

Assignment 3

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

Amortization is the reduction of loan balance owed due to payments that are made over a period of time. The term is normally used in mortgage payment and car loan. At the beginning, the borrower will pay mostly the interest (the principal is only reduced a little). At the end, as the amount owed declines, most of monthly payments will go to deducting the principal. A large sum of down payment or the initial deposit can help reduce the monthly payments. Also, longer loan duration allows the borrower to pay lower monthly payments.

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

Health insurance helps the policyholder meet medical expenses when he or she becomes ill. It helps lessen the financial burden a person may have in the future due to illness or injury. Basic insurance coverage includes hospital, surgical and physician expenses. Those who have limited budget may consider buying this type of coverage and if they want other additional protections, they should save some amount of money in order to buy a supplementary plan.

Disability insurance provides payments to those whose regular income stream is lost as a result of illness or accident. It can be considered as an earning-power insurance. Some policies offer to pay partially when the policyholder return to work on a part-time basis. This type of insurance eases the financial burden, i.e., the loss of income and the increase in expenses, that the policyholder may experience. People who rely on income from working should consider buying disability income insurance. How much coverage they should have depends on how much savings they accumulate. If they have sufficient savings and investment, they may not need a lot of coverage since they can still gain the investment income during the non-working period. Both health and disability insurances give the policyholders peace of mind and it is important that those who want to buy the insurance allocate some of their income to provide for the insurance premium.

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

Life insurance is an insurance that pays out upon the death of the policyholder. The main purpose of life insurance is to provide financial security for people who depend on the insured person. The persons specified by the holder or what is called the 'beneficiaries' will get some or all of the holder lost income when he or she dies and payments for some of the holder's expenses such as mortgage. Similar to other types of insurance, life insurance is based on the principle of risk pooling: the loss of a few is met by the pool of many. To elaborate, a considerable number of policyholders pay a small amount of premium

constituting a pool. The premium is a fee that the insured pays periodically to the insurance company which acts as a risk-sharing group.

- 4. Bob and Mary Martin 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 until the last five years. Then, with the economic downturn, they encountered major losses. How could asset allocation have reduced the dollar amounts of the Martin's losses?**

Asset allocation is the process of spreading the investments among different asset classes such as cash, stocks, bonds and derivatives. Each of these classes has different level of risk and return, so asset allocation will allow Bob and Mary to diversify unsystematic risks or what is normally called the firm-specific risk. The Martins could use the diversification technique by investing in various types of stocks that are not limited to only high-tech stocks. They could buy some corporate bonds or government bonds and invest in mutual funds. Once their currently-owned high tech stocks do not perform well, the loss could be covered by the gain in other assets they also own.