

RISK, RETURN, AND THE COST OF CAPITAL

Risk-Free Rate

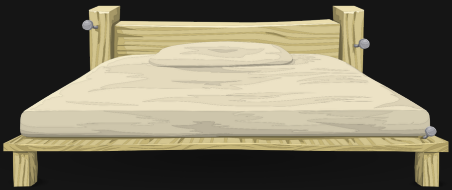
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RATE OF RETURN

► Safest possible investment?



US TREASURY BONDS

- ▶ US will not default (soon)
- ▶ Treasury can print money
- ▶ Backed by future taxes
- ▶ Treasury rate is safest

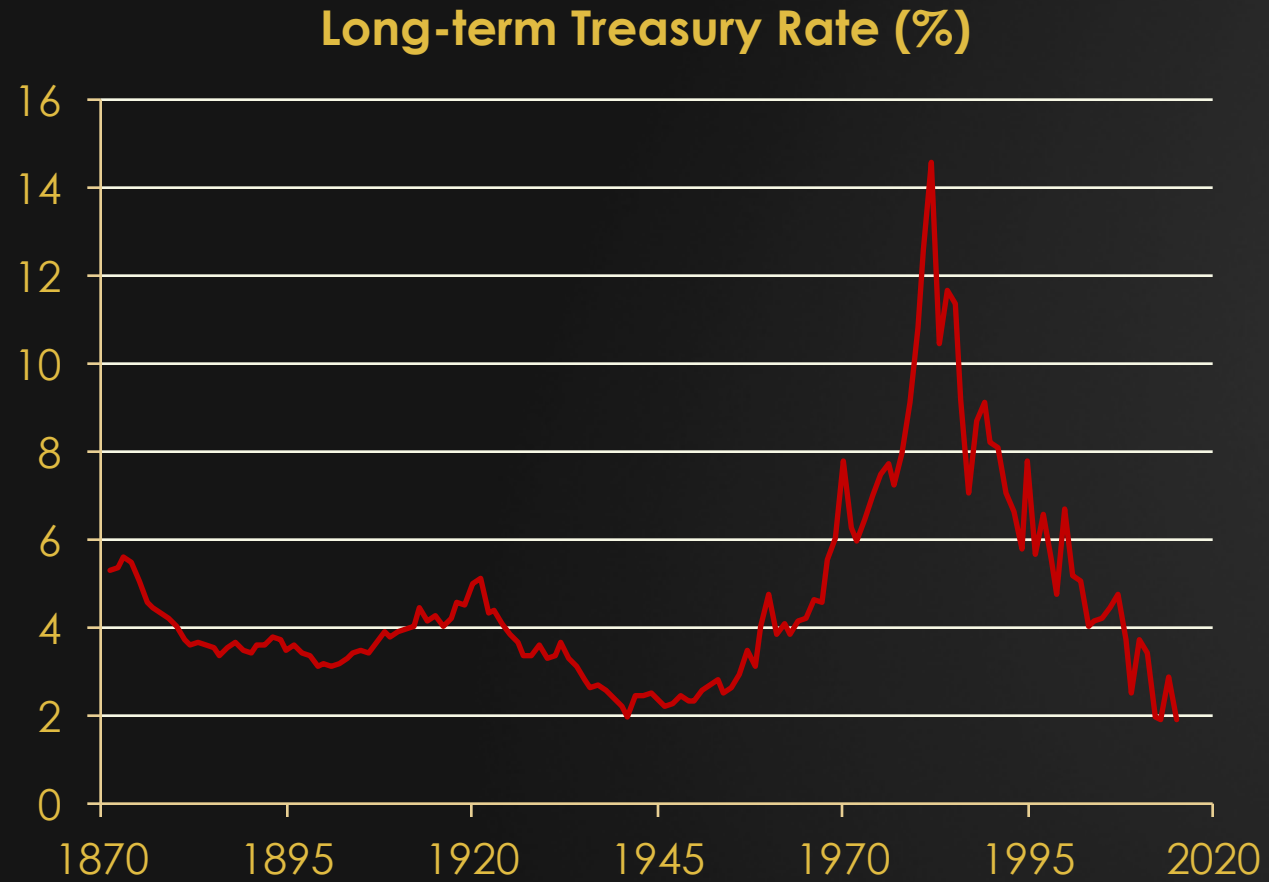
RISK FREE RATE

Rate of return

= risk free rate

+ risk premium

HISTORICAL RATES



RISK FREE RATES: MATURITY

- ▶ Yield curve
- ▶ Longer maturity = higher rates
 - ▶ Rates may rise
 - ▶ Greater liquidity risk

SUMMARY

- ▶ Risk free rates set the floor
- ▶ Risky returns earn a premium
- ▶ Benchmark is U.S. Treasury
- ▶ Rates rise with maturity