

Financial Mathematics

Prof. Mohamad Alghamdi

Department of Mathematics

October 13, 2026

Chapter 2: Annuities

Contents covered during the course in Chapter Two: Annuities

- class notes and slides which follow the order of ACTEX sections in this way:
- Sections: 2.1, 2.2, 2.3, 2.4, 2.5, 2.6, 2.7, 2.14, examples from 2.15,
- Sections: 2.8, 2.9, 2.10, examples 2.91 and 2.93 from section 2.15,
- Sections: 2.11, 2.12, 2.16, 2.17, 2.18
- Questions from 2018 sample Exam: 2,4,8,11,14,15,20, 23, 24, 35,45, 63, 66, 67, 68, 70, 76, 78, 80, 82, 83, 84, 85.

Chapter 2: Annuities

Main Content

- 1 Annuity
- 2 Annuity-immediate calculation
- 3 Annuity-due calculation
- 4 Perpetuity
- 5 Continuous Annuities
- 6 Basic Annuity Problems
- 7 Deferred Annuities
- 8 Annuities with Varying Payments
- 9 A Single Formula for Annuities with Terms in Arithmetic Progression
- 10 Annuities with Terms in Geometric Progression

Section 2.1: Annuity

■ **Annuity.** An annuity is a sequence of cash flows (paid/received) made at equal intervals of time. For example, house rents, mortgage payments and interest payments on money invested.

■ **Notes:**

- The interval between annuity payments is called payments period.
- An annuity is said to have level payments if all payments C_j are equal.
- An annuity has nonlevel payments if some payments C_j are different from other ones.
- The payments can be made either at **the beginning** or at **the end** of intervals of time:

■ **Annuity-immediate.** For an annuity-immediate, payments are made at the end of the intervals of time.

■ **Example.** Consider the intervals: $[0, 1], [1, 2], [2, 3], \dots, [n-1, n]$, the annuity-immediate payments are made at the end of the periods: $[0, 1], [1, 2], [2, 3], \dots, [n-1, n]$.

■ The cashflow under the annuity-immediate is of the type:

Time	0	1	2	...	n
Contributions	0	C_1	C_2	...	C_n

■ **Annuity-due.** For an annuity-due, payments are made at the beginning of the intervals of time.

■ **Example.** Consider the intervals: $[0, 1], [1, 2], [2, 3], \dots, [n-1, n]$, the annuity-due payments are made at the end of the periods: $[0, 1], [1, 2], [2, 3], \dots, [n-1, n]$.

■ The cashflow under the annuity-due is of the type:

Time	0	1	...	$n-1$	n
Contributions	C_0	C_1	...	C_{n-1}	0

Section 2.2: Annuity-immediate calculation

■ Recall.

Present value of a cashflow: If deposits/withdrawals are made according with the table

Time (in periods)	t_1	t_2	$\dots$	t_n
Investments	C_1	C_2	$\dots$	C_n

■ **Remember.** Under the accumulation function $a(t)$,

■ The present value of the considered cashflow at time zero is $PV = \sum_{j=1}^n C_j \frac{1}{a(t_j)}$

■ The future value at time t of the cashflow is $FV = \sum_{j=1}^n C_j \frac{a(t)}{a(t_j)}$

■ Now, consider an annuity-immediate with level payments of 1 (**Unit annuity** is one for which each regular payment is 1). The cashflow of the annuity is

Time	0	1	2	$\dots$	n
Contributions	0	1	1	$\dots$	1

■ The **present value** of annuity-immediate:

$$a_{\overline{n}|} = \frac{1}{a(1)} + \frac{1}{a(2)} + \dots + \frac{1}{a(n)} = \sum_{j=1}^n \frac{1}{a(j)}$$

■ The **future value** of an annuity-immediate:

$$s_{\overline{n}|} = \frac{a(n)}{a(1)} + \frac{a(n)}{a(2)} + \dots + \frac{a(n)}{a(n)} = \sum_{j=1}^n \frac{a(n)}{a(j)}$$

Section 2.2: Annuity-immediate calculation

Example. You are given that $\delta_t = \frac{1}{8+t}$, $t > 0$. Find $a_{\overline{n}|}$ and $s_{\overline{n}|}$.

Section 2.2: Annuity-immediate calculation

Example. You are given that $\delta_t = \frac{1}{8+t}$, $t > 0$. Find $a_{\overline{n}|}$ and $s_{\overline{n}|}$.

Solution. Remember. $a(t) = e^{\int_0^t \delta_s ds}$.

$$\int_0^t \delta_s ds = \int_0^t \frac{1}{8+s} ds = \ln(8+s) \Big|_0^t = \ln(8+t) - \ln(8) = \ln\left(\frac{8+t}{8}\right) \Rightarrow a(t) = e^{\ln\left(\frac{8+t}{8}\right)} = \frac{8+t}{8}$$

$$a_{\overline{n}|} = \sum_{j=1}^n \frac{1}{a(j)} = \sum_{j=1}^n \frac{8}{8+j}$$

$$s_{\overline{n}|} = \sum_{j=1}^n \frac{a(n)}{a(j)} = \sum_{j=1}^n \frac{\frac{8+n}{8}}{\frac{8+j}{8}} = \sum_{j=1}^n \frac{8+n}{8+j}$$

Section 2.2: Annuity-immediate calculation

Example. You are given that $\delta_t = \frac{1}{8+t}$, $t > 0$. Find $a_{\overline{n}|}$ and $s_{\overline{n}|}$.

Solution. Remember. $a(t) = e^{\int_0^t \delta_s ds}$.

$$\int_0^t \delta_s ds = \int_0^t \frac{1}{8+s} ds = \ln(8+s) \Big|_0^t = \ln(8+t) - \ln(8) = \ln\left(\frac{8+t}{8}\right) \Rightarrow a(t) = e^{\ln\left(\frac{8+t}{8}\right)} = \frac{8+t}{8}$$

$$a_{\overline{n}|} = \sum_{j=1}^n \frac{1}{a(j)} = \sum_{j=1}^n \frac{8}{8+j}$$

$$s_{\overline{n}|} = \sum_{j=1}^n \frac{a(n)}{a(j)} = \sum_{j=1}^n \frac{\frac{8+n}{8}}{\frac{8+j}{8}} = \sum_{j=1}^n \frac{8+n}{8+j}$$

■ **Remember in Chapter 1.** Under compound interest $a(t) = (1+i)^t$:

■ The present value of the considered cashflow at time zero is

$$PV = \sum_{j=1}^n C_j \frac{1}{(1+i)^{t_j}} = \sum_{j=1}^n C_j (1+i)^{-t_j} = \sum_{j=1}^n C_j v^{t_j} \quad \text{Remember in Chapter 1. } v = \frac{1}{1+i}$$

■ The future value at time t of the cashflow is

$$FV = \sum_{j=1}^n C_j \frac{(1+i)^t}{(1+i)^{t_j}} = \sum_{j=1}^n C_j (1+i)^{t-t_j}$$

Section 2.2: Annuity-immediate calculation

■ Consider unit annuity under which payments of 1 are made at the end of each period for n periods:

Time	0	1	2	...	n
Contributions	0	1	1	...	1

■ The **present value** of annuity-immediate is the sum of the individual present values of the payments of 1:

$$\begin{aligned}
 a_{\overline{n}|} &= \sum_{j=1}^n v^j \\
 &= v + v^2 + v^3 + \dots + v^{n-1} + v^n \\
 &= v \frac{1 - v^n}{1 - v} \quad \text{geometric series: } 1 + r + r^2 + \dots + r^n = \frac{1 - r^{n+1}}{1 - r}, r \neq 1 \\
 &= v \frac{1 - v^n}{iv} \quad \text{Remember: } 1 - v = d \text{ and } d = iv \Rightarrow 1 - v = iv \\
 &= \frac{1 - v^n}{i}
 \end{aligned}$$

■ The **future value** of annuity-immediate is the sum of the individual future values of the payments of 1:

$$\begin{aligned}
 s_{\overline{n}|} &= \sum_{j=1}^n (1 + i)^{n-j} \\
 &= (1 + i)^{n-1} + (1 + i)^{n-2} + \dots + (1 + i) + 1 \\
 &= \frac{(1 + i)^n - 1}{(1 + i) - 1} = \frac{(1 + i)^n - 1}{i}
 \end{aligned}$$

Section 2.2: Annuity-immediate calculation

Theorem. If $i \neq 0$, then for an annuity-immediate with level payments of one, we have

$$\blacksquare a_{\overline{n}|i} = \frac{1-\nu^n}{i} = \frac{1-(1+i)^{-n}}{i}$$

$$\blacksquare s_{\overline{n}|i} = \frac{(1+i)^n - 1}{i}$$

Notes.

Annuities with level payments other than 1. If an immediate annuity has payment P , then

The present value: $PV = P a_{\overline{n}|i}$

The future value: $FV = P s_{\overline{n}|i}$

Relationships between present and future values.

$$\blacksquare s_{\overline{n}|i} = (1+i)^n a_{\overline{n}|i} = \frac{(1+i)^n - 1}{i}$$

Proof. $(1+i)^n a_{\overline{n}|i} = (1+i)^n \frac{1-\nu^n}{i} = \frac{(1+i)^n - (1+i)^n \nu^n}{i} = \frac{(1+i)^n - 1}{i} = s_{\overline{n}|i}$

$$\blacksquare a_{\overline{n}|i} = \nu^n s_{\overline{n}|i}$$

Proof. $\nu^n s_{\overline{n}|i} = \nu^n \frac{(1+i)^n - 1}{i} = \frac{\nu^n (1+i)^n - \nu^n}{i} = \frac{1-\nu^n}{i}$

Example. Calculate the present and future values of \$5000 paid at the end of each year for 15 years using an annual effective interest rate of 7.5%.

Section 2.2: Annuity-immediate calculation

Theorem. If $i \neq 0$, then for an annuity-immediate with level payments of one, we have

$$\text{■ } a_{\overline{n}|i} = \frac{1 - \nu^n}{i} = \frac{1 - (1+i)^{-n}}{i}$$

$$\text{■ } s_{\overline{n}|i} = \frac{(1+i)^n - 1}{i}$$

Notes.

■ **Annuities with level payments other than 1.** If an immediate annuity has payment P , then

■ The present value: $PV = P a_{\overline{n}|i}$

■ The future value: $FV = P s_{\overline{n}|i}$

■ **Relationships between present and future values.**

$$\text{■ } s_{\overline{n}|i} = (1+i)^n a_{\overline{n}|i} = \frac{(1+i)^n - 1}{i}$$

Proof. $(1+i)^n a_{\overline{n}|i} = (1+i)^n \frac{1 - \nu^n}{i} = \frac{(1+i)^n - (1+i)^n \nu^n}{i} = \frac{(1+i)^n - 1}{i} = s_{\overline{n}|i}$

$$\text{■ } a_{\overline{n}|i} = \nu^n s_{\overline{n}|i}$$

Proof. $\nu^n s_{\overline{n}|i} = \nu^n \frac{(1+i)^n - 1}{i} = \frac{\nu^n (1+i)^n - \nu^n}{i} = \frac{1 - \nu^n}{i}$

Example. Calculate the present and future values of \$5000 paid at the end of each year for 15 years using an annual effective interest rate of 7.5%.

Solution. $PV = 5000 a_{\overline{15}|0.075} = (5000) \frac{1 - (1+0.075)^{-15}}{0.075} = 44135.59873$

$$FV = 5000 s_{\overline{15}|0.075} = (5000) \frac{(1+0.075)^{15} - 1}{0.075} = 130591.824$$

Section 2.2: Annuity-immediate calculation

Example. If $i = 5\%$ and $n = 10$, find $s_{\overline{n}|i}$.

Section 2.2: Annuity-immediate calculation

Example. If $i = 5\%$ and $n = 10$, find $s_{\overline{n}|}$.

Solution.

$$\begin{aligned}s_{\overline{n}|i} &= s_{\overline{n}|} = \frac{(1+i)^n - 1}{i} \\ \Rightarrow s_{\overline{10}|0.05} &= \frac{(1+0.05)^{10} - 1}{0.05} = 12.5779\end{aligned}$$

Section 2.2: Annuity-immediate calculation

Example. If $i = 5\%$ and $n = 10$, find $s_{\overline{n}|}$.

Solution.

$$\begin{aligned}s_{\overline{n}|i} &= s_{\overline{n}|} = \frac{(1+i)^n - 1}{i} \\ \Rightarrow s_{\overline{10}|0.05} &= \frac{(1+0.05)^{10} - 1}{0.05} = 12.5779\end{aligned}$$

Example. If $n = 15$ and $i = 6\%$, find

(1) $a_{\overline{n}|}$

(2) $s_{\overline{n}|}$.

Section 2.2: Annuity-immediate calculation

Example. If $i = 5\%$ and $n = 10$, find $s_{\overline{n}|}$.

Solution.

$$s_{\overline{n}|i} = s_{\overline{n}|} = \frac{(1+i)^n - 1}{i}$$
$$\Rightarrow s_{\overline{10}|0.05} = \frac{(1+0.05)^{10} - 1}{0.05} = 12.5779$$

Example. If $n = 15$ and $i = 6\%$, find

- (1) $a_{\overline{n}|}$
- (2) $s_{\overline{n}|}$.

Solution.

(1)

$$a_{\overline{15}|} = \frac{1 - (1 + 0.06)^{-15}}{0.06} = 9.712$$

(2)

$$s_{\overline{15}|} = \frac{(1 + 0.06)^{15} - 1}{0.06} = 23.276$$

Section 2.3: Annuity-due calculation

■ Consider unit annuity under which payments of 1 are made at the beginning of each period for n periods:

Time	0	1	...	$n-1$	n
Contributions	1	1	...	1	0

■ The **present value** of annuity-due:

$$\ddot{a}_{n|} = 1 + \frac{1}{a(1)} + \frac{1}{a(2)} + \cdots + \frac{1}{a(n-1)} = \sum_{j=0}^{n-1} \frac{1}{a(j)}$$

■ The **future value** of an annuity-due:

$$\ddot{s}_{n|} = a(n) + \frac{a(n)}{a(1)} + \frac{a(n)}{a(2)} + \cdots + \frac{a(n)}{a(n-1)} = \sum_{j=0}^{n-1} \frac{a(n)}{a(j)}$$

■ Now, we want to drive an expression for $\ddot{a}_{n|}$ and $\ddot{s}_{n|}$ under compound interest $a(t) = (1+i)^t$:

■ The **present value** of annuity-due is the sum of the individual present values of the payments of 1:

$$\begin{aligned} \ddot{a}_{n|} &= \sum_{j=0}^{n-1} \nu^j = 1 + \nu + \nu^2 + \nu^3 + \cdots + \nu^{n-1} \\ &= \frac{1 - \nu^n}{1 - \nu} \quad \text{geometric series: } 1 + r + r^2 + \cdots + r^n = \frac{1 - r^{n+1}}{1 - r}, r \neq 1 \\ &= \frac{1 - \nu^n}{d} \quad d = 1 - \nu \end{aligned}$$

Section 2.3: Annuity-due calculation

■ The **future value** of annuity-due is the sum of the individual future values of the payments of 1:

$$\begin{aligned}\ddot{s}_{n|} &= \sum_{j=0}^{n-1} (1+i)^{n-j} \\ &= (1+i) + (1+i)^2 + (1+i)^3 + \cdots + (1+i)^{n-1} + (1+i)^n \\ &= (1+i) \frac{(1+i)^n - 1}{(1+i) - 1} \\ &= \frac{(1+i)^n - 1}{d} \quad \text{Remember: } d = \frac{i}{1+i}\end{aligned}$$

Theorem. If $i \neq 0$, then for an annuity-due with level payments of one, we have

$$\ddot{a}_{n|} = \frac{1 - \nu^n}{d}$$

$$\ddot{s}_{n|} = \frac{(1+i)^n - 1}{d}$$

■ **Notes.**

■ **Annuities with level payments other than 1.** If due annuity has payment P , then

$$\text{■ } PV = P \ddot{a}_{n|}$$

$$\text{■ } FV = P \ddot{s}_{n|}$$

■ **Relationships between annuity-immediate and annuity-due**

$$\ddot{a}_{n|} = \frac{i}{d} a_{n|} = (1+i) a_{n|}$$

Proof.

$$\ddot{a}_{n|} = \frac{1 - \nu^n}{d} = i \frac{1 - \nu^n}{i d} = \frac{i}{d} \frac{1 - \nu^n}{i}$$

$$= \frac{i}{d} a_{n|} = (1+i) a_{n|} \quad \text{Remember: } d = \frac{i}{1+i} \Rightarrow 1 + i = \frac{1}{d} \text{ and } a_{n|} = \frac{1 - \nu^n}{i}$$

Section 2.3: Annuity-due calculation

$$\blacksquare \ddot{s}_{\overline{n}|} = \frac{i}{d} s_{\overline{n}|} = (1+i) s_{\overline{n}|}$$

Proof.

$$\begin{aligned}\ddot{s}_{\overline{n}|} &= \frac{(1+i)^n - 1}{d} \\ &= i \frac{(1+i)^n - 1}{i d} \\ &= \frac{i}{d} \frac{(1+i)^n - 1}{i} = \frac{i}{d} s_{\overline{n}|} \\ &= (1+i) s_{\overline{n}|} \quad \text{Remember: } d = \frac{i}{1+i} \Rightarrow 1+i = \frac{i}{d} \text{ and } s_{\overline{n}|} = \frac{(1+i)^n - 1}{d}\end{aligned}$$

$$\blacksquare \ddot{s}_{\overline{n}|} = (1+i)^{n+1} a_{\overline{n}|}$$

Proof.

$$\begin{aligned}(1+i)^{n+1} a_{\overline{n}|} &= (1+i)^{n+1} \frac{1 - v^n}{i} \\ &= (1+i) \frac{(1+i)^n \cdot 1 - (1+i)^n v^n}{i} & (1+i)^{n+1} &= (1+i) \cdot (1+i)^n \\ &= \frac{(1+i)^n - 1}{d} = \ddot{s}_{\overline{n}|}\end{aligned}$$

Section 2.3: Annuity-due calculation

Example. If $i = 5\%$ and $n = 10$, find $\ddot{a}_{\overline{n}|}$.

