal.

Key outputs of an amortization schedule include:

- Payment amount per period
- Interest paid each period
- Principal paid each period
- Remaining balance after each payment
- Total interest paid over the life of the loan

Step by Step Problem Solving Methods

1. Determining the Payment Amount (P)

When the loan amount, interest rate, and term are known, the payment amount can be found by rearranging the present value formula for an ordinary annuity:

$$P = PV \times [r / (1 - (1 + r)^{-n})]$$

Alternatively, use the future value formula if the future value is given:

$$P = FV \times [r / ((1 + r)^n - 1)]$$

2. Calculating Present Value (PV)

Apply the PV formula directly if you know the payment amount, rate, and number of periods.

3. Computing Future Value (FV)

Use the FV formula when you need to know what the series of payments will be worth at the end of the term.

4. Building an Amortization Schedule

1. Start with the initial loan balance.
2. For each period:

Calculate interest: $\text{Interest} = \text{Balance} \times r$

3. Determine principal: $\text{Principal} = \text{Payment} - \text{Interest}$
4. Update balance: $\text{New Balance} = \text{Balance} - \text{Principal}$

Illustrative Example Problems

Example /1: Monthly Mortgage Payment

Problem: A borrower takes out a 30 year fixed mortgage of \$300,000 with an annual interest rate of 4.5% compounded monthly. What is the monthly payment?

Solution:

- Annual rate: 4.5% !' Monthly rate $r = 0.045/12 = 0.00375$
- Number of payments $n = 30 \times 12 = 360$
- Use payment formula for ordinary annuity:

$$P = 300,000 \times [0.00375 / (1 - (1 + 0.00375)^{-360})]$$

Calculating:

1. $(1 + 0.00375)^{-360}$ "H 0.302
2. $1 - 0.302 = 0.698$
3. $0.00375 / 0.698$ "H 0.005374
4. $300,000 \times 0.005374$ "H \$1,612.20

So the monthly payment is approximately **\$1,612.20**.

Example /2: Present Value of a Retirement Annuity

Problem: A retiree plans to receive \$5,000 per year for 20 years, with an annual discount rate of 6%. What is the present value of this annuity?

Solution:

- Payment $P = \$5,000$
- Rate $r = 0.06$
- Number of periods $n = 20$

Apply PV formula:

$$PV = 5,000 \times [1 - (1 + 0.06)^{-20}] / 0.06$$

Compute:

1. $(1 + 0.06)^{-20}$ "H 0.3118
2. $1 - 0.3118 = 0.6882$
3. $0.6882 / 0.06$ "H 11.47
4. $5,000 \times 11.47$ "H \$57,350

The present value of the annuity is about **\$57,350**.

Example /3: Building a 5 Year Amortization Schedule

Problem: A \$10,000 loan at an annual interest rate of 8% is to be repaid over 5 years with equal annual payments. Construct the first three years of the amortization schedule.

Solution:

1. Annual rate $r = 0.08$
2. Number of periods $n = 5$
3. Compute payment P using PV formula:

$$P = 10,000 \times [0.08 / (1 - (1 + 0.08)^{-5})]$$

Calculations:

1. $(1 + 0.08)^{-5} = 0.6806$
2. $1 - 0.6806 = 0.3194$
3. $0.08 / 0.3194 = 0.2506$
4. $10,000 \times 0.2506 = \$2,506.00$

So each annual payment is \$2,506.

Now build the schedule:

Year	Beginning Balance	Interest	Principal	Ending Balance
1	\$10,000.00	\$800.00	\$1,706.00	\$8,294.00
2	\$8,294.00	\$663.52	\$1,842.48	\$6,451.52
3	\$6,451.52	\$516.12	\$1,989.88	\$4,461.64

Continue the same process for years /4 and /5 to complete the schedule.

Common Mistakes and How to Avoid Them

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