Mathematical Methods for International Commerce

Week 4/2: Geometric Series and Investment Appraisal

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March 28, 2025

Why This Topic Matters

Understanding **geometric series** and **investment appraisal** is crucial in economics and finance:

- **Geometric series** model regular payments, compounding, and amortization schedules
- **Investment appraisal** tools help evaluate project viability, return potential, and loan value
- Core to decisions in **banking, government budgeting, business strategy, and personal finance**
- Equips you to analyze time-based value of money, compare alternatives, and manage risk

> “A dollar today is worth more than a dollar tomorrow — let’s understand why.”

Section 3.3: Geometric Series

What is a Geometric Progression?

A **geometric sequence** has the form:

$$a, ar, ar^2, ar^3, \ldots$$

Where:

- a = first term
- r = common ratio (can be fraction or negative)

Basically, each term is the previous term multiplied by the common ratio.

Example: $2, 4, 8, 16, 32$

$a = 2, r = 2$

Sum of a Finite Geometric Series

$$S_n = a \cdot \frac{1 - r^n}{1 - r}, \quad r \neq 1$$

- Example: $5 + 10 + 20 + 40$
  $a = 5, r = 2, n = 4$

$$S_4 = 5 \cdot \frac{1 - 2^4}{1 - 2} = 5 \cdot \frac{-15}{-1} = 75$$

Example: Regular Savings Plan

Annual deposit: \$100, interest = 5%, duration = 5 years

It means that each year, you save \$100 and earn 5% interest.

$$S_5 = 100 \cdot \frac{1.05^5 - 1}{0.05} \approx 100 \cdot 5.526 = \boxed{\$552.60}$$

In 5 years, you will have saved \$552.60.

Your turn! Calculate the Sum

- Find the sum of the following geometric series:

$$2 + 4 + 8 + 16 + 32$$

$$3 + 6 + 12 + 24 + 48$$

- Find the final Savings Plan amount for $200/year, 4% interest, 10 years

Example: Loan Repayment by Instalments

Loan = $2000, repaid in 4 annual instalments at 10%

$$x \cdot \left(\frac{1 - (1.10)^{-4}}{0.10} \right) = 2000$$

Solve for x to find equal annual instalments.

$$x = 2000 \cdot \frac{0.4641}{0.10} \approx 928.20$$

Good job: it's a wrong answer!

Example: Loan Repayment by Instalments (continued)

Correct Calculation

We use the **Present Value of an Ordinary Annuity** formula:

$$PV = x \cdot \frac{1-(1+r)^{-n}}{r}$$

PS: we have $-n$ power because we are calculating the present value of future payments.

$$(1+r)^{-n} = \frac{1}{(1+r)^n}$$

This tells us:

- **Raising to a negative power** means **discounting** — calculating the **present value** of a future amount.
- It reflects how **$1 received in the future is worth less today**.

Substitute known values:

- $PV = 2000$
- $r = 0.10$
- $n = 4$

Step-by-Step Solution

Step 1: Plug values into the formula:

$$2000 = x \cdot \frac{1 - (1.10)^{-4}}{0.10}$$

$$(1.10)^{-4} = \frac{1}{1.4641} \approx 0.6830$$

$$\Rightarrow \frac{1 - 0.6830}{0.10} = \frac{0.3170}{0.10} = 3.170$$

Step 2: Solve for x

Now solve:

$$2000 = x \cdot 3.170 \Rightarrow x = \frac{2000}{3.170} \approx \boxed{631.23}$$

So your annual repayment is **$631.23**.

Your turn! Calculate the Instalments

- A loan of \$5000 is repaid in 5 annual instalments at 8%. Find the annual instalment.
- A loan of \$3000 is repaid in 3 annual instalments at 6%. Find the annual instalment.

Section 3.4: Investment Appraisal

Investment Appraisal

Stands for evaluating the financial viability of investments.

Present Value (Discrete)

- Present value PV is the current value of future cash flows.

$$PV = \frac{A}{(1+r)^n}$$

- 1000 in 3 years at 6%:

$$PV = \frac{1000}{1.06^3} \approx 839.62$$

Present Value (Continuous)

$$PV = A \cdot e^{-rt}$$

- 1000 in 3 years at 6%:

$$PV = 1000 \cdot e^{-0.18} \approx 836.00$$

What's the difference between discrete and continuous?

- **Discrete**: Values occur at specific intervals (e.g., yearly, monthly).
  Example: Annual interest compounding.
- **Continuous**: Values change smoothly over time, modeled using exponential functions.
  Example: Continuous compounding of interest.

Net Present Value (NPV)

- Net present value NPV is the sum of present values of cash flows.

$NPV = -C_0 + \sum_{t=1}^{n} \frac{C_t}{(1+r)^t}$

- Example: Cost = \$2000, Returns = \$800/year for 3 years, $r = 10\%$:

$$NPV \approx -2000 + \frac{800}{1.10} + \frac{800}{1.10^2} + \frac{800}{1.10^3} \approx 75.13$$

Good job - this answer is wrong!

Correct Calculation

$$= -2000 + 727.27 + 661.16 + 601.06 = \boxed{-10.51}$$

So, the project has a **negative NPV** of about **–$10.51**, meaning **it's not financially viable** at a 10% discount rate.

Present Value of an Annuity

- Annuity is a series of equal payments over time.

$$PV = PMT \cdot \frac{1-(1+r)^{-n}}{r}$$

- $1000/year for 5 years at 6%:

$$PV = 1000 \cdot \frac{1-(1.06)^{-5}}{0.06} \approx 4212.40$$

Internal Rate of Return (IRR)

- IRR is the rate at which NPV = 0.
- We calculate IRR to compare investment options.

Find r such that $NPV = 0$:

$$0 = -C_0 + \sum \frac{C_t}{(1+r)^t}$$

Solve numerically or using software.

Present Value of Government Bonds

Bond pays $50/year for 10 years, plus $1000 at end.

$$PV = \sum_{t=1}^{10} \frac{50}{(1.05)^t} + \frac{1000}{(1.05)^{10}} \approx 925.81$$

Good job - this answer is wrong!

Correct Calculation

$$PV = \sum_{t=1}^{10} \frac{50}{(1.05)^t} + \frac{1000}{(1.05)^{10}} \approx \boxed{1000}$$

This makes sense: at a 5% rate, the bond is worth **its face value**.

Practice Problems

1. Sum of: $3 + 6 + 12 + 24$
2. \$200/quarter, 4% quarterly compounding for 3 years
3. PV of \$1500 in 2 years at 8% (continuous)
4. NPV: \$3000 cost, \$1200/year for 3 years, 7% rate
5. PV of \$500 annuity for 6 years at 5%
6. IRR: \$2000 cost, \$500/year for 5 years

Summary

- Geometric series = finance modeling
- Investment tools = PV, NPV, IRR
- Practical for decision-making in public/private sectors

Any QUESTIONS?

Thank you for your attention!

Next Class

- (April 2) The Derivative of Functions (4.1), Rules of Differentiation (4.2)

Next Friday (April 4) - Quiz #1

- Please review your Home Work #1, in-class problems and problems from the textbook.