Section 2.3: Annuity-due calculation

Example. If $i = 5\%$ and $n = 10$, find $\ddot{a}_{\overline{n}|}$.

Solution. We know that $\ddot{a}_{\overline{n}|} = \frac{1-\nu^n}{d}$ where $\nu = \frac{1}{1+i}$ and $d = \frac{i}{1+i}$

So,

$$\ddot{a}_{\overline{10}|} = \frac{1 - \left(\frac{1}{1+0.05}\right)^{10}}{\frac{0.05}{1+0.05}} = 8.1078$$

Section 2.3: Annuity-due calculation

Example. If $i = 5\%$ and $n = 10$, find $\ddot{a}_{\overline{n}|}$.

Solution. We know that $\ddot{a}_{\overline{n}|} = \frac{1-\nu^n}{d}$ where $\nu = \frac{1}{1+i}$ and $d = \frac{i}{1+i}$

So,

$$\ddot{a}_{\overline{10}|} = \frac{1 - \left(\frac{1}{1+0.05}\right)^{10}}{\frac{0.05}{1+0.05}} = 8.1078$$

Example. If $i = 6\%$, find $\ddot{a}_{\overline{15}|}$ and $\ddot{s}_{\overline{15}|}$.

Section 2.3: Annuity-due calculation

Example. If $i = 5\%$ and $n = 10$, find $\ddot{a}_{\overline{n}|}$.

Solution. We know that $\ddot{a}_{\overline{n}|} = \frac{1-\nu^n}{d}$ where $\nu = \frac{1}{1+i}$ and $d = \frac{i}{1+i}$

So,

$$\ddot{a}_{\overline{10}|} = \frac{1 - \left(\frac{1}{1+0.05}\right)^{10}}{\frac{0.05}{1+0.05}} = 8.1078$$

Example. If $i = 6\%$, find $\ddot{a}_{\overline{15}|}$ and $\ddot{s}_{\overline{15}|}$.

Solution.

$$\ddot{a}_{\overline{15}|} = \frac{1 - \left(\frac{1}{1+0.06}\right)^{15}}{\frac{0.06}{1+0.06}} = 10.295$$

$$\ddot{s}_{\overline{15}|} = \frac{(1 + 0.06)^{15} - 1}{\frac{0.06}{1+0.06}} = 24.673$$

Section 2.3: Annuity-due calculation

Example. If $i = 5\%$ and $n = 10$, find $\ddot{a}_{\overline{n}|}$.

Solution. We know that $\ddot{a}_{\overline{n}|} = \frac{1-\nu^n}{d}$ where $\nu = \frac{1}{1+i}$ and $d = \frac{i}{1+i}$.
So,

$$\ddot{a}_{\overline{10}|} = \frac{1 - \left(\frac{1}{1+0.05}\right)^{10}}{\frac{0.05}{1+0.05}} = 8.1078$$

Example. If $i = 6\%$, find $\ddot{a}_{\overline{15}|}$ and $\ddot{s}_{\overline{15}|}$.

Solution.

$$\ddot{a}_{\overline{15}|} = \frac{1 - \left(\frac{1}{1+0.06}\right)^{15}}{\frac{0.06}{1+0.06}} = 10.295$$

$$\ddot{s}_{\overline{15}|} = \frac{(1 + 0.06)^{15} - 1}{\frac{0.06}{1+0.06}} = 24.673$$

Example. You want to accumulate \$12,000 in a 5% account by making a level deposit at the beginning of each of the next 9 years. Find the required level payment.

Section 2.3: Annuity-due calculation

Example. If $i = 5\%$ and $n = 10$, find $\ddot{a}_{\overline{n}|}$.

Solution. We know that $\ddot{a}_{\overline{n}|} = \frac{1-\nu^n}{d}$ where $\nu = \frac{1}{1+i}$ and $d = \frac{i}{1+i}$.
So,

$$\ddot{a}_{\overline{10}|} = \frac{1 - \left(\frac{1}{1+0.05}\right)^{10}}{\frac{0.05}{1+0.05}} = 8.1078$$

Example. If $i = 6\%$, find $\ddot{a}_{\overline{15}|}$ and $\ddot{s}_{\overline{15}|}$.

Solution.

$$\ddot{a}_{\overline{15}|} = \frac{1 - \left(\frac{1}{1+0.06}\right)^{15}}{\frac{0.06}{1+0.06}} = 10.295$$

$$\ddot{s}_{\overline{15}|} = \frac{(1+0.06)^{15} - 1}{\frac{0.06}{1+0.06}} = 24.673$$

Example. You want to accumulate \$12,000 in a 5% account by making a level deposit at the beginning of each of the next 9 years. Find the required level payment.

Solution. $FV = P \ddot{s}_{\overline{n}|} = P \frac{(1+i)^n - 1}{d}$ where

$$d = \frac{i}{1+i} = \frac{0.05}{1+0.05}$$

This implies

$$12000 = P \frac{(1.05)^9 - 1}{\frac{0.05}{1+0.05}} \Rightarrow P = \frac{12000}{\frac{(1.05)^9 - 1}{\frac{0.05}{1+0.05}}} = 1036.46$$

Section 2.3: Annuity-due calculation

Example. A loan for 8,000 must be repaid with 6 year end payments at an annual rate of 11%. What is the annual payment?

Section 2.3: Annuity-due calculation

Example. A loan for 8,000 must be repaid with 6 year end payments at an annual rate of 11%. What is the annual payment?

Solution.

$$PV = P a_{\overline{n}|} \Rightarrow P = \frac{PV}{a_{\overline{n}|}}$$

$$\text{where } a_{\overline{n}|} = \frac{1 - v^n}{i} \Rightarrow a_{\overline{n}|} = \frac{1 - (\frac{1}{1+i})^6}{0.11} = 4.2305 \Rightarrow P = \frac{8000}{4.2305} = 1,891.01$$

Section 2.3: Annuity-due calculation

Example. A loan for 8,000 must be repaid with 6 year end payments at an annual rate of 11%. What is the annual payment?

Solution.

$$PV = P a_{\overline{n}|} \Rightarrow P = \frac{PV}{a_{\overline{n}|}}$$

$$\text{where } a_{\overline{n}|} = \frac{1 - v^n}{i} \Rightarrow a_{\overline{n}|} = \frac{1 - (\frac{1}{1+i})^6}{0.11} = 4.2305 \Rightarrow P = \frac{8000}{4.2305} = 1,891.01$$

Example. You wish to make a deposit of now in an account earning 6% annually so that you can get a payment of 250 at the end of each of the next 8 years. How much should you deposit today?

Section 2.3: Annuity-due calculation

Example. A loan for 8,000 must be repaid with 6 year end payments at an annual rate of 11%. What is the annual payment?

Solution.

$$PV = P a_{\overline{n}|i} \Rightarrow P = \frac{PV}{a_{\overline{n}|i}}$$

$$\text{where } a_{\overline{n}|i} = \frac{1 - v^n}{i} \Rightarrow a_{\overline{n}|i} = \frac{1 - (\frac{1}{1+i})^6}{0.11} = 4.2305 \Rightarrow P = \frac{8000}{4.2305} = 1,891.01$$

Example. You wish to make a deposit of now in an account earning 6% annually so that you can get a payment of 250 at the end of each of the next 8 years. How much should you deposit today?

Solution.

$$FV = P s_{\overline{n}|i} = 250 \frac{(1 + 0.06)^8 - 1}{0.06} = 2474.367$$

$$\text{Now, } s_{\overline{n}|i} = (1 + i)^n a_{\overline{n}|i} \Rightarrow a_{\overline{n}|i} = \frac{s_{\overline{n}|i}}{(1+i)^n} = \frac{2474.367}{(1+0.06)^8} = 1552.45$$

OR

$$PV = Pa_{\overline{n}|i} \Rightarrow PV = 250a_{\overline{8}|6\%} = (250)(6.20979) = 1552.45$$

Section 2.4: Perpetuity

■ **Perpetuity.** A perpetuity is an annuity whose payments continue forever.

■ An example of a perpetuity is when someone purchases a property and then rents it out. The owner is entitled to an infinite stream of cash flow from the renter as long as the property continues to exist (assuming the renter continues to rent).

■ **Perpetuity-immediate**

The present value of a perpetuity-immediate that pays 1 per period is denoted by $a_{\infty|}$

$$\begin{aligned} a_{\infty|} &= v + v^2 + v^3 + \dots \\ &= \frac{v}{1-v} \quad \text{Remember: } \sum_{j=1}^n v^t = v \frac{1-v^n}{1-v} \quad \text{Remember: } d = iv \text{ and } d = 1-v \\ &= \frac{v}{iv} \\ &= \frac{1}{i} \end{aligned}$$

OR

$$a_{\infty|} = \lim_{n \rightarrow \infty} a_{n|} = \lim_{n \rightarrow \infty} \frac{1-v^n}{i} = \frac{1}{i} \quad \text{where } \lim_{n \rightarrow \infty} v^n = \lim_{n \rightarrow \infty} \frac{1}{(1+i)^n} = 0$$

■ **Perpetuity-due**

The present value of a perpetuity-due that pays 1 per period is denoted by $\ddot{a}_{\infty|}$

$$\ddot{a}_{\infty|} = \lim_{n \rightarrow \infty} \ddot{a}_{n|} = \lim_{n \rightarrow \infty} \frac{1-v^n}{d} = \frac{1}{d} = \frac{1+i}{i} \quad \text{where } \lim_{n \rightarrow \infty} v^n = 0$$

Section 2.4: Perpetuity

Theorem. Let $i \neq 0$.

■ For an perpetuity-immediate,

■ With level payments of **one**: $a_{\infty|} = \frac{1}{i}$

■ For an perpetuity-due,

■ With level payments of **one**: $\ddot{a}_{\infty|} = \frac{1}{d} = \frac{1+i}{i}$

■ With level payments of **P**: $PV = P a_{\infty|} = \frac{P}{i}$

■ With level payments of **P**: $PV = P \ddot{a}_{\infty|} = \frac{P}{d}$

Section 2.4: Perpetuity

Theorem. Let $i \neq 0$.

■ For an perpetuity-immediate,

■ With level payments of **one**: $a_{\infty|} = \frac{1}{i}$

■ For an perpetuity-due,

■ With level payments of **one**: $\ddot{a}_{\infty|} = \frac{1}{d} = \frac{1+i}{i}$

Example. If $i = 5\%$, find (1) $a_{\infty|}$ (2) $\ddot{a}_{\infty|}$.

■ With level payments of **P**: $PV = P a_{\infty|} = \frac{P}{i}$

■ With level payments of **P**: $PV = P \ddot{a}_{\infty|} = \frac{P}{d}$

Section 2.4: Perpetuity

Theorem. Let $i \neq 0$.

■ For an perpetuity-immediate,

■ With level payments of **one**: $a_{\infty|} = \frac{1}{i}$

■ For an perpetuity-due,

■ With level payments of **one**: $\ddot{a}_{\infty|} = \frac{1}{d} = \frac{1+i}{i}$

Example. If $i = 5\%$, find (1) $a_{\infty|}$ (2) $\ddot{a}_{\infty|}$.

Solution.

$$(1) a_{\infty|} = \frac{1}{i} = \frac{1}{0.05} = 20$$

■ With level payments of **P**: $PV = P a_{\infty|} = \frac{P}{i}$

■ With level payments of **P**: $PV = P \ddot{a}_{\infty|} = \frac{P}{d}$

$$(2) \ddot{a}_{\infty|} = \frac{1}{d} = \frac{1+i}{i} = \frac{1.05}{0.05} = 21$$

Section 2.4: Perpetuity

Theorem. Let $i \neq 0$.

■ For an perpetuity-immediate,

■ With level payments of **one**: $a_{\infty|} = \frac{1}{i}$

■ For an perpetuity-due,

■ With level payments of **one**: $\ddot{a}_{\infty|} = \frac{1}{d} = \frac{1+i}{i}$

■ With level payments of **P**: $PV = P a_{\infty|} = \frac{P}{i}$

■ With level payments of **P**: $PV = P \ddot{a}_{\infty|} = \frac{P}{d}$

Example. If $i = 5\%$, find (1) $a_{\infty|}$ (2) $\ddot{a}_{\infty|}$.

Solution.

$$(1) a_{\infty|} = \frac{1}{i} = \frac{1}{0.05} = 20$$

$$(2) \ddot{a}_{\infty|} = \frac{1}{d} = \frac{1+i}{i} = \frac{1.05}{0.05} = 21$$

Example. Find the present value of a perpetuity immediate with $i = 8\%$.

Section 2.4: Perpetuity

Theorem. Let $i \neq 0$.

■ For an perpetuity-immediate,

■ With level payments of **one**: $a_{\infty|} = \frac{1}{i}$

■ For an perpetuity-due,

■ With level payments of **one**: $\ddot{a}_{\infty|} = \frac{1}{d} = \frac{1+i}{i}$

■ With level payments of **P**: $PV = P a_{\infty|} = \frac{P}{i}$

■ With level payments of **P**: $PV = P \ddot{a}_{\infty|} = \frac{P}{d}$

Example. If $i = 5\%$, find (1) $a_{\infty|}$ (2) $\ddot{a}_{\infty|}$.

Solution.

$$(1) a_{\infty|} = \frac{1}{i} = \frac{1}{0.05} = 20$$

$$(2) \ddot{a}_{\infty|} = \frac{1}{d} = \frac{1+i}{i} = \frac{1.05}{0.05} = 21$$

Example. Find the present value of a perpetuity immediate with $i = 8\%$.

Solution. $a_{\infty|} = \frac{1}{i} = \frac{1}{0.08} = 12.5$

Section 2.4: Perpetuity

Theorem. Let $i \neq 0$.

■ For an perpetuity-immediate,

■ With level payments of **one**: $a_{\infty|} = \frac{1}{i}$

■ For an perpetuity-due,

■ With level payments of **one**: $\ddot{a}_{\infty|} = \frac{1}{d} = \frac{1+i}{i}$

■ With level payments of **P**: $PV = P a_{\infty|} = \frac{P}{i}$

■ With level payments of **P**: $PV = P \ddot{a}_{\infty|} = \frac{P}{d}$

Example. If $i = 5\%$, find (1) $a_{\infty|}$ (2) $\ddot{a}_{\infty|}$.

Solution.

$$(1) a_{\infty|} = \frac{1}{i} = \frac{1}{0.05} = 20$$

$$(2) \ddot{a}_{\infty|} = \frac{1}{d} = \frac{1+i}{i} = \frac{1.05}{0.05} = 21$$

Example. Find the present value of a perpetuity immediate with $i = 8\%$.

Solution. $a_{\infty|} = \frac{1}{i} = \frac{1}{0.08} = 12.5$

Example. John uses his retirement fund to buy a perpetuity-due of 20,000 per year based on an annual nominal interest 8% compounded monthly. Find Johns retirement fund.

Section 2.4: Perpetuity

Theorem. Let $i \neq 0$.

■ For an perpetuity-immediate,

■ With level payments of **one**: $a_{\infty|} = \frac{1}{i}$

■ For an perpetuity-due,

■ With level payments of **one**: $\ddot{a}_{\infty|} = \frac{1}{d} = \frac{1+i}{i}$

■ With level payments of **P**: $PV = P a_{\infty|} = \frac{P}{i}$

■ With level payments of **P**: $PV = P \ddot{a}_{\infty|} = \frac{P}{d}$

Example. If $i = 5\%$, find (1) $a_{\infty|}$ (2) $\ddot{a}_{\infty|}$.

Solution.

$$(1) a_{\infty|} = \frac{1}{i} = \frac{1}{0.05} = 20$$

$$(2) \ddot{a}_{\infty|} = \frac{1}{d} = \frac{1+i}{i} = \frac{1.05}{0.05} = 21$$

Example. Find the present value of a perpetuity immediate with $i = 8\%$.

Solution. $a_{\infty|} = \frac{1}{i} = \frac{1}{0.08} = 12.5$

Example. John uses his retirement fund to buy a perpetuity-due of 20,000 per year based on an annual nominal interest 8% compounded monthly. Find Johns retirement fund.

Solution. We use

$$PV = \frac{P}{d} \text{ where } d = \frac{i}{1+i}$$

First, we have to find i .

Remember.

$$1 + i = \left(1 + \frac{i^{(m)}}{m}\right)^m \Rightarrow 1 + i = \left(1 + \frac{0.08}{12}\right)^{12} \Rightarrow i = \left(1 + \frac{0.08}{12}\right)^{12} - 1 = 0.08299950681 = 8.299950681\%$$

$$d = \frac{0.08299950681}{1.08299950681} = 0.076638545, \text{ then } PV = \frac{20000}{0.076638545} = 260963.2872$$

Section 2.5: Continuous Annuities

■ **Continuous annuity.** Continuous annuity is a special case of annuities payable more frequently than convertible interest and it is a state in which the frequency of payment becomes infinite, i.e. payments are made continuously.

The present value of an annuity payable continuously for n interest conversion periods, such that the total amount paid during each interest conversion period is 1, by the symbol $\bar{a}_{n|}$ and is defined as follows:

$$\begin{aligned}\bar{a}_{n|} &= \int_0^n \nu^t dt = \int_0^n e^{t \ln \nu} dt && \text{Remember: } \nu^t = e^{\ln \nu^t} = e^{t \ln \nu} \\&= \int_0^n e^{-t \ln(1+i)} dt && \text{Remember: } \nu = \frac{1}{1+i} = (1+i)^{-1} \Rightarrow e^{\ln \nu} = e^{\ln(1+i)^{-1}} = e^{-\ln(1+i)} \\&= \int_0^n e^{-\delta t} dt && \text{Remember: } \delta = \ln(1+i) \\&= \left. \frac{-1}{\delta} e^{-\delta t} \right|_0^n && \text{Remember: } \int e^{at} dt = \frac{1}{a} \int a e^{at} dt = \frac{1}{a} e^{at} + c \\&= \frac{-1}{\delta} [e^{-\delta n} - 1] = \frac{-1}{\delta} [(e^{-\delta})^n - 1] = \frac{-1}{\delta} [(e^{\ln(1+i)^{-1}})^n - 1] \\&= \frac{-1}{\delta} [(e^{\ln \nu})^n - 1] = \frac{-1}{\delta} (\nu^n - 1) = \frac{1}{\delta} (1 - \nu^n)\end{aligned}$$

$$\begin{aligned}\text{OR } \bar{a}_{n|} &= \int_0^n \nu^t dt = \frac{1}{\ln \nu} \int_0^n \nu^t \ln \nu dt \\&= \frac{1}{\ln \nu} [\nu^t]_0^n && \text{Remember: } \int a^{u(t)} u'(t) \ln a dt = a^{u(t)} + c \\&= \frac{1}{-\ln(1+i)} (\nu^n - 1) = \frac{1 - \nu^n}{\delta} && \text{Remember: } \delta = \ln(1+i)\end{aligned}$$

Section 2.5: Continuous Annuities

Similarly, the future value is

$$\begin{aligned}\bar{s}_{n|} &= \int_0^n (1+i)^t dt \\ &= \frac{1}{\ln(1+i)} \int_0^n (1+i)^t \ln(1+i) dt \\ &= \frac{1}{\delta} [(1+i)^t]_0^n \quad \text{Remember: } \delta = \ln(1+i) \\ &= \frac{1}{\delta} ((1+i)^n - 1) \\ &= \frac{(1+i)^n - 1}{\delta}\end{aligned}$$

Theorem.

