Math 211

Lecture #11

Financial Models

September 21, 2003

Compound Interest

Put some money into an account that returns a percentage each year, compounded continuously. How fast will it grow?

- $P(t)$ is the principal balance measured in $1000.
- "Some money" is $P(0) = P_0$.
- "Returns a percentage" is r%/year.
- "Some time later" is measured in years.
- "Compounded continuously" means $P' = rP$.
- The solution is $P(t) = P_0 e^{rt}$.
- The principal grows exponentially.
- If $r = 8\%$, then $P(20) = P_0 e^{0.08 \times 20} = 4.953\, P_0$
  - $P(40) = 24.5325\, P_0$.

Return

Returns on Investments

What rates of return can we expect?

- Checking accounts — 0 – 3%.
- Money market accounts — 1/4 – 3%.
- Certificates of deposit (3 years) 3 – 4 %.
- Industrial bonds — 5.3% (average from 1926 – 2001).
- Stocks — 10.7% (average from 1926 – 2001).

Return Compound interest

Retirement Account

- Set up a retirement account by investing an initial amount. In addition, deposit a fixed amount each year until you retire. Assume it returns a percentage each year, compounded continuously. How much is there some time later?
  - "A fixed amount each year" is D, measured in $1,000 each year. We assume this is invested continuously.
- The model is $P' = rP + D$.
- The solution is $P(t) = P_0 e^{rt} + \dfrac{D}{r}[e^{rt} - 1]$.

Example of a Retirement Acount

- Suppose you start with an investment of $1,000 at the age of 25, and invest $100 each month until you retire at 65. The account returns 8% per year. How much is in the retirement account when you retire?
  - $P_0 = 1000,\ D = 100 \times 12 = 1200,\ r = 8\% = 0.08.$
- At 65 the principal is $377,521.
- Is this enough to retire on?

Retirement Planning

- If you need a certain income after you retire, how much must you have in your retirement account when you retire?
  - "Certain income" is I (in $1000/year) withdrawn from the account.
  - "How much" is the amount P_0 in the account at retirement.
  - The account still grows due to its return at r%/year.
- The model is $P' = rP - I, \quad P(0) = P_0$.
- The solution is $P(t) = P_0 e^{rt} - \dfrac{I}{r}[e^{rt} - 1]$.
- We are given $I,\ r,\ \&\ P(t_d)$. We need to compute P_0.

Retirement Planning – Example 1

- If you will need an income of $75,000 for 30 years after retirement and your account returns 6%, your account balance at retirement should be

$1,043,000.

- How are you going to save over a million dollars?

Return

Retirement Planning (second try)

- Instead of investing a fixed amount each month, it would be more realistic to invest a percentage of your salary. What should this percentage be in order to accumulate an adequate investment balance? Include the effect of inflation.
- You starting salary is S_0. Assume it will increase at s% per year.
  - Then $S' = sS$, or $S(t) = S_0 e^{st}$.
- The model for the growth of the retirement account is $P' = rP + \lambda S_0 e^{st}$ with $P(0) = P_0$.
- The solution is $P(t) = P_0 e^{rt} + \dfrac{\lambda S_0}{r - s}\left[e^{rt} - e^{st}\right]$.

Return

Retirement Planning – Example 2

- Assume
  - $P_0 =$ $1,000 and $r = 8\%$
  - $S_0 =$ $35,000 and $s = 4\%$
    - Notice that $S(40) =$ $173,356.
  - Need a retirement income of $150,000.
    - Aim for a balance at retirement of $2,000,000.
- Requires $\lambda = 11.53\%$.

Return Model

Other Strategies

- Delayed gratification. Deposit a percentage of your salary that starts at λ%, and decays linearly to 0 over 40 years.

$$P' = rP + \lambda(1 - t/40)S_0e^{st}$$

- Immediate gratification. Deposit a percentage of your salary that starts at 0 and grows linearly over 40 years to λ%.

$$P' = rP + \frac{\lambda t}{40}S_0e^{st}$$