

# CHAPTER 2

## The Financial Markets and Interest Rates

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### CHAPTER ORIENTATION

This chapter considers the market environment in which long-term capital is raised. The underlying rationale for the existence of security markets is presented, investment banking services and procedures are detailed, private placements are discussed, and recent security market regulation is reviewed. Further discussions cover rates of return over long periods of time and interest rates in recent periods, interest rate determinants, and theories of the term structure of interest rates.

### CHAPTER OUTLINE

- I. Financing of Business: The Movement of Funds Through the Economy
  - A. Capital can be transferred from saving-surplus units (those who spend less than they take in) to savings-deficit units (those who need additional funds) using one of three methods.
    - 1. Direct transfer of funds—The firm seeking cash sells its securities directly to investors. These transfers may involve an **angel investor** (a wealthy private investor who provides capital for a business start-up) or a **venture capitalist** (an investment firm or individual investor that provides money to business start-ups).
    - 2. Indirect transfer using an investment bank—An investment bank buys the entire issue of securities from the firm seeking funds and then sells them at a higher price to the investing public.
    - 3. Indirect transfer using financial intermediaries—A financial intermediary (e.g., life insurance companies, mutual funds, or pension funds) collects the savings of individuals and issues its own securities to these savers. The intermediary then invests the accumulated funds in various securities.
  - B. Public Offerings Versus Private Placements
    - 1. The public financial market is an impersonal market in which both individual and institutional investors have the opportunity to acquire securities.
      - a. A **public offering** is a security offering where all investors have the opportunity to acquire a portion of the securities being sold in the public market.

- b. The security-issuing firm does not meet the actual investors in the securities face-to-face.
- 2. In a **private placement** of securities, only a limited number of investors have the opportunity to purchase a portion of the issue.
  - a. The market for private placements is more personal than its public counterpart.
  - b. The specific details of the issue may actually be developed on a face-to-face basis among the potential investors and the issuer.
- 3. Private placements and venture capital
  - a. Private placements can involve issuing both debt and equity, and venture capitalists can play an active role in both placements.
  - b. For start-up companies or companies in the early stages of business, as well as firms in “turnaround” situations, venture capital is a prime source of funds. The venture capital firm will frequently acquire a meaningful dollar stake in the start-up firm.

#### C. Primary Markets Versus Secondary Markets

- 1. Securities are first offered for sale in the **primary market**. For example, the sale of a new bond, preferred stock, or common stock issue takes place in the primary market. These transactions increase the total stock of financial assets in existence within the economy.
- 2. Trading in currently existing securities takes place in the **secondary market**. The total stock of financial assets is unaffected by such transactions.

#### D. The Money Market Versus the Capital Market

- 1. The **money market** consists of the institutions and procedures that provide for transactions in short-term debt instruments that are generally issued by borrowers who have very high credit ratings.
  - a. “Short-term” means that the securities traded in the money market have maturity periods of not more than one year.
  - b. Equity instruments are not traded in the money market.
  - c. Typical examples of money market instruments are (1) U.S. Treasury bills, (2) federal agency securities, (3) bankers’ acceptances, (4) negotiable certificates of deposit, and (5) commercial paper.
- 2. The capital market consists of the institutions and procedures that provide for transactions in long-term financial instruments. This market encompasses those securities that have maturity periods exceeding one year.

E. Spot Markets Versus Futures Markets

1. Cash markets are markets where something sells today, right now, on the spot; in fact, cash markets are often referred to as **spot markets**.
2. **Futures markets** are markets where you can set a price to buy or sell something at some future date; in effect, you sign a contract that states what you are buying, how much of it you are buying, at what price you are buying it, and when you will actually make the purchase.

F. Stock Exchanges: Organized Security Exchanges Versus Over-the-Counter Markets, A Blurring Difference

1. Because of the technological advances during the past 25 years, coupled with deregulation and increased competition, the difference between an organized exchange and the over-the-counter market has blurred. **Organized security exchanges** are tangible entities that facilitate the trading of securities. Their activities are governed by a set of bylaws. **Security exchanges** physically occupy space, and financial instruments are traded on the premises.
2. Stock Exchange Benefits. Both corporations and investors enjoy several benefits provided by the existence of organized security exchanges. These include the following:
  - a. Providing a continuous market. A continuous market provides a series of continuous security prices, resulting in smaller price changes from trade to trade.
  - b. Establishing and publicizing fair security prices. An organized exchange permits security prices to be set by competitive forces with the specific price of a security is determined in the manner of an auction.
  - c. Helping business raise new capital. Because a continuous secondary market exists, it is easier for firms to float, or issue, new security offerings at competitively determined prices.

II. Selling Securities to the Public

The **investment banker** is a financial specialist who acts as an intermediary in the selling of securities. He or she works for an investment banking firm (house).

A. The investment banker provides three basic functions.

1. The investment banker assumes the risk of selling a new security issue at a satisfactory (profitable) price. This is called **underwriting**. Typically, the investment banking house, along with the underwriting syndicate, actually buys the new issue from the corporation that is raising funds. The syndicate (group of investment banking firms) then sells the issue to the investing public at a higher price than it paid (one hopes).
2. The investment banker provides for the **distribution** of the securities to the investing public.
3. The investment banker **advises** firms on the details of selling securities.

## B. Distribution Methods

Several distribution methods are available for placing new securities into the hands of final investors. The investment banker's role is different in each case.