■ The present value of a continuous annuity with rate $C(t) = 1$, $0 \leq t \leq n$, is

$$\bar{a}_{n|} = \frac{1 - v^n}{\delta}$$

■ The future value at time n of a continuous annuity with rate of one is

$$\bar{s}_{n|} = \frac{(1+i)^n - 1}{\delta}$$

Section 2.5: Continuous Annuities

Theorem.

$$\blacksquare \bar{a}_{n|} = \frac{i}{\delta} a_{n|}$$

Proof.

$$\begin{aligned}\bar{a}_{n|} &= \frac{1 - \nu^n}{\delta} \\ &= i \frac{1 - \nu^n}{i \delta} \\ &= \frac{i}{\delta} \frac{1 - \nu^n}{i} = \frac{i}{\delta} a_{n|}\end{aligned}$$

$$\blacksquare \bar{s}_{n|} = \frac{i}{\delta} s_{n|}$$

Proof.

$$\begin{aligned}\bar{s}_{n|} &= \frac{(1+i)^n - 1}{\delta} \\ &= i \frac{(1+i)^n - 1}{i \delta} \\ &= \frac{i}{\delta} \frac{(1+i)^n - 1}{i} = \frac{i}{\delta} s_{n|}\end{aligned}$$

Section 2.5: Continuous Annuities

Example. If $i = 5\%$ and $n = 10$, find $\bar{a}_{\overline{n}|}$ and $\bar{s}_{\overline{n}|}$.

Section 2.5: Continuous Annuities

Example. If $i = 5\%$ and $n = 10$, find $\bar{a}_{\overline{n}|}$ and $\bar{s}_{\overline{n}|}$.

Solution. First, find $\delta = \ln(1 + i)$, then

$$\bar{a}_{\overline{10}|} = \frac{1 - (\frac{1}{1+0.05})^{10}}{\ln(1 + 0.05)} = 7.9132$$

$$\bar{s}_{\overline{10}|} = \frac{(1 + 0.05)^{10} - 1}{\ln(1 + 0.05)} = 12.8898$$

Section 2.5: Continuous Annuities

Example. If $i = 5\%$ and $n = 10$, find $\bar{a}_{n|}$ and $\bar{s}_{n|}$.

Solution. First, find $\delta = \ln(1 + i)$, then

$$\bar{a}_{10|} = \frac{1 - (\frac{1}{1+0.05})^{10}}{\ln(1 + 0.05)} = 7.9132$$

$$\bar{s}_{10|} = \frac{(1 + 0.05)^{10} - 1}{\ln(1 + 0.05)} = 12.8898$$

Example. If $i = 6\%$ and $n = 15$, find $\bar{a}_{n|}$ and $\bar{s}_{n|}$.

Section 2.5: Continuous Annuities

Example. If $i = 5\%$ and $n = 10$, find $\bar{a}_{n|}$ and $\bar{s}_{n|}$.

Solution. First, find $\delta = \ln(1 + i)$, then

$$\bar{a}_{10|} = \frac{1 - \left(\frac{1}{1+0.05}\right)^{10}}{\ln(1 + 0.05)} = 7.9132$$

$$\bar{s}_{10|} = \frac{(1 + 0.05)^{10} - 1}{\ln(1 + 0.05)} = 12.8898$$

Example. If $i = 6\%$ and $n = 15$, find $\bar{a}_{n|}$ and $\bar{s}_{n|}$.

Solution. First, find $\delta = \ln(1 + i)$, then

$$\bar{a}_{15|} = \frac{1 - \left(\frac{1}{1+0.06}\right)^{15}}{\ln(1 + 0.06)} = 10.0008$$

$$\bar{s}_{15|} = \frac{(1 + 0.06)^{15} - 1}{\ln(1 + 0.06)} = 23.9675$$

Section 2.6: Basic Annuity Problems

Example. A loan for 20,000 must be repaid by 5 year-end payments with interest at an annual effective rate of 12%. What is the annual payment?

Section 2.6: Basic Annuity Problems

Example. A loan for 20,000 must be repaid by 5 year-end payments with interest at an annual effective rate of 12%. What is the annual payment?

Solution. Apply the formula: $PV = P a_{\overline{n}|i}$ where $a_{\overline{n}|i} = \frac{1-v^n}{i}$.

For $n = 5$ and $i = 12\%$, we have $a_{\overline{5}|} = \frac{1 - (\frac{1}{1+0.12})^5}{0.12} = 3.60478$

The annual payment:

$$20000 = P a_{\overline{5}|} \Rightarrow P = \frac{20000}{a_{\overline{5}|}} = \frac{20000}{3.60478} = 5548.1946$$

Section 2.6: Basic Annuity Problems

Example. A loan for 20,000 must be repaid by 5 year-end payments with interest at an annual effective rate of 12%. What is the annual payment?

Solution. Apply the formula: $PV = P a_{\overline{n}|i}$ where $a_{\overline{n}|i} = \frac{1-v^n}{i}$.

For $n = 5$ and $i = 12\%$, we have $a_{\overline{5}|12\%} = \frac{1 - (\frac{1}{1+0.12})^5}{0.12} = 3.60478$

The annual payment:

$$20000 = P a_{\overline{5}|12\%} \Rightarrow P = \frac{20000}{a_{\overline{5}|12\%}} = \frac{20000}{3.60478} = 5548.1946$$

Example. You have a 5,000 balance in an account earning a 4.5% annual effective rate. You want to increase your balance to 20,000 at the end of 12 years by making a level deposit at the beginning of each of the next 12 years. Find the required level payment.

Section 2.6: Basic Annuity Problems

Example. A loan for 20,000 must be repaid by 5 year-end payments with interest at an annual effective rate of 12%. What is the annual payment?

Solution. Apply the formula: $PV = P a_{\overline{n}|i}$ where $a_{\overline{n}|i} = \frac{1-v^n}{i}$.

For $n = 5$ and $i = 12\%$, we have $a_{\overline{5}|12\%} = \frac{1 - (\frac{1}{1+0.12})^5}{0.12} = 3.60478$

The annual payment:

$$20000 = P a_{\overline{5}|12\%} \Rightarrow P = \frac{20000}{a_{\overline{5}|12\%}} = \frac{20000}{3.60478} = 5548.1946$$

Example. You have a 5,000 balance in an account earning a 4.5% annual effective rate. You want to increase your balance to 20,000 at the end of 12 years by making a level deposit at the beginning of each of the next 12 years. Find the required level payment.

Solution. We have that

$$FV = ka(t) + P \ddot{s}_{\overline{n}|i}$$

where $ka(t) = k(1+i)^t$ and $\ddot{s}_{\overline{n}|i} = \frac{(1+i)^n - 1}{d}$, and $d = \frac{i}{1+i}$.

This implies

$$20000 = 5000(1 + 0.045)^{12} + P \frac{(1 + 0.045)^{12} - 1}{\frac{0.045}{1 + 0.045}}$$

$$20000 = 5000(1 + 0.045)^{12} + 16.1599 P$$

$$\Rightarrow P = \frac{20000 - 5000(1 + 0.045)^{12}}{16.1599}$$

$$\Rightarrow P = 712.912$$

Section 2.6: Basic Annuity Problems

Example. An account earning a 5% annual effective rate has a current balance of 6,000. If a deposit of 1,500 is made at the end of each year for 20 years, what will be the balance in the account at the end of 20 years?

Section 2.6: Basic Annuity Problems

Example. An account earning a 5% annual effective rate has a current balance of 6,000. If a deposit of 1,500 is made at the end of each year for 20 years, what will be the balance in the account at the end of 20 years?

Solution. $FV = ka(t) + Ps_{\overline{n}|}$ where $ka(t) = k(1+i)^t$ and $s_{\overline{n}|} = \frac{(1+i)^n - 1}{i}$. So,

$$FV = 6000(1 + 0.05)^{20} + 1500 \frac{(1 + 0.05)^{20} - 1}{0.05} = 65,518.72$$

Section 2.6: Basic Annuity Problems

Example. An account earning a 5% annual effective rate has a current balance of 6,000. If a deposit of 1,500 is made at the end of each year for 20 years, what will be the balance in the account at the end of 20 years?

Solution. $FV = ka(t) + Ps_{\overline{n}|}$ where $ka(t) = k(1+i)^t$ and $s_{\overline{n}|} = \frac{(1+i)^n - 1}{i}$. So,

$$FV = 6000(1 + 0.05)^{20} + 1500 \frac{(1 + 0.05)^{20} - 1}{0.05} = 65,518.72$$

Example. You want to accumulate at least 20,000 in an account earning a 5% annual effective rate. You will make a level deposit of 1,000 at the beginning of each year for n years. What is the value of n ?

Section 2.6: Basic Annuity Problems

Example. An account earning a 5% annual effective rate has a current balance of 6,000. If a deposit of 1,500 is made at the end of each year for 20 years, what will be the balance in the account at the end of 20 years?

Solution. $FV = ka(t) + Ps_{\overline{n}|i}$ where $ka(t) = k(1+i)^t$ and $s_{\overline{n}|i} = \frac{(1+i)^n - 1}{i}$. So,

$$FV = 6000(1 + 0.05)^{20} + 1500 \frac{(1 + 0.05)^{20} - 1}{0.05} = 65,518.72$$

Example. You want to accumulate at least 20,000 in an account earning a 5% annual effective rate. You will make a level deposit of 1,000 at the beginning of each year for n years. What is the value of n ?

Solution.

$$\begin{aligned} FV &= P\ddot{s}_{\overline{n}|i} \\ 20000 &= 1000 \frac{(1 + 0.05)^n - 1}{0.05} \\ \Rightarrow (1 + 0.05)^n &= \frac{20000}{1000} \cdot \frac{0.05}{1.05} \\ \Rightarrow \ln(1 + 0.05)^n &= \ln(1.9524) \\ \Rightarrow n \ln(1.05) &= \ln(1.9524) \Rightarrow n = \frac{\ln(1.9524)}{\ln(1.05)} = 13.71 \end{aligned}$$

For $n = 13$, we have $FV = 1000\ddot{s}_{\overline{13}|0.05} = 18,598.63$ but this amount is less than 20,000.

For $n = 14$, we have $FV = 1000\ddot{s}_{\overline{14}|0.05} = 20,578.56$

Thus, 14th payment is required to reach at least 20,000.

Section 2.7: Deferred Annuities

Deferred annuity is an annuity whose first payment takes place at future period.

■ Consider an annuity of under which payments of 1 (**unit annuity**) are made at the end of each period for n periods:

Time	0	1	2	3	4	5	6	7	8
Contributions	0	1	1	1	1	1	1	1	1

■ The present value of an annuity-immediate with level payments of one is $a_{\overline{8}|}$

■ Assume that the payment starts from the end the third period.

Time	0	1	2	3	4	5	6	7	8
Contributions	0	0	0	1	1	1	1	1	1

■ The present value of the annuity would be $\nu^2 a_{\overline{6}|}$ (the present value at the end of the third period discounted for two periods).

■ To see this imagine the payment starts at the end of the first period:

Time	0	1	2	3	4	5	6	7	8
Contributions	0	1	1	1	1	1	1	1	1

The present value at $t = 0$ is $a_{\overline{8}|}$. However, we must remove the present value of the imaginary payments, which is $a_{\overline{2}|}$. Thus, the present value at the end of the third period:

$$a_{\overline{8}|} - a_{\overline{2}|} = \frac{1 - \nu^8}{i} - \frac{1 - \nu^2}{i} = \frac{-\nu^8 + \nu^2}{i} = \nu^2 \frac{1 - \nu^6}{i} = \nu^2 a_{\overline{6}|}$$

An annuity like this is called a deferred annuity.

Section 2.7: Deferred Annuities

- the present value of an n -year unit annuity-immediate deferred for k years is $\nu^k a_{n|}$.
- **Notation** for the present value of an n -year unit annuity-immediate deferred for k years is ${}_k|a_{n|}$, so we have:

$${}_k|a_{n|} = \nu^k a_{n|}$$

Notes.

- From above explanation, we have

$$\nu^k a_{n|} = a_{k+n|} - a_{k|}$$

Also,

$$a_{k+n|} = a_{k|} + \nu^k a_{n|}$$

The present value of an annuity-immediate for $n + k$ periods is the sum of the present value of a k -period annuity-immediate and an n -period annuity deferred for k periods.

Take this example:

$$a_{5|} = \nu + \nu^2 + \nu^3 + \nu^4 + \nu^5 = (\nu + \nu^2 + \nu^3) + (\nu^4 + \nu^5) = (\nu + \nu^2 + \nu^3) + \nu^3(\nu + \nu^2) = a_{3|} + \nu^3 a_{2|}$$

The present value of a five-period annuity-immediate can be expressed as the sum of a 3-year annuity-immediate and a 2-year annuity-immediate deferred for 3 years:

- The present value of an n -year annuity-immediate deferred for k years with level of payment P is

$$P {}_k|a_{n|} = P \nu^k a_{n|}$$

Section 2.7: Deferred Annuities

Example. If $\overline{a}_{4|} = 3.5460$ and $\nu^4 = 0.8227$. Find $\overline{a}_{8|}$

Section 2.7: Deferred Annuities

Example. If $a_{\overline{4}|} = 3.5460$ and $\nu^4 = 0.8227$. Find $a_{\overline{8}|}$

Solution. From

$$a_{\overline{k+n}|} = a_{\overline{k}|} + \nu^k a_{\overline{n}|}$$

we have

$$a_{\overline{8}|} = a_{\overline{4}|} + \nu^4 a_{\overline{4}|} = 3.5460 + (0.8227)(3.5460) = 6.463$$

Section 2.7: Deferred Annuities

Example. If $a_{\overline{4}|} = 3.5460$ and $\nu^4 = 0.8227$. Find $a_{\overline{8}|}$

Solution. From

$$a_{\overline{k+n}|} = a_{\overline{k}|} + \nu^k a_{\overline{n}|}$$

we have

$$a_{\overline{8}|} = a_{\overline{4}|} + \nu^4 a_{\overline{4}|} = 3.5460 + (0.8227)(3.5460) = 6.463$$

Example. Based on a 5% annual interest rate, find the present value of a 10-year annuity with level payments of 100 each, with the first payment occurring 4 years from now.

Section 2.7: Deferred Annuities

Example. If $a_{\overline{4}|} = 3.5460$ and $\nu^4 = 0.8227$. Find $a_{\overline{8}|}$

Solution. From

$$a_{\overline{k+n}|} = a_{\overline{k}|} + \nu^k a_{\overline{n}|}$$

we have

$$a_{\overline{8}|} = a_{\overline{4}|} + \nu^4 a_{\overline{4}|} = 3.5460 + (0.8227)(3.5460) = 6.463$$

Example. Based on a 5% annual interest rate, find the present value of a 10-year annuity with level payments of 100 each, with the first payment occurring 4 years from now.

Solution.

The first payment at the end of the 4th year i.e, no payments during the first 3 years, so this is a 3-year-deferred annuity immediate.

$$P_{3|} a_{\overline{10}|} = 100 \nu^3 a_{\overline{10}|} = 100 \left(\frac{1}{1+0.05} \right)^3 \frac{1 - \left(\frac{1}{1+0.05} \right)^{10}}{0.05} = 667.03$$

OR

Use the relation:

$$\nu^k a_{\overline{n}|} = a_{\overline{k+n}|} - a_{\overline{k}|}$$

$$100 \nu^3 a_{\overline{10}|} = 100(a_{\overline{13}|} - a_{\overline{3}|}) = 100 \left(\frac{1 - \left(\frac{1}{1+0.05} \right)^{13}}{0.05} - \frac{1 - \left(\frac{1}{1+0.05} \right)^3}{0.05} \right) = 100(9.3936 - 2.7232) = 667.03$$

Section 2.7: Deferred Annuities

Now, assume that the payments ends at the end the sixth period:

Time	0	1	2	3	4	5	6	7	8
Contributions	0	1	1	1	1	1	1	0	0

The future value of the annuity would be at $t = 8$: $(1+i)^2 s_{\overline{6}|}$.

To see this imagine the payment ends at the end of the eighth period:

Time	0	1	2	3	4	5	6	7	8
Contributions	0	1	1	1	1	1	1	1	1

The future value at $t = 8$ is $s_{\overline{8}|}$. However, we must remove the future value of the imaginary payments, which is $s_{\overline{2}|}$. Thus, the future value at the end of the last period:

$$s_{\overline{8}|} - s_{\overline{2}|} = \frac{(1+i)^8 - 1}{i} - \frac{(1+i)^2 - 1}{i} = \frac{(1+i)^8 - (1+i)^2}{i} = (1+i)^2 \frac{(1+i)^6 - 1}{i} = (1+i)^2 s_{\overline{6}|}$$

In general, **the future value of n payments at $n + k$ years is** $(1+i)^k s_{\overline{n}|}$.

Section 2.8: Annuities with Varying Payments

■ Remember.

