

1.7: The Time Value of Money

Learning Objectives

1. Explain the value of liquidity.
2. Demonstrate how time creates distance, risk, and opportunity cost.
3. Demonstrate how time affects liquidity.
4. Analyze how time affects value.

Part of the planning process is evaluating the possible future results of a decision. Since those results will occur some time from now (i.e., in the future), it is critical to understand how time passing may affect those benefits and costs—not only the probability of their occurrence, but also their value when they do. Time affects value because time affects liquidity.

Liquidity is valuable, and the liquidity of an asset affects its value: all things being equal, the more liquid an asset is, the better. This relationship—how the passage of time affects the liquidity of money and thus its value—is commonly referred to as the **time value of money**, which can actually be calculated concretely as well as understood abstractly.

Suppose you went to Mexico, where the currency is the peso. Coming from the United States, you have a fistful of dollars. When you get there, you are hungry. You see and smell a taco stand and decide to have a taco. Before you can buy the taco, however, you have to get some pesos so that you can pay for it because the right currency is needed to trade in that market. You have wealth (your fistful of dollars), but you don't have wealth that is liquid. In order to change your dollars into pesos and acquire liquidity, you need to exchange currency. There is a fee to exchange your currency: a **transaction cost**, which is the cost of simply making the trade. It also takes a bit of time, and you could be doing other things, so it creates an opportunity cost (see Chapter 2). There is also the chance that you won't be able to make the exchange for some reason, or that it will cost more than you thought, so there is a bit of risk involved. Obtaining liquidity for your wealth creates transaction costs, opportunity costs, and risk.

Figure 4.2.1



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In general, transforming not-so-liquid wealth into liquid wealth creates transaction costs, opportunity costs, and risk, all of which take away from the value of wealth. Liquidity has value because it can be used without any additional costs.

One dimension of difference between not-so-liquid wealth and liquidity is time. Cash flows (CF) in the past are sunk, cash flows in the present are liquid, and cash flows in the future are not yet liquid. You can only make choices with liquid wealth, not with cash that you don't have yet or that has already been spent. Separated from your liquidity and your choices by time, there is an opportunity cost: if you had liquidity now, you could use it for consumption or investment and benefit from it now. There is also risk, as there is always some uncertainty about the future: whether or not you will actually get your cash flows and just how much they'll be worth when you do.

The further in the future cash flows are, the farther away you are from your liquidity, the more opportunity cost and risk you have, and the more that takes away from the present value (PV) of your wealth, which is not yet liquid. In other words, time puts distance between you and your liquidity, and that creates costs that take away from value. The more time there is, the larger its effect on the value of wealth.

Financial plans are expected to happen in the future, so financial decisions are based on values some distance away in time. You could be trying to project an amount at some point in the future—perhaps an investment payout or college tuition payment. Or perhaps you are thinking about a series of cash flows that happen over time—for example, annual deposits into and then withdrawals from a retirement account. To really understand the time value of those cash flows, or to compare them in any reasonable way, you have to understand the relationships between the nominal or face values in the future and their equivalent, present values (i.e., what their values would be if they were liquid today). The equivalent present values today will be less than the nominal or face values in the future because that distance over time, that separation from liquidity, costs us by discounting those values.

KEY TAKEAWAY

- Liquidity has value because it enables choice.
- Time creates distance or delay from liquidity.
- Distance or delay creates risk and opportunity costs.
- Time affects value by creating distance, risk, and opportunity costs.
- Time discounts value.

EXERCISE

1. How does the expression “a bird in the hand is worth two in the bush” relate to the concept of the time value of money?
2. In what four ways can “delay to liquidity” affect the value of your wealth?

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