

FN281

Assignment 4: 3/31/2018

1. Explain what amortization is and how a down payment and loan duration impact it.

Amortization is the fixed amount paying off over time, but the compositions of interest payment and principle payment are different. In the Beginning of the period, the interest payment drops over time, while the principle payment slightly rises over time.

The impact from a down payment is that higher down payment, the lower debt we borrow. The lower debt we borrow also leads to shorter loan duration. So, the amortization will be lower in terms of loan amount and duration.

2. What is the important of health insurance and disability insurance in personal planning?

Health insurance and disability insurance are important in terms of transferring financial burdens to the insurance companies when individuals have sicknesses or accidents. However, as a return, they have to pay premiums annually. There might be uncertainties that cause individuals severe injuries and it takes such a long time to recover. This recovery causes medical expenses. Without the health insurance or disability insurance might cause individuals to miss their personal financial goal in the long term.

3. What is life insurance? What is its purpose and principle?

Life insurance is the contract that gives compensation to the dependents, if the life-insurance buyer dies before time. It cannot protect the loss, but it transfers the risks to insurance companies. The purpose of the life insurance is for a person who has the dependents needed to take care of such as the head of a family. However, it provides more functions in terms of investments and policy loan.

4. Joe and Jane are both 35 years old. Although they graduated from college almost 15 years ago, they have never developed a diversified investment program. What extra money they had was invested in high-tech stocks that did quite well. Then, with the economic downturn, they encountered major losses. How could asset allocation have reduced the dollar amounts of the Joe's and Jane's losses?

Asset allocation can help to allocate the assets and get reasonable returns from the investments. Since each investment has different level of risks. The higher diversified assets allocations, the lower risk investors face. The asset types will not have the same magnitude loss in value at the same time, once the negative shock hits.

For example, the economic downturn comes, assuming the high-tech stocks industry has a 30% loss. If Joe and Jane invest only in this industry, they face 30% loss for the whole portfolio. However, if Joe and Jane put 50% of their money invest in government bonds. Once the shock hits, then their portfolio volatility be lowered than 30% because of asset allocation. The negative shock hits, people will hold safer assets (i.e. government bonds) and sell the risky assets (stocks). If Joe and Jane hold 50% of portfolio in government bonds, they can reduce the loss in dollar amount by selling the government bond (as the price goes up due to higher demand) or they can have capital gain in portfolio instead.