- An annuity is said to have level payments if all payments C_j are equal.
- An annuity has nonlevel payments if some payments C_j are different from other ones.
- For any type of varying annuity, the present value (the accumulated value) can be evaluated by taking the present value (the accumulated value) of each payment separately and summing the results:

Time (in periods)	t_1	t_2	$\dots$	t_n
Investments	C_1	C_2	$\dots$	C_n

Under the accumulation function $a(t)$,

- The present value of the considered cashflow at time zero: $PV(t) = \sum_{j=1}^n C_j \frac{1}{a(t_j)}$
- The future value at time t of the cashflow: $FV(t) = \sum_{j=1}^n C_j \frac{a(t)}{a(t_j)}$
- In this section, we consider special annuities with varying payments. In particular, we focus on varying annuities for which simple expressions can be developed:
 - (1) Annuities with Terms in Arithmetic Progression.
 - (2) Annuities with Terms in Geometric Progression.

Section 2.8: Annuities with Varying Payments

(1) Annuities with Terms in Arithmetic Progression.

(A) Increasing Annuities with Terms in Arithmetic Progression

- An annuity whose n payments are $1, 2, 3, \dots, n$ is called a unit increasing annuity.
- If payments are made at the end of each period, it is an increasing annuity-immediate.
- The present value of the increasing annuity-immediate for n payments is denoted by $(Ia)_{\overline{n}|}$

Time	1	2	3	...	n	Present Value
Payments	1	1	1	...	1	$\frac{1-\nu^n}{i}$
		1	1	...	1	$\nu \cdot a_{\overline{n-1} } = \nu \cdot \frac{1-\nu^{n-1}}{i} = \frac{\nu-\nu^n}{i}$
			1	...	1	$\nu^2 \cdot a_{\overline{n-2} } = \nu^2 \cdot \frac{1-\nu^{n-2}}{i} = \frac{\nu^2-\nu^n}{i}$
						...
					1	$\nu^{n-1} \cdot a_{\overline{1} } = \nu^{n-1} \cdot \frac{1-\nu}{i} = \frac{\nu^{n-1}-\nu^n}{i}$
Total	1	2	3	...	n	$\frac{\sum_{t=0}^{n-1} \nu^t - n\nu^n}{i} = \frac{\ddot{a}_{\overline{n} } - n\nu^n}{i}$

Now, we have

$$(Ia)_{\overline{n}|} = \frac{\ddot{a}_{\overline{n}|} - n\nu^n}{i}$$

Section 2.8: Annuities with Varying Payments

Example. Let $i = 5\%$ and $n = 4$. If the annuity-immediate payments are 1, 2, 3, 4, then find the present value.

Section 2.8: Annuities with Varying Payments

Example. Let $i = 5\%$ and $n = 4$. If the annuity-immediate payments are 1, 2, 3, 4, then find the present value.

Solution. Apply $(Ia)_{\overline{n}|} = \frac{\ddot{a}_{\overline{n}|} - n\nu^n}{i}$ for $i = 5\%$ and $n = 4$:

$$(Ia)_{\overline{4}|} = \frac{\ddot{a}_{\overline{4}|} - 4\nu^4}{0.05} = 8.6488$$

Section 2.8: Annuities with Varying Payments

Example. Let $i = 5\%$ and $n = 4$. If the annuity-immediate payments are 1, 2, 3, 4, then find the present value.

Solution. Apply $(Ia)_{\overline{n}|} = \frac{\ddot{a}_{\overline{n}|} - n\nu^n}{i}$ for $i = 5\%$ and $n = 4$:

$$(Ia)_{\overline{4}|} = \frac{\ddot{a}_{\overline{4}|} - 4\nu^4}{0.05} = 8.6488$$

■ If payments are made at the beginning of each period, it is an increasing annuity-due.

Remember: $\ddot{a}_{\overline{n}|} = \frac{i}{d} a_{\overline{n}|} = (1+i)a_{\overline{n}|}$

From this, we have $(I\ddot{a})_{\overline{n}|} = \frac{i}{d} (Ia)_{\overline{n}|} = \frac{i}{d} \cdot \frac{\ddot{a}_{\overline{n}|} - n\nu^n}{i} = \frac{\ddot{a}_{\overline{n}|} - n\nu^n}{d}$

$$(I\ddot{a})_{\overline{n}|} = \frac{i}{d} (Ia)_{\overline{n}|} = (1+i)(Ia)_{\overline{n}|} = \frac{\ddot{a}_{\overline{n}|} - n\nu^n}{d}$$

■ For increasing continuously payable annuity, remember that $\bar{a}_{\overline{n}|} = \frac{i}{\delta} a_{\overline{n}|}$ so we have

$$(I\bar{a})_{\overline{n}|} = \frac{i}{\delta} (Ia)_{\overline{n}|} = \frac{\bar{a}_{\overline{n}|} - n\nu^n}{\delta}$$

Section 2.8: Annuities with Varying Payments

■ In the case of an increasing perpetuity, the present value is the limit of the appropriate formula as n approaches infinity:

■ Increasing unit perpetuity-immediate: (Remember: $\ddot{a}_{n|} = \frac{1-\nu^n}{d}$)

$$(Ia)_{\infty|} = \lim_{n \rightarrow \infty} (Ia)_{n|} = \lim_{n \rightarrow \infty} \frac{\ddot{a}_{n|} - n\nu^n}{i} = \frac{\frac{1}{d} - 0}{i} = \frac{1}{id}$$

■ Increasing unit perpetuity-due:

$$(I\ddot{a})_{\infty|} = \lim_{n \rightarrow \infty} (I\ddot{a})_{n|} = \lim_{n \rightarrow \infty} \frac{\ddot{a}_{n|} - n\nu^n}{d} = \frac{\frac{1}{d} - 0}{d} = \frac{1}{d^2}$$

■ Increasing continuously payable perpetuity:

$$(I\bar{a})_{\infty|} = \lim_{n \rightarrow \infty} (I\bar{a})_{n|} = \lim_{n \rightarrow \infty} \frac{\ddot{a}_{n|} - n\nu^n}{\delta} = \frac{\frac{1}{d} - 0}{\delta} = \frac{1}{\delta d}$$

Section 2.8: Annuities with Varying Payments

Example. Let $i = 5\%$ and $n = 4$, find $(I\ddot{a})_{\overline{4}|}$.

Section 2.8: Annuities with Varying Payments

Example. Let $i = 5\%$ and $n = 4$, find $(I\ddot{a})_{\overline{4}|}$.

Solution. Apply $(I\ddot{a})_{\overline{n}|} = \frac{\ddot{a}_{\overline{n}|} - n\nu^n}{d}$

we have $(I\ddot{a})_{\overline{4}|} = \frac{\ddot{a}_{\overline{4}|} - 4\nu^4}{d} = 9.0812$

Section 2.8: Annuities with Varying Payments

Example. Let $i = 5\%$ and $n = 4$, find $(I\ddot{a})_{\overline{4}|}$.

Solution. Apply $(I\ddot{a})_{\overline{n}|} = \frac{\ddot{a}_{\overline{n}|} - n\nu^n}{d}$

$$\text{we have } (I\ddot{a})_{\overline{4}|} = \frac{\ddot{a}_{\overline{4}|} - 4\nu^4}{d} = 9.0812$$

■ The future value of an increasing unit annuity-immediate is denoted by $(Is)_{\overline{n}|}$. **Remember.** $s_{\overline{n}|} = (1+i)^n a_{\overline{n}|}$

Notes. We use the previous relation to find expressions to calculate $(Is)_{\overline{n}|}$, and for $(I\ddot{a})_{\overline{n}|}$, $(I\bar{a})_{\overline{n}|}$ students can follow same procedure:

$$(Is)_{\overline{n}|} = (1+i)^n (Ia)_{\overline{n}|} = (1+i)^n \frac{\ddot{a}_{\overline{n}|} - n\nu^n}{i} = \frac{(1+i)^n \ddot{a}_{\overline{n}|} - (1+i)^n n\nu^n}{i} = \frac{\ddot{s}_{\overline{n}|} - n}{i}$$

$$(Is)_{\overline{n}|} = (1+i)^n (Ia)_{\overline{n}|} = \frac{\ddot{s}_{\overline{n}|} - n}{i}$$

$$(I\ddot{s})_{\overline{n}|} = (1+i)^n (I\ddot{a})_{\overline{n}|} = \frac{\ddot{s}_{\overline{n}|} - n}{d} = \frac{i}{d} (Is)_{\overline{n}|}$$

$$(I\bar{s})_{\overline{n}|} = (1+i)^n (I\bar{a})_{\overline{n}|} = \frac{\ddot{s}_{\overline{n}|} - n}{\delta} = \frac{i}{\delta} (Is)_{\overline{n}|}$$

Section 2.8: Annuities with Varying Payments

(B) Decreasing Annuities with Terms in Arithmetic Progression

- An annuity whose n payments are $n, n-1, n-2, \dots, 1$ is called a unit decreasing annuity.
- If payments are made at the end of each period, it is an decreasing annuity-immediate.
- The present value of the decreasing annuity-immediate for n payments is denoted by $(Da)_{\overline{n}|}$

Time	1	2	3	...	...	$n-1$	n
Payments	n	$n-1$	$n-2$	...	...	2	1

Now,

Time	1	2	3	...	$n-2$	$n-1$	n
decreasing annuity-immediate	n	$n-1$	$n-2$	...	3	2	1
increasing annuity-immediate	1	2	3	...	$n-2$	$n-1$	n
Total	$n+1$	$n+1$	$n+1$	...	$n+1$	$n+1$	$n+1$

This implies that $PV = (n+1)a_{\overline{n}|}$ i.e. $(Da)_{\overline{n}|} + (Ia)_{\overline{n}|} = (n+1)a_{\overline{n}|}$.

Section 2.8: Annuities with Varying Payments

We can rearrange that formula and solve for $(Da)_{\overline{n}|}$:

$$\begin{aligned}(Da)_{\overline{n}|} &= (n+1)a_{\overline{n}|} - (Ia)_{\overline{n}|} \\&= (n+1)\frac{1-\nu^n}{i} - \frac{\ddot{a}_{\overline{n}|} - n\nu^n}{i} \\&= \frac{(n+1) - (n+1)\nu^n - \ddot{a}_{\overline{n}|} + n\nu^n}{i} \\&= \frac{(n+1) - \ddot{a}_{\overline{n}|} - \nu^n}{i} = \frac{n - (\ddot{a}_{\overline{n}|} - 1 + \nu^n)}{i} \\&= \frac{n - a_{\overline{n}|}}{i}\end{aligned}$$

Note:

$$\ddot{a}_{\overline{n}|} - 1 + \nu^n = \frac{1-\nu^n}{d} - 1 + \nu^n = \frac{1-\nu^n - d + d\nu^n}{d} = \frac{(1-d) - \nu^n(1-d)}{d} = \frac{(1-d)(1-\nu^n)}{d} = \frac{1-\nu^n}{i} = a_{\overline{n}|}$$

where $\frac{1-d}{d} = \frac{1}{i}$. So, we have

$$(Da)_{\overline{n}|} = \frac{n - a_{\overline{n}|}}{i}$$

Section 2.8: Annuities with Varying Payments

■ For decreasing unit annuity-due, **remember that** $\ddot{a}_{n|} = \frac{i}{d} a_{n|} = (1+i)a_{n|}$.

So we have $(D\ddot{a})_{n|} = \frac{i}{d}(Da)_{n|} = \frac{i}{d} \cdot \frac{n - a_{n|}}{i} = \frac{n - a_{n|}}{d}$

$$(D\ddot{a})_{n|} = \frac{i}{d}(Da)_{n|} = (1+i)(Da)_{n|} = \frac{n - a_{n|}}{d}$$

■ For increasing continuously payable annuity, **remember that** $\bar{a}_{n|} = \frac{i}{\delta} a_{n|}$.

So we have

$$(D\bar{a})_{n|} = \frac{i}{\delta}(Da)_{n|} = \frac{n - a_{n|}}{\delta}$$

Section 2.8: Annuities with Varying Payments

■ The future value of an decreasing unit annuity-immediate is denoted by $(Ds)_{\overline{n}|}$. Remember: $s_{\overline{n}|} = (1+i)^n a_{\overline{n}|}$.

Note: We use the previous relation to find expressions to calculate $(Ds)_{\overline{n}|}$, and for $(D\ddot{s})_{\overline{n}|}$, $(D\bar{s})_{\overline{n}|}$ students can follow same procedure:

$$(Ds)_{\overline{n}|} = (1+i)^n (Da)_{\overline{n}|} = (1+i)^n \frac{n - a_{\overline{n}|}}{i} = \frac{(1+i)^n n - (1+i)^n a_{\overline{n}|}}{i} = \frac{n(1+i)^n - s_{\overline{n}|}}{i}$$

$$(Ds)_{\overline{n}|} = (1+i)^n (Da)_{\overline{n}|} = \frac{n(1+i)^n - s_{\overline{n}|}}{i}$$

$$(D\ddot{s})_{\overline{n}|} = (1+i)^n (D\ddot{a})_{\overline{n}|} = \frac{n(1+i)^n - s_{\overline{n}|}}{d}$$

$$(D\bar{s})_{\overline{n}|} = (1+i)^n (D\bar{a})_{\overline{n}|} = \frac{n(1+i)^n - s_{\overline{n}|}}{\delta}$$

Section 2.8: Annuities with Varying Payments

■ The future value of an decreasing unit annuity-immediate is denoted by $(Ds)_{\overline{n}|}$. **Remember:** $s_{\overline{n}|} = (1+i)^n a_{\overline{n}|}$.

Note: We use the previous relation to find expressions to calculate $(Ds)_{\overline{n}|}$, and for $(D\ddot{s})_{\overline{n}|}$, $(D\bar{a})_{\overline{n}|}$ students can follow same procedure:

$$(Ds)_{\overline{n}|} = (1+i)^n (Da)_{\overline{n}|} = (1+i)^n \frac{n - a_{\overline{n}|}}{i} = \frac{(1+i)^n n - (1+i)^n a_{\overline{n}|}}{i} = \frac{n(1+i)^n - s_{\overline{n}|}}{i}$$

$$(Ds)_{\overline{n}|} = (1+i)^n (Da)_{\overline{n}|} = \frac{n(1+i)^n - s_{\overline{n}|}}{i}$$

$$(D\ddot{s})_{\overline{n}|} = (1+i)^n (D\ddot{a})_{\overline{n}|} = \frac{n(1+i)^n - s_{\overline{n}|}}{d}$$

$$(D\bar{s})_{\overline{n}|} = (1+i)^n (D\bar{a})_{\overline{n}|} = \frac{n(1+i)^n - s_{\overline{n}|}}{\delta}$$

Example. Given $i = 5\%$ and $n = 4$, find $(Da)_{\overline{4}|}$

Section 2.8: Annuities with Varying Payments

■ The future value of an decreasing unit annuity-immediate is denoted by $(Ds)_{\overline{n}|}$. Remember: $s_{\overline{n}|} = (1+i)^n a_{\overline{n}|}$.

Note: We use the previous relation to find expressions to calculate $(Ds)_{\overline{n}|}$, and for $(D\ddot{s})_{\overline{n}|}$, $(D\bar{a})_{\overline{n}|}$ students can follow same procedure:

$$(Ds)_{\overline{n}|} = (1+i)^n (Da)_{\overline{n}|} = (1+i)^n \frac{n - a_{\overline{n}|}}{i} = \frac{(1+i)^n n - (1+i)^n a_{\overline{n}|}}{i} = \frac{n(1+i)^n - s_{\overline{n}|}}{i}$$

$$(Ds)_{\overline{n}|} = (1+i)^n (Da)_{\overline{n}|} = \frac{n(1+i)^n - s_{\overline{n}|}}{i}$$

$$(D\ddot{s})_{\overline{n}|} = (1+i)^n (D\ddot{a})_{\overline{n}|} = \frac{n(1+i)^n - s_{\overline{n}|}}{d}$$

$$(D\bar{s})_{\overline{n}|} = (1+i)^n (D\bar{a})_{\overline{n}|} = \frac{n(1+i)^n - s_{\overline{n}|}}{\delta}$$

Example. Given $i = 5\%$ and $n = 4$, find $(Da)_{\overline{4}|}$

Solution. $(Da)_{\overline{n}|} = \frac{n - a_{\overline{n}|}}{i}$, so for $n = 4$ and $i = 0.05$, we have

$$(Da)_{\overline{4}|} = \frac{4 - a_{\overline{4}|}}{0.05} = \frac{4 - 3.546}{0.05} = 9.08$$

Exercises

Exercise 1. An annuity pays 1 at the end of each of the next four years and 2 at the end of each of the four following years. Based on a 5% annual effective rate, what is the present value of this annuity?

Exercises

Exercise 1. An annuity pays 1 at the end of each of the next four years and 2 at the end of each of the four following years. Based on a 5% annual effective rate, what is the present value of this annuity?

Solution. This sequence of payments can be broken down into an 8-year annuity-immediate with payments of 1, plus a 4-year-deferred annuity-immediate with 4 payments of 1 each:

Time	1	2	3	4	5	6	7	8	Present Value
Payments	1	1	1	1	1	1	1	1	$a_{\overline{8} } = \frac{1-\nu^8}{0.05}$ $\nu^4 \cdot a_{\overline{4} } = \nu^4 \cdot \frac{1-\nu^4}{0.05}$
Total	1	1	1	1	2	2	2	2	$a_{\overline{8} } + \nu^4 \cdot a_{\overline{4} }$

$$a_{\overline{8}|} + \nu^4 \cdot a_{\overline{4}|} = \frac{1-\nu^8}{0.05} + \nu^4 \cdot \frac{1-\nu^4}{0.05} = 9.38$$

■ Another approach is to analyze this series of payments:

a 4-year annuity-immediate with payments of 1, plus a 4-year-deferred annuity-immediate with 4 payments of 2 each:

$$a_{\overline{4}|} + \nu^4 \cdot 2a_{\overline{4}|} = \frac{1-\nu^4}{0.05} + 2\nu^4 \cdot \frac{1-\nu^4}{0.05} = 9.38$$

Exercises

Exercise 2. An annuity pays 100 at the end of each of the next 10 years and 200 at the end of each of the five subsequent years. If $i = 0.08$, find the present value of the annuity.

Exercises

Exercise 2. An annuity pays 100 at the end of each of the next 10 years and 200 at the end of each of the five subsequent years. If $i = 0.08$, find the present value of the annuity.

Solution. This sequence of payments can be broken down into an 10-year annuity-immediate with payments of 100, plus a 5-year-deferred annuity-immediate with 5 payments of 100 each:

Time	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	Present Value
Payments	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	$100a_{\overline{15} }$
											100	100	100	100	100	$100\nu^{10} \cdot a_{\overline{5} }$
Total	100	100	100	100	100	100	100	100	100	100	200	200	200	200	200	$100(a_{\overline{15} } + \nu^{10} \cdot a_{\overline{5} })$

$$100(a_{\overline{15}|} + \nu^{10} \cdot a_{\overline{5}|}) = 100 \frac{1 - \nu^{15}}{0.08} + 100\nu^{10} \cdot \frac{1 - \nu^5}{0.08} = 1,040.89$$

■ Another approach is to analyze this series of payments:

a 10-year annuity-immediate with payments of 100, plus a 10-year-deferred annuity-immediate with 5 payments of 200 each:

$$100a_{\overline{10}|} + \nu^{10} \cdot 200a_{\overline{5}|} = 100 \frac{1 - \nu^{10}}{0.08} + 200\nu^{10} \cdot \frac{1 - \nu^5}{0.08} = 1,040.89$$

Exercises

Exercise 3. An annuity-immediate has a first payment of 100, and the payments increase by 100 each year until they reach 500. There are 10 further payments of 500. Find the present value of this annuity at 6.5%.

Exercises

Exercise 3. An annuity-immediate has a first payment of 100, and the payments increase by 100 each year until they reach 500. There are 10 further payments of 500. Find the present value of this annuity at 6.5%.

Solution.

Time	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Payments	100	200	300	400	500	500	500	500	500	500	500	500	500	500	500
	$100(la)_{\overline{5} }$					$\nu^5 \cdot 500 \cdot a_{\overline{10} }$									

$$PV = 100(la)_{\overline{5}|} + \nu^5 \cdot 500 \cdot a_{\overline{10}|} = 100(11.9445) + (0.7299)(500)(7.1888) = 3,817.95$$

Exercises

Exercise 3. An annuity-immediate has a first payment of 100, and the payments increase by 100 each year until they reach 500. There are 10 further payments of 500. Find the present value of this annuity at 6.5%.

Solution.

Time	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Payments	100	200	300	400	500	500	500	500	500	500	500	500	500	500	500
	$100(la)_{\overline{5} }$					$\nu^5 \cdot 500 \cdot a_{\overline{10} }$									

$$PV = 100(la)_{\overline{5}|} + \nu^5 \cdot 500 \cdot a_{\overline{10}|} = 100(11.9445) + (0.7299)(500)(7.1888) = 3,817.95$$

Exercise 4. An annuity-immediate has 5 annual payments of 100, followed by a perpetuity of 200 starting in the 6th year. Find the present value at 8%.

Exercises

Exercise 3. An annuity-immediate has a first payment of 100, and the payments increase by 100 each year until they reach 500. There are 10 further payments of 500. Find the present value of this annuity at 6.5%.

Solution.

Time	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Payments	100	200	300	400	500	500	500	500	500	500	500	500	500	500	500
	$100(1a)_{\overline{5} }$					$\nu^5 \cdot 500 \cdot a_{\overline{10} }$									

$$PV = 100(1a)_{\overline{5}|} + \nu^5 \cdot 500 \cdot a_{\overline{10}|} = 100(11.9445) + (0.7299)(500)(7.1888) = 3,817.95$$

Exercise 4. An annuity-immediate has 5 annual payments of 100, followed by a perpetuity of 200 starting in the 6th year. Find the present value at 8%.

Solution.

Time	1	2	3	4	5	6	7	8	...
Payments	100	100	100	100	100	200	200	...	...
	$100a_{\overline{5} }$					$\nu^5 \cdot 200 \cdot a_{\infty } = \nu^5 \cdot 200 \cdot \frac{1}{i}$			

$$PV = 100a_{\overline{5}|} + \nu^5 \cdot 200 \cdot a_{\infty|} = 399.271 + 1701.458 = 2100.73$$

Exercises

Exercise 5. An annuity-immediate has a first payment of 100, and the payments increase by 100 each year until they reach 500. Find the present value of this annuity at 6.5%.

Exercises

Exercise 5. An annuity-immediate has a first payment of 100, and the payments increase by 100 each year until they reach 500. Find the present value of this annuity at 6.5%.

Solution.

Time	1	2	3	4	5
Payments	100	200	300	400	500

The present value of this cashflow is

$$PV = 100(1a)_{\overline{5}|} = 100(11.9445) = 1194.45$$

Exercises

Exercise 5. An annuity-immediate has a first payment of 100, and the payments increase by 100 each year until they reach 500. Find the present value of this annuity at 6.5%.

Solution.

Time	1	2	3	4	5
Payments	100	200	300	400	500

The present value of this cashflow is

$$PV = 100(la)_{\overline{5}|} = 100(11.9445) = 1194.45$$

Exercise 6. Find the present value of a 15year decreasing annuity-immediate paying 150000 the first year and decreasing by 10000 each year thereafter. The effective annual interest rate of 4.5%.

Exercises

Exercise 5. An annuity-immediate has a first payment of 100, and the payments increase by 100 each year until they reach 500. Find the present value of this annuity at 6.5%.

Solution.

Time	1	2	3	4	5
Payments	100	200	300	400	500

The present value of this cashflow is

$$PV = 100(1a)_{\overline{5}|} = 100(11.9445) = 1194.45$$

Exercise 6. Find the present value of a 15year decreasing annuity-immediate paying 150000 the first year and decreasing by 10000 each year thereafter. The effective annual interest rate of 4.5%.

Solution. The cashflow of payments is

Time	1	2	3	...	15
Payments	(15) (10000)	(14) (10000)	(13) (10000)	...	(1) (10000)

The present value of this cashflow is

$$PV = 10000(Da)_{\overline{15}|} = (10000)(94.6767616) = 946767.616$$

Section 2.9: A Single Formula for Annuities with Terms in Arithmetic Progression

Suppose the first payment in an annuity-immediate is P and the subsequent payments change by Q per period, where Q can be either positive or negative. If the annuity has n payments, the sequence of payments is:

$$P, P + Q, P + 2Q, \dots, P + (n - 1)Q$$

We find the present value for this sequence of payments:

Time	1	2	3	...	n	Present Value
Payments	P	P	P	...	P	$Pa_{\overline{n} i}$
		Q	Q	...	Q	$\nu \cdot Q \cdot a_{\overline{n-1} i} = \nu \cdot Q \cdot \frac{1-\nu^{n-1}}{i} = Q \cdot \frac{\nu-\nu^n}{i}$
			Q	...	Q	$\nu^2 \cdot Q \cdot a_{\overline{n-2} i} = \nu^2 \cdot Q \cdot \frac{1-\nu^{n-2}}{i} = Q \cdot \frac{\nu^2-\nu^n}{i}$
						...
					Q	$\nu^{n-1} \cdot Q \cdot a_{\overline{1} i} = \nu^{n-1} \cdot Q \cdot \frac{1-\nu}{i} = Q \cdot \frac{\nu^{n-1}-\nu^n}{i}$
Total	P	$P+Q$	$P+2Q$	...	$P + (n - 1)Q$	$Pa_{\overline{n} i} + Q \frac{\sum_{t=1}^n \nu^t - n\nu^n}{i} = Pa_{\overline{n} i} + Q \left(\frac{a_{\overline{n} i} - n\nu^n}{i} \right)$ add $Q \frac{\nu^n - \nu^n}{i}$

The present value of this annuity is:

$$PV = Pa_{\overline{n}|i} + Q \left(\frac{a_{\overline{n}|i} - n\nu^n}{i} \right)$$

Section 2.9: A Single Formula for Annuities with Terms in Arithmetic Progression

■ Another approach to find the present value for the previous sequence of payments is as follows:

$$P, P + Q, P + 2Q, \dots, P + (n - 1)Q$$

Time	1	2	3	4	...	n	Present Value
Payments	P	P	P	P	...	P	$Pa_{\overline{n} }$
		Q	$2Q$	$3Q$	...	$(n - 1)Q$	$Q \cdot \nu \cdot (Ia)_{\overline{n-1} }$

$$\begin{aligned}
 PV &= Pa_{\overline{n}|} + Q \cdot \nu \cdot (Ia)_{\overline{n-1}|} \\
 &= Pa_{\overline{n}|} + Q \cdot \nu \cdot \frac{\ddot{a}_{\overline{n-1}|} - (n-1)\nu^{n-1}}{i} \\
 &= Pa_{\overline{n}|} + Q \cdot \frac{a_{\overline{n-1}|} - (n-1)\nu^n}{i} \quad \nu \cdot \ddot{a}_{\overline{n-1}|} = \nu \frac{1 - \nu^{n-1}}{d} = \frac{\nu}{d}(1 - \nu^{n-1}) = \frac{1 - \nu^n}{i} = a_{\overline{n-1}|} \\
 &= Pa_{\overline{n}|} + Q \cdot \frac{a_{\overline{n-1}|} - n\nu^n + \nu^n}{i} \\
 &= Pa_{\overline{n}|} + Q \cdot \left(\frac{a_{\overline{n}|} - n\nu^n}{i} \right) \quad a_{\overline{n-1}|} + \nu^n = \frac{1 - \nu^{n-1}}{i} + \nu^n = \frac{1 - \nu^n(\nu^{-1} - i)}{i} = \frac{1 - \nu^n(1 + i - i)}{i} = a_{\overline{n}|}
 \end{aligned}$$

Section 2.9: A Single Formula for Annuities with Terms in Arithmetic Progression

Notes. For the formula: $PV = Pa_{\overline{n}|} + Q\left(\frac{a_{\overline{n}|} - n\nu^n}{i}\right)$,

■ In the previous formula, if $P = 1$ and $Q = 1$, then we have **the present value of the unit increasing annuity-immediate**

$$\begin{aligned} PV &= a_{\overline{n}|} + \frac{a_{\overline{n}|} - n\nu^n}{i} = \frac{i a_{\overline{n}|} + a_{\overline{n}|} - n\nu^n}{i} \\ &= \frac{(1+i)a_{\overline{n}|} - n\nu^n}{i} \\ &= \frac{\ddot{a}_{\overline{n}|} - n\nu^n}{i} \quad \text{Remember: } \ddot{a}_{\overline{n}|} = (1+i)a_{\overline{n}|} \\ &= (Ia)_{\overline{n}|} \end{aligned}$$

■ In the previous formula, if $P = n$ and $Q = -1$, then we have **the present value of the unit decreasing annuity-immediate**

$$\begin{aligned} PV &= na_{\overline{n}|} - \frac{a_{\overline{n}|} - n\nu^n}{i} = \frac{i n a_{\overline{n}|} - a_{\overline{n}|} + n\nu^n}{i} \\ &= \frac{n(ia_{\overline{n}|} + \nu^n) - a_{\overline{n}|}}{i} \\ &= \frac{n(1 - \nu^n + \nu^n) - a_{\overline{n}|}}{i} \quad \text{Note: } ia_{\overline{n}|} = i \frac{1 - \nu^n}{i} = 1 - \nu^n \\ &= \frac{n - a_{\overline{n}|}}{i} = (Da)_{\overline{n}|} \end{aligned}$$

Section 2.9: A Single Formula for Annuities with Terms in Arithmetic Progression

■ The present value of an increasing perpetuity-immediate of the form $P, P + Q, P + 2Q, \dots$:

$$\begin{aligned}\lim_{n \rightarrow \infty} PV &= \lim_{n \rightarrow \infty} P a_{\overline{n}|} + Q \left(\frac{a_{\overline{n}|} - n v^n}{i} \right) \\ &= P a_{\overline{\infty}|} + Q \left(\frac{a_{\overline{\infty}|} - 0}{i} \right) \\ &= \frac{P}{i} + Q \left(\frac{\frac{1}{i}}{i} \right) = \frac{P}{i} + \frac{Q}{i^2}\end{aligned}$$

■ To develop a formula for the future value of the annuity at time n , we can multiply the present value by $(1 + i)^n$ as follows:

$$\begin{aligned}(1 + i)^n PV &= P (1 + i)^n a_{\overline{n}|} + Q \left(\frac{(1 + i)^n a_{\overline{n}|} - n(1 + i)^n v^n}{i} \right) \\ FV &= P s_{\overline{n}|} + Q \left(\frac{s_{\overline{n}|} - n}{i} \right)\end{aligned}$$

The future value of this annuity is:

$$FV = P s_{\overline{n}|} + Q \left(\frac{s_{\overline{n}|} - n}{i} \right)$$

Section 2.9: A Single Formula for Annuities with Terms in Arithmetic Progression

For annuity-due, suppose the first payment is P and the subsequent payments change by Q per period, where Q can be either positive or negative. If the annuity has n payments, the sequence of payments is: $P, P + Q, P + 2Q, \dots, P + (n - 1)Q$:

Time	0	1	2	3	...	$n - 1$	Present Value
Payments	P	P	P	P	...	P	$P\ddot{a}_{\overline{n} }$
		Q	$2Q$	$3Q$	...	$(n - 1)Q$	$Q \cdot \nu \cdot (I\ddot{a})_{\overline{n-1} }$

$$PV = P\ddot{a}_{\overline{n}|} + Q \cdot \nu \cdot (I\ddot{a})_{\overline{n-1}|}$$

$$= P\ddot{a}_{\overline{n}|} + Q \cdot \nu \cdot \frac{\ddot{a}_{\overline{n-1}|} - (n-1)\nu^{n-1}}{d}$$

$$= P\ddot{a}_{\overline{n}|} + Q \cdot \frac{\ddot{a}_{\overline{n-1}|} - (n-1)\nu^n}{d} \quad \nu \cdot \ddot{a}_{\overline{n-1}|} = \nu \frac{1 - \nu^{n-1}}{d} = \frac{\nu}{d}(1 - \nu^{n-1}) = \frac{1 - \nu^n}{i} = \ddot{a}_{\overline{n-1}|}$$

$$= P\ddot{a}_{\overline{n}|} + Q \cdot \frac{\ddot{a}_{\overline{n-1}|} - n\nu^n + \nu^n}{d}$$

$$= P\ddot{a}_{\overline{n}|} + Q \cdot \left(\frac{\ddot{a}_{\overline{n-1}|} - n\nu^n}{d} \right) \quad \ddot{a}_{\overline{n-1}|} + \nu^n = \frac{1 - \nu^{n-1}}{i} + \nu^n = \frac{1 - \nu^n(\nu^{-1} - i)}{i} = \frac{1 - \nu^n(1 + i - i)}{i} = \ddot{a}_{\overline{n}|}$$

The present value of this annuity is:

$$PV = P\ddot{a}_{\overline{n}|} + Q \cdot \left(\frac{\ddot{a}_{\overline{n-1}|} - n\nu^n}{d} \right)$$

Section 2.9: A Single Formula for Annuities with Terms in Arithmetic Progression

■ Another approach to find the present value for the previous sequence of payments is as follows:

We know that

$$\ddot{a}_{n|} = (1+i)a_{n|}$$

and the present value for the annuity-immediate:

$$PV = Pa_{n|} + Q\left(\frac{a_{n|} - nv^n}{i}\right)$$

This implies that the present value for annuity-due

$$PV = P(1+i)a_{n|} + Q(1+i)\frac{a_{n|} - nv^n}{i}$$

Hence,

$$PV = P\ddot{a}_{n|} + Q\frac{a_{n|} - nv^n}{d} \quad d = \frac{i}{1+i}$$

Section 2.9: A Single Formula for Annuities with Terms in Arithmetic Progression

Notes:

■ In the previous formula, if $P = 1$ and $Q = 1$, then we have present value of the unit increasing annuity-due

$$\begin{aligned}
 PV &= \ddot{a}_{n|} + \frac{a_{n|} - n\nu^n}{d} = \frac{d \ddot{a}_{n|} + a_{n|} - n\nu^n}{d} \\
 &= \frac{d\ddot{a}_{n|} + \nu \cdot \ddot{a}_{n|} - n\nu^n}{d} & a_{n|} &= \nu \cdot \ddot{a}_{n|} \\
 &= \frac{\ddot{a}_{n|}(d + \nu) - n\nu^n}{d} \\
 &= \frac{\ddot{a}_{n|} - n\nu^n}{d} & \text{Note: } d + \nu &= \frac{i}{1+i} + \frac{1}{1+i} = \frac{1+i}{1+i} = 1 \\
 &= (I\ddot{a})_{n|}
 \end{aligned}$$

■ In the previous formula, if $P = n$ and $Q = -1$, then we have present value of the unit decreasing annuity-due

$$\begin{aligned}
 PV &= n\ddot{a}_{n|} - \frac{a_{n|} - n\nu^n}{d} = \frac{d n \ddot{a}_{n|} - a_{n|} + n\nu^n}{d} \\
 &= \frac{n(d\ddot{a}_{n|} + \nu^n) - a_{n|}}{d} \\
 &= \frac{n - a_{n|}}{d} = (D\ddot{a})_{n|} & \text{Note: } d\ddot{a}_{n|} + \nu^n &= d \frac{1 - \nu^n}{d} + \nu^n = 1
 \end{aligned}$$

Section 2.9: A Single Formula for Annuities with Terms in Arithmetic Progression

■ The present value of an increasing perpetuity-due of the form $P, P + Q, P + 2Q, \dots$:

$$\begin{aligned}\lim_{n \rightarrow \infty} PV &= \lim_{n \rightarrow \infty} P \ddot{a}_{\overline{n}|} + Q \left(\frac{\ddot{a}_{\overline{n}|} - n \nu^n}{d} \right) \\ &= P \ddot{a}_{\overline{\infty}|} + Q \left(\frac{\ddot{a}_{\overline{\infty}|} - 0}{d} \right) \\ &= \frac{P}{d} + Q \left(\frac{1}{d} \right) = \frac{P}{d} + \frac{Q}{id}\end{aligned}$$

■ To develop a formula for the future value of the annuity at time n , we can multiply the present value by $(1 + i)^n$ as follows:

$$\begin{aligned}(1 + i)^n PV &= P (1 + i)^n \ddot{a}_{\overline{n}|} + Q \left(\frac{(1 + i)^n \ddot{a}_{\overline{n}|} - n(1 + i)^n \nu^n}{d} \right) \\ FV &= P \ddot{s}_{\overline{n}|} + Q \left(\frac{\ddot{s}_{\overline{n}|} - n}{d} \right)\end{aligned}$$

The future value of this annuity is:

$$FV = P \ddot{s}_{\overline{n}|} + Q \left(\frac{\ddot{s}_{\overline{n}|} - n}{d} \right)$$

Section 2.9: A Single Formula for Annuities with Terms in Arithmetic Progression

Exercise 3. A 10-year annuity-immediate has a first-year payment of 500. The subsequent payments increase by 100 each year. Find the present value of this annuity based on an annual effective rate of 5%.

Section 2.9: A Single Formula for Annuities with Terms in Arithmetic Progression

Exercise 3. A 10-year annuity-immediate has a first-year payment of 500. The subsequent payments increase by 100 each year. Find the present value of this annuity based on an annual effective rate of 5%.

Solution.

$$PV = Pa_{\overline{n}|i} + Q \left(\frac{a_{\overline{n}|i} - n\nu^n}{i} \right)$$

where $n = 10$, $i = 0.05$, $P = 500$, $Q = 100$.

$$PV = 500 \frac{1 - (1.05)^{-10}}{0.05} + 100 \left(\frac{\frac{1 - (1.05)^{-10}}{0.05} - \frac{10}{1.05}}{0.05} \right) = 7,026.07$$

Section 2.10: Annuities with Terms in Geometric Progression

■ A **geometric annuity** is an annuity where the payments increase geometrically with a common ratio.

For example, consider the sequence of three payments 1, 1.05, $1.1025 = (1.05)^2$ made at the end of the years 1, 2, 3:

Time	0	1	2	3
Payments		1	1.05	$(1.05)^2$

■ The payments increase geometrically with a common ratio of 1.05: $\frac{1.05}{1} = \frac{(1.05)^2}{1.05}$

■ The payments increase geometrically with a growth rate $g = 0.05$: 1, $(1 + 0.05)$, $(1 + 0.05)^2$

■ More generally, we can consider an n -year geometric annuity-immediate with growth rate g . Its payments are $1, (1 + g), (1 + g)^2, (1 + g)^3, \dots, (1 + g)^{n-1}$.

■ The present value is represented by the symbol $a_{\overline{n}|i}^g$ or $a_{\overline{n}|}^g$. Sometimes present value is represented by the symbol $(Ga)_{\overline{n}|i,r}$

■ The first payment in the geometric series is 1.

■ The annual rate of change, g , can be either positive or negative, reflecting payments that increase or decrease geometrically.

Section 2.10: Annuities with Terms in Geometric Progression

Now, we have the following cashflow:

Time	1	2	3	...	n
Payments	1	$(1+g)$	$(1+g)^2$	...	$(1+g)^{n-1}$

■ We can express the present value of a **geometric annuity-immediate** as follows:

$$\begin{aligned} a_{\overline{n}|i}^g &= \frac{1}{1+i} + \frac{(1+g)}{(1+i)^2} + \frac{(1+g)^2}{(1+i)^3} + \dots + \frac{(1+g)^{n-1}}{(1+i)^n} \\ &= \frac{1}{1+i} \left[1 + \left(\frac{1+g}{1+i} \right) + \left(\frac{1+g}{1+i} \right)^2 + \dots + \left(\frac{1+g}{1+i} \right)^{n-1} \right] \\ &= \frac{1}{1+i} \frac{1 - \left(\frac{1+g}{1+i} \right)^n}{1 - \left(\frac{1+g}{1+i} \right)} \quad \text{we apply the formula: } \frac{1-r^n}{1-r} \text{ for } r = \frac{(1+g)}{(1+i)} \\ &= \frac{1}{1+i} \frac{1 - \left(\frac{1+g}{1+i} \right)^n}{\frac{(1+i) - (1+g)}{1+i}} = \frac{1 - \left(\frac{1+g}{1+i} \right)^n}{i - g} \end{aligned}$$

$$a_{\overline{n}|i}^g = \frac{1 - \left(\frac{1+g}{1+i} \right)^n}{i - g}$$

Section 2.10: Annuities with Terms in Geometric Progression

Notes:

■ If $g = 0$, then $a_{n|}^g = \frac{1-\nu^n}{i} = a_{n|}$

■ If $g = i$,

$$\begin{aligned} a_{n|}^g &= \frac{1}{1+i} \left[1 + \left(\frac{1+g}{1+i} \right) + \left(\frac{1+g}{1+i} \right)^2 + \cdots + \left(\frac{1+g}{1+i} \right)^{n-1} \right] \\ &= \frac{1}{1+i} [1 + 1 + 1 + \cdots + 1] = \frac{n}{1+i} \end{aligned}$$

■ For geometric annuities—due:

$$\begin{aligned} \ddot{a}_{n|}^g &= (1+i)a_{n|}^g = (1+i) \frac{1 - \left(\frac{1+g}{1+i} \right)^n}{i - g} \\ &= \frac{1}{\nu} \cdot \frac{1 - \left(\frac{1+g}{1+i} \right)^n}{i - g} \quad \nu = \frac{1}{1+i} \Rightarrow \frac{1}{\nu} = 1+i \\ &= \frac{1 - \left(\frac{1+g}{1+i} \right)^n}{i\nu - g \cdot \nu} \\ &= \frac{1 - \left(\frac{1+g}{1+i} \right)^n}{d - g \cdot \nu} \quad i\nu = d \end{aligned}$$

Section 2.10: Annuities with Terms in Geometric Progression

■ For the future values of geometric annuities:

$$\begin{aligned} s_{\overline{n}|}^g &= (1+i)^n \cdot a_{\overline{n}|}^g = (1+i)^n \cdot \frac{1 - \left(\frac{1+g}{1+i}\right)^n}{i-g} \\ &= \frac{(1+i)^n - (1+g)^n}{i-g} \end{aligned}$$

and

$$\begin{aligned} \ddot{s}_{\overline{n}|}^g &= (1+i)^n \cdot \ddot{a}_{\overline{n}|}^g = (1+i)^n \cdot \frac{1 - \left(\frac{1+g}{1+i}\right)^n}{d-g \cdot v} \\ &= \frac{(1+i)^n - (1+g)^n}{d-g \cdot v} \end{aligned}$$

■ For the perpetuity, (1) annuity-immediate

$$\begin{aligned} \lim_{n \rightarrow \infty} a_{\overline{n}|}^g &= \lim_{n \rightarrow \infty} \frac{1 - \left(\frac{1+g}{1+i}\right)^n}{i-g} \\ a_{\infty|}^g &= \frac{1-0}{i-g} = \frac{1}{i-g} \text{ for } i > g \end{aligned}$$

If $g \geq i$, the present value of the perpetuity is infinite.

Section 2.10: Annuities with Terms in Geometric Progression

(2) annuity-due

$$\lim_{n \rightarrow \infty} \ddot{a}_{n|}^g = \lim_{n \rightarrow \infty} \frac{1 - \left(\frac{1+g}{1+i}\right)^n}{d - g \cdot \nu} \Rightarrow \ddot{a}_{\infty|}^g = \frac{1 - 0}{d - g \cdot \nu} = \frac{1}{d - g \cdot \nu} \text{ for } i > g$$

(1) geometric annuity-immediate

$$a_{n|}^g = \frac{1 - \left(\frac{1+g}{1+i}\right)^n}{i - g} \text{ and } s_{n|}^g = \frac{(1+i)^n - (1+g)^n}{i - g}$$

$$\text{If } g = 0, a_{n|}^g = \frac{1 - \nu^n}{i} = a_{n|} \text{ and if } g = i, a_{n|}^g = \frac{n}{1+i}$$

(2) geometric annuity-due

$$\ddot{a}_{n|}^g = \frac{1 - \left(\frac{1+g}{1+i}\right)^n}{d - g \cdot \nu} \text{ and } \ddot{s}_{n|}^g = \frac{(1+i)^n - (1+g)^n}{d - g \cdot \nu}$$

$$\text{For } i > g, \ddot{a}_{\infty|}^g = \frac{1}{i - g} \text{ and } \ddot{a}_{\infty|}^g = \frac{1}{d - g \cdot \nu}$$

Section 2.10: Annuities with Terms in Geometric Progression

For an annuity-immediate or for future values, you must first calculate the present value of the annuity-due, and then adjust it by the appropriate interest factor, using $(1 + i)$:

(1)

$$\begin{aligned}\frac{\ddot{a}_{n|}^g}{1+i} &= \frac{1 - \left(\frac{1+g}{1+i}\right)^n}{(1+i)d - (1+i)g \cdot \nu} \\ &= \frac{1 - \left(\frac{1+g}{1+i}\right)^n}{(1+i)\frac{i}{1+i} - g} \\ &= \frac{1 - \left(\frac{1+g}{1+i}\right)^n}{i - g} = \ddot{a}_{n|}^g\end{aligned}$$

(2)

$$\begin{aligned}(1+i)^{n-1} \cdot \ddot{a}_{n|}^g &= \frac{(1+i)^{n-1} - \frac{(1+g)^n}{1+i}}{d - g \cdot \nu} \\ &= \frac{\frac{(1+i)^n - (1+g)^n}{(1+i)}}{d - g \cdot \nu} \\ &= \frac{(1+i)^n - (1+g)^n}{(1+i) \cdot d - (1+i)g \cdot \nu} \\ &= \frac{(1+i)^n - (1+g)^n}{i - g} = s_{n|}^g\end{aligned}$$

Section 2.10: Annuities with Terms in Geometric Progression

(3)

$$\begin{aligned}(1+i)^n \cdot \ddot{a}_{n|}^g &= \frac{(1+i)^n - (1+i)^n \cdot \left(\frac{1+g}{1+i}\right)^n}{d - g \cdot v} \\ &= \frac{(1+i)^n - (1+g)^n}{d - g \cdot v} = \ddot{s}_{n|}^g\end{aligned}$$

$$a_{n|}^g = \frac{\ddot{a}_{n|}^g}{1+i}$$

$$s_{n|}^g = (1+i)^{n-1} \cdot \ddot{s}_{n|}^g$$

$$\dot{s}_{n|}^g = (1+i)^n \cdot \ddot{s}_{n|}^g$$

Example. Given $i = 10\%$, find the present value of the sequence of payments: $1.05, (1.05)^2, \dots, (1.05)^{10}$. Payments are made at the beginning of each year.

Section 2.10: Annuities with Terms in Geometric Progression

(3)

$$\begin{aligned}(1+i)^n \cdot \ddot{a}_{n|}^g &= \frac{(1+i)^n - (1+i)^n \cdot \left(\frac{1+g}{1+i}\right)^n}{d - g \cdot v} \\ &= \frac{(1+i)^n - (1+g)^n}{d - g \cdot v} = \ddot{s}_{n|}^g\end{aligned}$$

$$\ddot{a}_{n|}^g = \frac{\ddot{a}_{n|}}{1+i}$$

$$\ddot{s}_{n|}^g = (1+i)^{n-1} \cdot \ddot{a}_{n|}^g$$

$$\ddot{s}_{n|}^g = (1+i)^n \cdot \ddot{a}_{n|}^g$$

Example. Given $i = 10\%$, find the present value of the sequence of payments: $1.05, (1.05)^2, \dots, (1.05)^{10}$. Payments are made at the beginning of each year.

Solution. Note that this series starts with 1.05, not 1, and that payments are made at the beginning of each period with $g = 0.05$.

$$(1.05) \cdot \ddot{a}_{10|0.10}^{0.05} = (1.05) \cdot \frac{1 - \left(\frac{1.05}{1.10}\right)^{10}}{\frac{0.10}{1.10} - \frac{0.05}{1.10}} = 8.59$$

Section 2.10: Annuities with Terms in Geometric Progression

Example. You want to save 1,000,000 for retirement. You plan to make annual deposits at the beginning of each year into an account that earns an annual effective rate of 7.5%. You will increase the amount of your deposit each year by 4%. If you plan to retire in 40 years, what should be the amount of your first deposit?

Section 2.10: Annuities with Terms in Geometric Progression

Example. You want to save 1,000,000 for retirement. You plan to make annual deposits at the beginning of each year into an account that earns an annual effective rate of 7.5%. You will increase the amount of your deposit each year by 4%. If you plan to retire in 40 years, what should be the amount of your first deposit?

Solution. Let P be the amount of the first deposit.

$$\begin{aligned}FV &= P \cdot \ddot{s}_{\overline{n}|}^g = P \cdot \frac{(1+i)^n - (1+g)^n}{d - g \cdot v} \\1,000,000 &= P \cdot \ddot{s}_{\overline{40}|0.075}^{0.04} = P \cdot \frac{(1.075)^{40} - (1.04)^{10}}{\frac{0.075}{1.075} - \frac{0.04}{1.075}} \\1,000,000 &= P(406.756) \\\Rightarrow P &= \frac{1,000,000}{406.756} = 2,458.48.\end{aligned}$$

Section 2.10: Annuities with Terms in Geometric Progression

Example. You want to save 1,000,000 for retirement. You plan to make annual deposits at the beginning of each year into an account that earns an annual effective rate of 7.5%. You will increase the amount of your deposit each year by 4%. If you plan to retire in 40 years, what should be the amount of your first deposit?

Solution. Let P be the amount of the first deposit.

$$\begin{aligned}FV &= P \cdot \ddot{s}_{\overline{n}|}^g = P \cdot \frac{(1+i)^n - (1+g)^n}{d - g \cdot v} \\1,000,000 &= P \cdot \ddot{s}_{\overline{40}|0.075}^{0.04} = P \cdot \frac{(1.075)^{40} - (1.04)^{10}}{\frac{0.075}{1.075} - \frac{0.04}{1.075}} \\1,000,000 &= P(406.756) \\\Rightarrow P &= \frac{1,000,000}{406.756} = 2,458.48.\end{aligned}$$

Example. An annuity provides for 10 annual payments, the first payment a year hence being \$2600. The payments increase in such a way that each payment is 3% greater than the previous one. The annual effective rate of interest is 4%. Find the present value of this annuity.

Section 2.10: Annuities with Terms in Geometric Progression

Example. You want to save 1,000,000 for retirement. You plan to make annual deposits at the beginning of each year into an account that earns an annual effective rate of 7.5%. You will increase the amount of your deposit each year by 4%. If you plan to retire in 40 years, what should be the amount of your first deposit?

Solution. Let P be the amount of the first deposit.

$$\begin{aligned}FV &= P \cdot \ddot{s}_{\overline{n}|i}^g = P \cdot \frac{(1+i)^n - (1+g)^n}{d - g \cdot v} \\1,000,000 &= P \cdot \frac{\ddot{s}_{\overline{40}|0.075}^{0.04}}{\frac{0.075}{1.075} - \frac{0.04}{1.075}} = P \cdot \frac{(1.075)^{40} - (1.04)^{10}}{\frac{0.075}{1.075} - \frac{0.04}{1.075}} \\1,000,000 &= P(406.756) \\\Rightarrow P &= \frac{1,000,000}{406.756} = 2,458.48.\end{aligned}$$

Example. An annuity provides for 10 annual payments, the first payment a year hence being \$2600. The payments increase in such a way that each payment is 3% greater than the previous one. The annual effective rate of interest is 4%. Find the present value of this annuity.

Solution. Let P be the first payment.

$$\begin{aligned}PV &= P \cdot a_{\overline{n}|i}^g = P \cdot \frac{1 - \left(\frac{1+g}{1+i}\right)^n}{i - g} \\PV &= (2600) \cdot \frac{a_{\overline{10}|0.04}^{0.03}}{\frac{0.04}{1.04} - \frac{0.03}{1.04}} = (2600) \cdot \frac{1 - \left(\frac{1.03}{1.04}\right)^{10}}{0.04 - 0.03} \\&= 23945.54454\end{aligned}$$

Section 2.10: Annuities with Terms in Geometric Progression

Example. Given $i = 10\%$, find the present value of the payments: (1.05) , $(1.05)^2$, $(1.05)^3$, $\dots$
if a) the payments are made at the end of the period, and
b) the payments are made at the beginning of the period.

Section 2.10: Annuities with Terms in Geometric Progression

Example. Given $i = 10\%$, find the present value of the payments: (1.05) , $(1.05)^2$, $(1.05)^3$, $\dots$
if a) the payments are made at the end of the period, and

b) the payments are made at the beginning of the period.

Solution. We have $i = 10\%$, $g = 5\%$ and $P = 1.05$.

a) $PV = P \cdot \frac{1}{i-g} = (1.05) \frac{1}{0.01-0.05} = 21$

b) $PV = P \cdot \frac{1}{d-g \cdot v} = (1.05) \frac{1}{\frac{0.01}{1+0.01} - 0.05 \cdot \frac{1}{1+0.01}} = 23.1$

Section 2.11: Annuities With More Complex Payment Patterns

Example. You will make 3 deposits of 10,000 each into a bank account, at the beginning of this year and the following two years. At the end of two years, you will retire and want to withdraw a level payment P starting at the beginning of year 4 and continuing for five years. The account pays interest at an annual effective rate $i = 8\%$. What is the amount of the level payment P ?

Section 2.11: Annuities With More Complex Payment Patterns

Example. You will make 3 deposits of 10,000 each into a bank account, at the beginning of this year and the following two years. At the end of two years, you will retire and want to withdraw a level payment P starting at the beginning of year 4 and continuing for five years. The account pays interest at an annual effective rate $i = 8\%$. What is the amount of the level payment P ?

Solution.

Time	0	1	2	3	4	5	6	7
Contribution	10,000	10,000	10,000	P	P	P	P	P

To solve this example, we equate the present values for both payments at time $t = 0$:

$$10,000\ddot{a}_{\overline{3}|} = \nu^3 P\ddot{a}_{\overline{5}|}$$
$$\Rightarrow P = \frac{10,000\ddot{a}_{\overline{3}|}}{\nu^3 P\ddot{a}_{\overline{5}|}} = 8,130.82$$

Section 2.11: Annuities With More Complex Payment Patterns

Example. You will make 3 deposits of 10,000 each into a bank account, at the beginning of this year and the following two years. At the end of two years, you will retire and want to withdraw a level payment P starting at the end of the 4th year and continue for ten years. The account pays interest at an annual effective rate $i = 8\%$. What is the amount of the level payment P ?

Section 2.11: Annuities With More Complex Payment Patterns

Example. You will make 3 deposits of 10,000 each into a bank account, at the beginning of this year and the following two years. At the end of two years, you will retire and want to withdraw a level payment P starting at the end of the 4th year and continue for ten years. The account pays interest at an annual effective rate $i = 8\%$. What is the amount of the level payment P ?

Solution.

Time	0	1	2	3	4	5	6	7	8	9	10	11	12	13
Contribution	10,000	10,000	10,000		P	P	P	P	P	P	P	P	P	P

To solve this example, we equate the present values for both payments at time $t = 0$:

$$10,000 \ddot{a}_{\overline{3}|} = \nu^4 P \ddot{a}_{\overline{10}|}$$

$$\Rightarrow P = \frac{10,000 \ddot{a}_{\overline{3}|}}{\nu^4 \ddot{a}_{\overline{10}|}} = 5225.1408$$

Section 2.11: Annuities With More Complex Payment Patterns

Example. The present value of a series of payments of 3 at the end of every eight years, forever, is equal to 9.5. Calculate the effective annual rate of interest.

Section 2.11: Annuities With More Complex Payment Patterns

Example. The present value of a series of payments of 3 at the end of every eight years, forever, is equal to 9.5. Calculate the effective annual rate of interest.

Solution. Remember: The effective rate of interest over a certain period of time depends only on the length of this period, i.e. for $0 \leq s \leq t$,

$$\frac{A(t) - A(s)}{A(s)} = \frac{A(0)(1+i)^t - A(0)(1+i)^s}{A(0)(1+i)^s} = (1+i)^{t-s} - 1 = \frac{A(t-s) - A(0)}{A(0)}$$

where i is the effective annual rate of interest.

So, the 8-year effective interest rate is $(1+i)^8 - 1$. We have that

$$PV = Pa_{\infty|(1+i)^8-1} \Rightarrow 9.5 = (3)a_{\infty|(1+i)^8-1} \quad \text{Remember: } a_{\infty|i} = \frac{1}{i}$$

$$\Rightarrow 9.5 = (3) \frac{1}{(1+i)^8 - 1}$$

$$\Rightarrow (1+i)^8 - 1 = \frac{3}{9.5}$$

$$\Rightarrow (1+i)^8 = \frac{3}{9.5} + 1$$

$$\Rightarrow 1+i = \sqrt[8]{\frac{3}{9.5} + 1}$$

$$\Rightarrow i = \sqrt[8]{\frac{3}{9.5} + 1} - 1 = 0.03489979511$$

$$\Rightarrow i = 3.489979511\%$$

Section 2.11: Annuities With More Complex Payment Patterns

Example. A perpetuity pays \$1 at the end of every year plus an additional \$1 at the end of every second year. The effective rate of interest is $i = 5\%$. Find the present value of the perpetuity at time 0.

Section 2.11: Annuities With More Complex Payment Patterns

Example. A perpetuity pays \$1 at the end of every year plus an additional \$1 at the end of every second year. The effective rate of interest is $i = 5\%$. Find the present value of the perpetuity at time 0.

Solution.

Time	0	1	2	3	4	5	6	...	Present value
Payments		1	1	1	1	1	1	...	$a_{\infty } = \frac{1}{i}$
			1		1		1	...	$a_{\infty (1+i)^2-1} = \frac{1}{(1+i)^2-1}$ The 2-year interest factor is $(1+i)^2$, so the 2-year effective interest rate is $(1+i)^2 - 1$.
Total		1	2	1	2	1	2	...	$\frac{1}{i} + \frac{1}{(1+i)^2-1}$

$$PV = \frac{1}{i} + \frac{1}{(1+i)^2-1} = 29.7561$$

Section 2.11: Annuities With More Complex Payment Patterns

Example. An annuity-immediate has a first payment of 100, and its payments increase by 100 each year until they reach 500. The remaining payments are a perpetuity-immediate of 500 beginning in year 6. Find the present value at 6.5%.

Section 2.11: Annuities With More Complex Payment Patterns

Example. An annuity-immediate has a first payment of 100, and its payments increase by 100 each year until they reach 500. The remaining payments are a perpetuity-immediate of 500 beginning in year 6. Find the present value at 6.5%.

Solution.

Time	1	2	3	4	5	6	7	...
Payments	100	200	300	400	500	500	...	...
	$100(1a)_{\overline{5} 0.065}$					$\nu^5 \cdot 500 \cdot a_{\infty } = \nu^5 \cdot 500 \cdot \frac{1}{i}$		

$$PV = 100 \frac{\ddot{a}_{\overline{5}|0.065} - 5\left(\frac{1}{1.065}\right)^5}{0.065} + \left(\frac{1}{1.065}\right)^5 \cdot 500 \cdot \frac{1}{0.065} = 1194.45 + 5614.47 = 6808.92$$

Section 2.12: Annuities with Payments More Frequent than Annual

Example. John invest \$500 into an account at the end of each month for 5 years. The annual effective interest rate is 4.5%. Calculate the balance of this account at the end of 5 years.

Section 2.12: Annuities with Payments More Frequent than Annual

Example. John invest \$500 into an account at the end of each month for 5 years. The annual effective interest rate is 4.5%. Calculate the balance of this account at the end of 5 years.

Solution. The number of payments made is $(5)(12) = 60$.

Remember: $FV = P \cdot s_{\overline{n}|i} = P \cdot \frac{(1+i)^n - 1}{i}$

However, we use

$$FV = P \cdot s_{\overline{n \times m}| \frac{i^{(m)}}{m}}$$

where m is number of payments each year.

Now, we want to find $\frac{i^{(m)}}{m}$:

$$(1 + i) = \left(1 + \frac{i^{(m)}}{m}\right)^m \Rightarrow \frac{i^{(12)}}{12} = (1 + 0.045)^{\frac{1}{12}} - 1$$

The one-month effective interest rate is $(1.045)^{1/12} - 1$.

Hence, the balance of this account at the end of 5 years is

$$FV = 500 \cdot s_{\overline{60}|(1.045)^{1/12} - 1} = (500) \frac{((1.045)^{1/12} - 1 + 1)^{60} - 1}{(1.045)^{1/12} - 1} = (500) \frac{(1.045)^5 - 1}{(1.045)^{1/12} - 1} = 33495.8784$$

Section 2.12: Annuities with Payments More Frequent than Annual

Example. Find the level monthly payment for a 30-year mortgage loan of 300,000 at an interest rate of 6% convertible monthly.

Section 2.12: Annuities with Payments More Frequent than Annual

Example. Find the level monthly payment for a 30-year mortgage loan of 300,000 at an interest rate of 6% convertible monthly.

Solution. The number of payments made is $(30)(12) = 360$.

Remember: $PV = P \cdot a_{\overline{n}|i}$

However, we use

$$PV = P \cdot a_{\overline{n \times m}| \frac{i^{(m)}}{m}}$$

where m is number of payments each year.

A nominal rate of interest 6% convertible monthly means an interest rate of $\frac{i^{(m)}}{m} = \frac{6\%}{12} = 0.5\% = 0.005$ per month.

We can simply use the usual annuity functions, recognizing that the period is 1 month instead of 1 year:

$$\begin{aligned} PV &= P \cdot a_{\overline{n \times m}| \frac{i^{(m)}}{m}} \\ 300,000 &= P \cdot a_{\overline{360}|0.005} \\ \Rightarrow P &= \frac{300,000}{a_{\overline{360}|0.005}} \\ P &= \frac{300,000}{166.7916} = \frac{1 - (\frac{1}{1.005})^{360}}{0.005} \\ P &= 1798.65 \end{aligned}$$

Section 2.12: Annuities with Payments More Frequent than Annual

Example. An annuity-immediate has 20 initial quarterly payments of 25 each, followed by a perpetuity of quarterly payments of 50 starting in the sixth year. Find the present value at 8% convertible quarterly.

Section 2.12: Annuities with Payments More Frequent than Annual

Example. An annuity-immediate has 20 initial quarterly payments of 25 each, followed by a perpetuity of quarterly payments of 50 starting in the sixth year. Find the present value at 8% convertible quarterly.

Solution. A nominal rate of interest 8% convertible quarterly means an interest rate of $\frac{8\%}{4} = 2\% = 0.02$ per quarter.

$$\begin{aligned}PV &= P \cdot a_{\overline{n}|i} + \nu^n \cdot P \cdot a_{\infty|i} \\&= (25)a_{\overline{20}|2\%} + (50)\nu^{20}a_{\infty|2\%} \\&= (25)(16.3514) + (50)(0.6729)(50) \quad \text{Remember: } a_{\infty|i} = \frac{1}{i} \\&= 2091.2142\end{aligned}$$

Section 2.12: Annuities with Payments More Frequent than Annual

■ Many annuities, such as loan payments or pensions, have more frequent payments (e.g., monthly or quarterly). We will develop methods for annuities whose payments are more frequent than annual.

■ The symbol $a_{\overline{n}|i}^{(m)}$ indicates the present value of an annuity-immediate that pays $\frac{1}{m}$ at the end of each $\frac{1}{m}$ of a year. For example, consider an annuity that makes 12 payments per year. The symbol $a_{\overline{n}|i}^{(12)}$ is the present value of an annuity that pays $\frac{1}{12}$ at the end of each month for n years.

■ The cashflow value of the annuity-immediate with level payments of one per year and m payments per year is

Time	$\frac{1}{m}$	$\frac{2}{m}$	$\frac{3}{m}$	...	...	$n \times m$
Payments	$\frac{1}{m}$	$\frac{1}{m}$	$\frac{1}{m}$	...	...	$\frac{1}{m}$

$$a_{\overline{n}|i}^{(m)} = \frac{1}{m} a_{\overline{m \times n}|i} = \frac{1}{m} \frac{1 - \left(1 + \frac{i}{m}\right)^{-m \times n}}{\frac{i}{m}} = \frac{1 - \left[\left(1 + \frac{i}{m}\right)^m\right]^{-n}}{i^{(m)}} = \frac{1 - [1+i]^{-n}}{i^{(m)}} = \frac{1 - \nu^n}{i^{(m)}} = \frac{i}{i^{(m)}} a_{\overline{n}|}$$

$$\begin{aligned} a_{\overline{n}|i}^{(m)} &= \frac{1 - \nu^n}{i^{(m)}} = \frac{i}{i^{(m)}} a_{\overline{n}|}, & s_{\overline{n}|i}^{(m)} &= \frac{(1+i)^n - 1}{i^{(m)}} = \frac{i}{i^{(m)}} s_{\overline{n}|} \\ \ddot{a}_{\overline{n}|i}^{(m)} &= \frac{(1 - \nu^n)}{d^{(m)}} = \frac{i}{d^{(m)}} a_{\overline{n}|} = \frac{d}{d^{(m)}} \ddot{a}_{\overline{n}|}, & \ddot{s}_{\overline{n}|i}^{(m)} &= \frac{(1+i)^n - 1}{d^{(m)}} = \frac{i}{d^{(m)}} s_{\overline{n}|} = \frac{d}{d^{(m)}} \ddot{s}_{\overline{n}|} \\ a_{\infty|i}^{(m)} &= \frac{1}{m(\nu - \frac{1}{m} - 1)} = \frac{1}{i^{(m)}}, & \ddot{a}_{\infty|i}^{(m)} &= \frac{1}{m} \frac{1}{1 - \nu \frac{1}{m}} = \frac{1}{d^{(m)}} \end{aligned}$$

Section 2.12: Annuities with Payments More Frequent than Annual

Example. John invest \$500 into an account at the end of each month for 5 years. The annual effective interest rate is 4.5%. Calculate the balance of this account at the end of 5 years.

Section 2.12: Annuities with Payments More Frequent than Annual

Example. John invest \$500 into an account at the end of each month for 5 years. The annual effective interest rate is 4.5%. Calculate the balance of this account at the end of 5 years.

Solution. Note: each year there are 12 deposits of \$500, we have to multiply by 12 i.e., 12×500 :

$$s_{\bar{n}|}^{(m)} = \frac{i}{i^{(m)}} s_{\bar{n}|} \quad \text{Remember. } (1+i) = \left(1 + \frac{i^{(m)}}{m}\right)^m$$

$$FV = P \cdot s_{\bar{n}|}^{(m)} = P \cdot \frac{i}{i^{(m)}} s_{\bar{n}|}$$

This implies

$$FV = (12 \times 500) \frac{0.045}{12((1.045)^{1/12} - 1)} \frac{(1 + 0.045)^5 - 1}{0.045} = 33495.8784$$

Section 2.12: Annuities with Payments More Frequent than Annual

Example. John invest \$500 into an account at the end of each month for 5 years. The annual effective interest rate is 4.5%. Calculate the balance of this account at the end of 5 years.

Solution. Note: each year there are 12 deposits of \$500, we have to multiply by 12 i.e., 12×500 :

$$s_{\bar{n}|}^{(m)} = \frac{i}{i^{(m)}} s_{\bar{n}|} \quad \text{Remember. } (1+i) = \left(1 + \frac{i^{(m)}}{m}\right)^m$$

$$FV = P \cdot s_{\bar{n}|}^{(m)} = P \cdot \frac{i}{i^{(m)}} s_{\bar{n}|}$$

This implies

$$FV = (12 \times 500) \frac{0.045}{12((1.045)^{1/12} - 1)} \frac{(1 + 0.045)^5 - 1}{0.045} = 33495.8784$$

Example. A saver deposits 100 into a bank account at the end of every three months for 10 years. If the account earns interest at an annual effective rate of 6%, what is the savers balance at the end of 10 years?

Section 2.12: Annuities with Payments More Frequent than Annual

Example. John invest \$500 into an account at the end of each month for 5 years. The annual effective interest rate is 4.5%. Calculate the balance of this account at the end of 5 years.

Solution. Note: each year there are 12 deposits of \$500, we have to multiply by 12 i.e., 12×500 :

$$s_{\bar{n}|}^{(m)} = \frac{i}{i^{(m)}} s_{\bar{n}|} \quad \text{Remember. } (1+i) = \left(1 + \frac{i^{(m)}}{m}\right)^m$$

$$FV = P \cdot s_{\bar{n}|}^{(m)} = P \cdot \frac{i}{i^{(m)}} s_{\bar{n}|}$$

This implies

$$FV = (12 \times 500) \frac{0.045}{12((1.045)^{1/12} - 1)} \frac{(1 + 0.045)^5 - 1}{0.045} = 33495.8784$$

Example. A saver deposits 100 into a bank account at the end of every three months for 10 years. If the account earns interest at an annual effective rate of 6%, what is the savers balance at the end of 10 years?

Solution. Note: each year there are 4 deposits of \$100, we have to multiply by 4 i.e., 4×100 :

$$s_{\bar{n}|}^{(m)} = \frac{i}{i^{(m)}} s_{\bar{n}|}$$

$$FV = P \cdot s_{\bar{n}|}^{(m)} = P \cdot \frac{i}{i^{(m)}} s_{\bar{n}|}$$

This implies

$$FV = (4 \times 100) \frac{0.06}{4((1.06)^{1/4} - 1)} \frac{(1.06)^{10} - 1}{0.06} = 5389.505$$

Section 2.13: Continuously Payable Annuities With Continuously Varying Payments

We will address situations where a continuously payable annuity's rate of payment changes continuously.

■ (A) Arithmetic Annuities

■ (1) The continuously increasing annuity.

■ The symbol for the present value of this annuity is $(\bar{I}\bar{a})_{\overline{n}|}$.

■ The bar over the a indicates that payments are continuous.

■ The bar over the I indicates that the increases in the rate of payment also occur continuously.

At the beginning of the first year (at time 0), the payment rate is 0 and the payment rate at the end of the first year is 1 per year. It builds up from 0 at time 0 to 1 at time 1, and continues to increase, reaching a rate of n per year at time n .

At any time t , the payment rate is t per year, so the amount paid during a small time interval dt is $(t \cdot dt)$, and the present value of that amount at time 0 is $(t \cdot \nu^t \cdot dt)$.

To find the present value of all the payments from time 0 to time n , we integrate this value from 0 to n :

$$(\bar{I}\bar{a})_{\overline{n}|} = \int_0^n t \cdot \nu^t dt$$

Using integration by part:

$$u = t \Rightarrow du = dt ,$$
$$dw = \nu^t dt \Rightarrow w = \int \nu^t dt = -\frac{1}{\delta} e^{-\delta t} \quad \text{Revise the continuous annuity (slide 37)}$$

Section 2.13: Continuously Payable Annuities With Continuously Varying Payments

$$\begin{aligned}\int t \cdot \nu^t dt &= -\frac{t}{\delta} e^{-\delta t} + \frac{1}{\delta} \int e^{-\delta t} dt \\&= -\frac{t}{\delta} e^{-\delta t} - \frac{1}{\delta^2} e^{-\delta t} \\&= -\frac{t}{\delta} \nu^t - \frac{1}{\delta^2} \nu^t \quad e^{-\delta t} = (e^{\ln(1+i)-1})^t = \nu^t \\&= \frac{-\nu^t}{\delta} \left(t + \frac{1}{\delta} \right)\end{aligned}$$

This implies

$$\begin{aligned}(\bar{I}\bar{a})_{\overline{n}|} &= \int_0^n t \cdot \nu^t dt = \frac{-\nu^t}{\delta} \left(t + \frac{1}{\delta} \right) \Big|_0^n \\&= \frac{-\nu^n}{\delta} \left(n + \frac{1}{\delta} \right) + \frac{1}{\delta} \left(\frac{1}{\delta} \right) \\&= \frac{1}{\delta} \left(-n\nu^n - \frac{\nu^n}{\delta} + \frac{1}{\delta} \right) \\&= \frac{1}{\delta} \left(-n\nu^n + \frac{1 - \nu^n}{\delta} \right) \\&= \frac{1}{\delta} \left(-n\nu^n + \bar{a}_{\overline{n}|} \right) \\&= \frac{\bar{a}_{\overline{n}|} - n\nu^n}{\delta}\end{aligned}$$

Section 2.13: Continuously Payable Annuities With Continuously Varying Payments

This gives us the formula for the present value of a continuously increasing arithmetic annuity:

$$(\bar{I}\bar{a})_{\overline{n}|} = \frac{\bar{a}_{\overline{n}|} - n\nu^n}{\delta}$$

In the case of a continuously increasing perpetuity, we have:

$$(\bar{I}\bar{a})_{\infty|} = \lim_{n \rightarrow \infty} \frac{\bar{a}_{\overline{n}|} - n\nu^n}{\delta}$$

This implies

$$(\bar{I}\bar{a})_{\infty|} = \frac{1}{\delta^2}$$

For the future values of these annuities:

$$(\bar{I}\bar{s})_{\overline{n}|} = (1+i)^n (\bar{I}\bar{a})_{\overline{n}|} = (1+i)^n \frac{\bar{a}_{\overline{n}|} - n\nu^n}{\delta} = \frac{\bar{s}_{\overline{n}|} - n}{\delta}$$

■ (2) The continuously decreasing annuity.

A continuously decreasing annuity $(\bar{D}\bar{a})_{\overline{n}|}$ makes continuous payments at a rate that decreases linearly from n per year at time 0 to a rate of 0 at time n . We can develop a formula for $(\bar{D}\bar{a})_{\overline{n}|}$ as follows:

$$(\bar{I}\bar{a})_{\overline{n}|} + (\bar{D}\bar{a})_{\overline{n}|} = n\bar{a}_{\overline{n}|} \Rightarrow (\bar{D}\bar{a})_{\overline{n}|} = n\bar{a}_{\overline{n}|} - (\bar{I}\bar{a})_{\overline{n}|} \Rightarrow n \cdot \frac{1 - \nu^n}{\delta} - \frac{\bar{a}_{\overline{n}|} - n\nu^n}{\delta} = \frac{n - \bar{a}_{\overline{n}|}}{\delta}$$

Section 2.13: Continuously Payable Annuities With Continuously Varying Payments

$$(\bar{D}\bar{a})_{\bar{n}|} = \frac{n - \bar{a}_{\bar{n}|}}{\delta}$$

For the future value:

$$(\bar{D}\bar{s})_{\bar{n}|} = (1+i)^n (\bar{D}\bar{a})_{\bar{n}|} = (1+i)^n \frac{n - \bar{a}_{\bar{n}|}}{\delta} = \frac{n(1+i)^n - \bar{s}_{\bar{n}|}}{\delta}$$

Section 2.13: Continuously Payable Annuities With Continuously Varying Payments

$$(\bar{D}\bar{a})_{\bar{n}|} = \frac{n - \bar{a}_{\bar{n}|}}{\delta}$$

For the future value:

$$(\bar{D}\bar{s})_{\bar{n}|} = (1+i)^n (\bar{D}\bar{a})_{\bar{n}|} = (1+i)^n \frac{n - \bar{a}_{\bar{n}|}}{\delta} = \frac{n(1+i)^n - \bar{s}_{\bar{n}|}}{\delta}$$

Example. An annuity provides continuous payments at the rate of 500 per year at time 0, and its payment rate increases continuously at a rate of 100 per year for 10 years. Calculate the accumulated value of this annuity at the end of 10 years, assuming an annual effective interest rate of 10%.

Section 2.13: Continuously Payable Annuities With Continuously Varying Payments

$$(\bar{D}\bar{a})_{\overline{n}|} = \frac{n - \bar{a}_{\overline{n}|}}{\delta}$$

For the future value:

$$(\bar{D}\bar{s})_{\overline{n}|} = (1+i)^n (\bar{D}\bar{a})_{\overline{n}|} = (1+i)^n \frac{n - \bar{a}_{\overline{n}|}}{\delta} = \frac{n(1+i)^n - \bar{s}_{\overline{n}|}}{\delta}$$

Example. An annuity provides continuous payments at the rate of 500 per year at time 0, and its payment rate increases continuously at a rate of 100 per year for 10 years. Calculate the accumulated value of this annuity at the end of 10 years, assuming an annual effective interest rate of 10%.

Solution. We have two parts:

Part (1): The original payment rate of 500 per year is a level continuously payable annuity, $500\bar{s}_{\overline{10}|}$

Part (2): The increasing portion is a separate continuously increasing annuity, $100(\bar{I}\bar{s})_{\overline{10}|}$

The accumulated value is:

$$500\bar{s}_{\overline{10}|} + 100(\bar{I}\bar{s})_{\overline{10}|} = 500 \frac{(1.10)^{10} - 1}{\ln(1.10)} + 100 \frac{\frac{(1.10)^{10} - 1}{\ln(1.10)} - 10}{\ln(1.10)} = 15,413.20$$

Section 2.13: Continuously Payable Annuities With Continuously Varying Payments

■ (B) Geometric Annuities

A continuously payable geometric annuity can also have a continuously changing rate of payment. The present value of such an annuity can be represented by the symbol $\ddot{a}_{n|}^{\bar{g}}$, where $\bar{g}$ is the continuously compounded rate of change in the payment rate.

This means that the payment rate at time t is $e^{\bar{g}t}$. We can develop a formula for $\ddot{a}_{n|}^{\bar{g}}$ by integration:

$$\ddot{a}_{n|}^{\bar{g}} = \int_0^n e^{\bar{g}t} e^{-\delta t} dt = \int_0^n e^{-(\delta - \bar{g})t} dt = \frac{1 - e^{-n(\delta - \bar{g})}}{\delta - \bar{g}} \quad \ddot{a}_{n|} = \int_0^n \nu^t dt = \int_0^n e^{-\delta t} dt$$

In the case of a continuously perpetuity, we have:

$$\ddot{s}_{\infty|}^{\bar{g}} = \lim_{n \rightarrow \infty} \frac{1 - e^{-n(\delta - \bar{g})}}{\delta - \bar{g}} = \frac{1}{\delta - \bar{g}} \quad \text{such that } \delta > \bar{g}$$

The future value of a continuously varying geometric annuity is found by accumulating the present value to time n at the force of interest, δ :

$$\ddot{s}_{n|}^{\bar{g}} = \ddot{a}_{n|}^{\bar{g}} e^{n\delta} = \frac{1 - e^{-n(\delta - \bar{g})}}{\delta - \bar{g}} e^{n\delta} = \frac{e^{n\delta} - e^{n\bar{g}}}{\delta - \bar{g}} \quad (1+i)^n = e^{n \ln(1+i)} = e^{n\delta}$$

Section 2.13: Continuously Payable Annuities With Continuously Varying Payments

$$\begin{aligned}\frac{\ddot{a}_{\bar{n}|\bar{g}}}{n} &= \frac{1 - e^{-n(\delta - \bar{g})}}{\delta - \bar{g}} \\ \frac{\ddot{a}_{\infty|\bar{g}}}{n} &= \frac{1}{\delta - \bar{g}} \quad \text{such that } \delta > \bar{g} \\ \frac{\underline{s}_{\bar{n}|\bar{g}}}{n} &= \frac{e^{n\delta} - e^{n\bar{g}}}{\delta - \bar{g}}\end{aligned}$$

Note: In some cases, the pattern of continuously varying payments is not arithmetic or geometric, and the interest rate also varies continuously. In this situation, the present value of the annuity must be expressed as an integral:

$$PV = \int_0^n \rho(t) e^{-\int_0^t \delta_s ds} dt$$

where $\rho(t)$ is a rate of payment per year that varies as a function of t and $e^{-\int_0^t \delta_s ds}$ is the present value factor.

Section 2.13: Continuously Payable Annuities With Continuously Varying Payments

Example. A 5-year annuity makes continuous payments at a rate of $(1000 + 50t)$ per year. Calculate the present value of this annuity at a continuously varying force of interest $\delta(t) = \frac{1}{20+t}$.

Section 2.13: Continuously Payable Annuities With Continuously Varying Payments

Example. A 5-year annuity makes continuous payments at a rate of $(1000 + 50t)$ per year. Calculate the present value of this annuity at a continuously varying force of interest $\delta(t) = \frac{1}{20+t}$.

Solution:

$$PV = \int_0^5 \rho(t) e^{-\int_0^t \delta_s ds} dt$$

By substitution, we have

$$PV = \int_0^5 (1000 + 50t) e^{-\int_0^t \frac{1}{20+s} ds} dt$$

The present value factor in this expression is $e^{-\int_0^t \frac{1}{20+s} ds}$.

The integral can be evaluated as follows:

$$-\int_0^t \frac{1}{20+s} ds = -\ln(20+s) \Big|_0^t = -[\ln(20+t) - \ln(20)] = -\ln\left(\frac{20+t}{20}\right)$$

The present value factor is

$$e^{-\int_0^t \frac{1}{20+s} ds} = e^{\ln\left(\frac{20+t}{20}\right)^{-1}} = \left(\frac{20+t}{20}\right)^{-1} = \left(1 + \frac{1}{20}t\right)^{-1} = (1 + 0.05t)^{-1} = \frac{1}{1 + 0.05t}$$

$$\Rightarrow PV = \int_0^5 (1000 + 50t) \frac{1}{1 + 0.05t} dt = 1000 \int_0^5 (1 + 0.05t) \frac{1}{1 + 0.05t} dt = 1000 \int_0^5 1 dt = 1000 t \Big|_0^5 = 1000(5-0) = 5000$$

Section: Exercises

The answers: <https://drive.google.com/file/d/1SvQsGlvIKK71NNDQ2lp9wBwS6TXxPQb6/view?usp=sharing>

Exercise 1: If $n = 15$ and $i = 6\%$, find $a_{\overline{n}|i}$ and $s_{\overline{n}|i}$.

Exercise 2: Find the present value of a unit perpetuity-immediate with $i = 8\%$.

Exercise 3: Find the present value of an annuity with $n = 30$ payments of $P = 500$ if $i = 8\%$.

Exercise 4: If $n = 15$ and $i = 6\%$, find $\ddot{a}_{\overline{n}|i}$ and $\ddot{s}_{\overline{n}|i}$.

Exercise 5: If $i = 6\%$, find $\ddot{a}_{\overline{15}|i}$ and $\ddot{s}_{\overline{15}|i}$.

Exercise 6: An account pays interest at a continuously compounded rate of 0.05 per year. Continuous deposits are made to the account at a rate of 1,000 per year for 6 years, and then at a rate of 2,000 per year for the next 4 years. What is the account balance at the end of 10 years?

Exercise 7: A loan for 20,000 must be repaid by 5 year-end payments with interest at an annual effective rate of 10%. What is the annual payment?

Exercise 8: You have a 5,000 balance in an account earning a 4.5% annual effective rate. You want to increase your balance to 20,000 at the end of 12 years by making a level deposit at the beginning of each of the next 12 years. Find the required level payment.

Exercise 9: Emily wants to make a deposit today into an account earning a 5.4% annual effective interest rate. She plans to withdraw \$1,300 at the end of each of the next 17 years. How much money should Emily deposit today to be able to make these payments?

Exercise 10: Michael's savings account earns an annual effective interest rate of 6.3%. The current balance in his account is \$4,500. He plans to make an additional deposit of \$1,250 at the end of each year for the next 18 years. What will be the total amount in Michael's account at the end of 18 years?

Exercise 11: You took out a loan of \$20,000 and plan to repay it through six equal annual payments of \$5,000 each. The first payment will be made one year from today. What is the annual effective interest rate you are effectively paying on this loan? Set $N=6$, $PV=20,000$, $PMT = -5,000$ and CPT $I/Y =$

Exercise 12: Jane wants to save at least \$25,000 in a savings account that earns an annual effective interest rate of 4%. She plans to make an equal deposit of \$1,200 at the start of each year for a certain number of years, n . What is the value of n ? What will be the account balance after n years?

Exercise 13: Given an annual interest rate of 6%, find the present value of a 12-year annuity with annual payments of \$150, where the first payment is made four years from today.

Exercise 14: Let $i = 5\%$ be the interest rate and $n = 4$ be the number of periods. Suppose the annuity payments are 20, 40, 60, 80. What is the present value of this series of payments?

Section: Exercises

Exercise 15: A perpetuity due pays an initial amount of \$1 annually, and each payment increases by \$1 every year indefinitely. If the discount rate is 6%, what is the present value of this increasing perpetuity due?

Exercise 16: Given $i = 8\%$, find the present value of the following sequence of payments that are made at the end of each year: $1, (1 - 0.06), (1 - 0.06)^2, (1 - 0.06)^3, \dots, (1 - 0.06)^9$.

Exercise 17: Given $i = 9\%$, find the present value of the payments: $(1.04), (1.04)^2, (1.04)^3, \dots$

if a) the payments are made at the end of the period, and

b) the payments are made at the beginning of the period.

Exercise 18: Alex wants to save \$2,500,000 for retirement. Alex plans to make annual deposits at the beginning of each year into an account that earns an annual effective interest rate of 6.4%. Alex intends to increase the amount of each deposit by 3% each year. If Alex plans to retire in 40 years, what should be the amount of the first deposit?

Exercise 19: Ali plans to make three deposits of \$12,000 each into a bank account, made at the beginning of this year and the next two years. After two years, upon retirement, he intend to withdraw a fixed amount Y annually, starting at the end of the 4th year, and continuing for ten years. If the account earns an annual effective interest rate of $i = 7.5\%$, what is the amount of the level payment Y ?

Exercise 20: Based on a 5% annual interest rate, find the present value of a 10-year annuity with level payments of 100 each, with the first payment occurring at the beginning of the 6th year.

Exercise 21: An annuity pays 150 at the end of each of the next 12 years and 300 at the end of each of the six subsequent years. If $i = 0.08$, find the present value of the annuity.

Exercise 22: An annuity-immediate has its first payment of \$20, and each subsequent payment increases by \$20 annually until the payment amount reaches \$100. After that, from year 6 onward, the payments remain constant at \$100, continuing indefinitely as a perpetuity. Find the present value of this annuity at an effective interest rate of 4.3%.

Exercise 23: Emma deposits \$130 into her bank account at the end of every three months for 15 years. If the account earns interest at an annual effective rate of 5.4%, what will be Emma's balance at the end of 15 years?

Exercise 24: Alex has taken out a car loan of \$65,000. He will repay the loan with monthly payments over a 5-year period. Payments are made at the end of each month, with the first payment one month after receiving the loan. If the loan has a nominal interest rate of 7.4% convertible monthly, what is the amount of each monthly payment?

Exercise 25: Suppose you receive a series of quarterly payments of \$115 each, over a period of 9 years. If the interest rate is 4.5% per year, convertible monthly, what is the present value of this annuity?

Section: Exercises

Exercise 26: An annuity makes monthly payments of \$233 for 12 years. Determine its present value at a nominal interest rate of 6.4% convertible quarterly, under the following conditions:

- a) If it is an annuity-immediate.
- b) If it is an annuity-due.

Exercise 27: A 17-year annuity-immediate makes quarterly payments that increase annually. Specifically, the quarterly payment is 15 in the first year, 30 in the second year, and continues to increase by 15 each year, reaching 255 per quarter in the 17th year. Find the present value of this annuity at an interest rate of 6.5% convertible semi-annually.

Exercise 28: A 11-year annuity-immediate involves quarterly payments that decrease each year. Specifically, the payments are 110 in the first year, 100 in the second year, and continue decreasing annually, reaching 10 per quarter in the seventh year. Determine the present value of this annuity at an interest rate of 5.5% convertible monthly.

Exercise 29: A 20-year annuity-due makes quarterly payments that start at \$100 in the first year. In the second year, payments decrease to \$97, and this pattern of decreasing payments by 3% each subsequent year continues throughout the 20-year term. If the interest rate is 6.3% compounded monthly, what is the present value of this annuity?

Exercise 30: A 15-year annuity-immediate makes quarterly payments. The payments start at \$1,100 per quarter in the first year, increase to \$1,144 in the second year, and continue to increase by 4% each subsequent year throughout the 15-year period. What is the future value of this annuity at the end of 15 years, assuming an interest rate of 4.5% convertible semi-annually?

Exercise 31: Nadia wants to save \$1,300,000 for retirement. She plans to make annual deposits at the beginning of each year into an account that earns an effective annual interest rate of 5.6%. Nadia intends to increase the amount of each deposit by 3% each year. If she plans to retire in 45 years, what should be the amount of her first deposit?

Exercise 32: Emily is evaluating a 12-year continuously increasing arithmetic annuity. The annuity's payment rate starts at \$0 and increases continuously at a rate of \$370 per year. Calculate the present value of this annuity at an annual effective interest rate of 7.4%.

Exercise 33: A 6-year annuity provides continuous payments at a rate of $(1000 + 25t)$ dollars per year, where t is measured in years. The force of interest varies continuously over time and is given by $\delta(t) = \frac{1}{40+t}$. Calculate the present value of this annuity at time zero.

Exercise 34: Alex deposits \$100 into an account at the start of each 4-year interval over a period of 40 years. The account earns interest at an annual effective interest rate of i . Let Y be the total amount in the account at the end of 40 years. It is given that this amount Y is five times the amount in the account at the end of 20 years. Determine the value of Y .

Exercise 35: A perpetuity has a present value of 77.1 and makes annual payments at the end of each year. It pays 1 at the end of year 2, 2 at the end of year 3, 3 at the end of year 4, and so on, up to year $n + 1$, when the payment is n . After year $n + 1$, the payments continue indefinitely at a constant amount of n . If the effective annual interest rate is 10.5%, what is the value of n ?

Section: Exercises

Exercise 36: A perpetuity has a present value of 81 and makes annual payments at the end of each year. It pays 1 at the end of year 2, 2 at the end of year 3, 3 at the end of year 4, and so on, up to year $n + 1$, when the payment is n . After year $n + 1$, the payments continue indefinitely at a constant amount of n . If the effective annual interest rate is 9.4%, what is the value of n ?

Exercise 37: A perpetuity-immediate pays \$150 annually. Immediately following the fifth payment, this perpetuity is exchanged for a 27-year annuity-immediate that begins with a payment of P at the end of the first year. Each subsequent payment increases by 8% compared to the previous payment. The effective annual interest rate is 8%. Calculate the value of P .

Exercise 38: Alex purchases a perpetuity-immediate with varying annual payments. For the first six years, the payment remains constant at \$12 each year. Starting in year 7, the payments begin to increase, with each year's payment being $E\%$ larger than the previous year's payment. Given an annual effective interest rate of 7.5%, the present value of the perpetuity is \$180. Calculate the value of E , given that E is less than 7.5%.

Exercise 39: To accumulate \$40,000 after $4n$ years, deposits of \$75 are made at the end of each year for the first $2n$ years, and deposits of \$150 are made at the end of each year for the following $2n$ years. The annual effective interest rate is i . If $(1 + i)^{2n} = 3$, determine the value of i .