1. In a **negotiated purchase**, the firm in need of funds contacts an investment banker and begins the sequence of steps leading to the final distribution of the offered securities. The price that the investment banker pays for the securities is negotiated with the issuing firm individually.
2. In a **competitive bid purchase**, the investment banker and underwriting syndicate are selected by an auction process. The syndicate willing to pay the issuing firm the greatest dollar amount per new security wins the competitive bid. This means that it will underwrite and distribute the issue. In this situation, the price paid to the issuer is not negotiated; instead, it is determined by a sealed-bid process, much on the order of construction bids.
3. In a **commission** (or **best-efforts**) offering, the investment banker does not act as an underwriter. He or she attempts to sell the issue in return for a fixed commission on each security that is actually sold. Unsold securities are simply returned to the firm that was hoping to raise funds.
4. In a **privileged subscription**, the new issue is not offered to the investing public. It is sold to a definite and limited group of investors. Current stockholders are often the privileged group.
5. In a **Dutch auction**, investors first put in bids giving the number of shares they would like to buy and the price they are willing to pay for them. Once in, the bids are ranked, and the selling price is calculated as the highest price that allows all the stock to be sold.
6. In a **direct sale**, the issuing firm sells the securities to the investing public without involving an investment banker. This is not a typical procedure.

## C. Private Debt Placements

1. Each year, billions of dollars of new securities are privately (directly) placed with final investors. In a private placement, a small number of investors purchase the entire security offering. Most private placements involve debt instruments.
2. Large financial institutions are the major investors in private placements. These include (1) life insurance firms, (2) state and local retirement funds, and (3) private pension funds.
3. The advantages and disadvantages of private placements as opposed to public offerings must be carefully evaluated by management.
  - a. The advantages include (1) greater speed than a public offering in actually obtaining the needed funds, (2) lower flotation costs than are associated with a public issue, and (3) increased flexibility in the financing contract.
  - b. The disadvantages include (1) higher interest costs than are ordinarily associated with a comparable public issue, (2) the imposition of several restrictive covenants

in the financing contract, and (3) the possibility that the security may have to be registered some time in the future at the lender's option.

#### D. Flotation Costs

1. The firm raising long-term capital typically incurs two types of **flotation costs**: (1) the underwriter's spread and (2) issuing costs. The former is typically the larger.
  - a. The underwriter's spread is the difference between the gross and net proceeds from a specific security issue. This absolute dollar difference is usually expressed as a percentage of the gross proceeds.
  - b. Many components comprise issue costs. The two most significant are (1) printing and engraving and (2) legal fees. For comparison purposes, these costs are usually expressed as a percentage of the issue's gross proceeds.
2. SEC data reveal two relationships about flotation costs.
  - a. Issue costs (as a percentage of gross proceeds) for common stock exceed those of preferred stock, which in turn exceed those of bonds.
  - b. Total flotation costs per dollar raised decrease as the dollar size of the security issue increases.

#### E. Regulation Aimed at Making the Goal of the Firm Work: The Sarbanes-Oxley Act

1. In July 2002, Congress passed the Public Company Accounting Reform and Investor Protection Act. The short name for the act became the Sarbanes-Oxley Act of 2002.
  - a. The Sarbanes-Oxley Act was passed as the result of a large series of corporate indiscretions.
  - b. The act holds corporate advisors (e.g., accountants, lawyers, company officers, and boards of directors) who have access to or influence over company decisions strictly accountable in a legal sense for any instances of misconduct.

### III. Rates of Return in the Financial Markets

#### A. Rates of Return Over Long Periods

Although interest rates are presently at historically low levels and stock prices have been extremely volatile since 2007, the following relationships have been observed over the longer run (88 years from 1926 to 2014):

1. The average inflation rate (the "inflation-risk premium") has been about 3.0 percent annually.
2. The default-risk premium for long-term corporate bonds over long-term government bonds has been about 0.4 percent annually.
3. Large common stocks earned 4.0 percent more than the rate earned on long-term corporate bonds.

#### B. Interest Rate Levels in Recent Periods

1. The **nominal (or quoted) rate of interest** is the interest rate paid on debt securities without an adjustment for inflation.

2. An **inflation premium** is the additional return required by investors to compensate for inflation expected to occur over the life of the investment.
3. The **default-risk premium** is the additional return required by investors to compensate for the risk of default.
4. The **maturity-risk premium** is another factor that affects interest rate levels and arises even if a security possesses equal odds of default. It is the additional return required by investors in longer-term securities to compensate for a greater risk of price fluctuations on these securities due to changes in interest rates.
5. The **liquidity-risk premium** also determines interest rate levels. It is the additional return required by investors for securities that cannot be converted into cash quickly without a substantial loss in value.

#### IV. Interest Rate Determinants in a Nutshell

A. The interest rate on a security is equal to the real risk-free interest rate plus compensation for taking on different types of risk (measured by risk premiums).

1. The real risk-free interest rate is the required rate of return on a fixed-income security that has no risk in an economic environment of zero inflation. It is one component of the nominal interest rate.
2. The nominal rate of interest can be expressed as,  
nominal interest rate = real risk-free interest rate

$$\begin{aligned}
 &+ \text{inflation premium} \\
 &+ \text{default-risk premium} \\
 &+ \text{maturity-risk premium} \\
 &+ \text{liquidity-risk premium} \qquad (2-1)
 \end{aligned}$$

B. Estimating Specific Interest Rates Using Risk Premiums

C. Real Risk-Free Interest Rate and the Risk-Free Interest Rate

1. In economics and finance, the term “real” means that the variable has been adjusted for inflation.
2. Thus, the real interest rate is an inflation-adjusted risk-free interest rate.
3. Real risk-free interest rate  $\approx$  risk-free interest rate – inflation premium

#### D. Real and Nominal Rates of Interest

1. The **real rate of interest** is the difference in the nominal rate and the anticipated rate of inflation.
2. It tells you how much more purchasing power you have.
3. An approximation of the nominal interest rate is given by the following equation:

$$\text{Nominal interest rate} \approx \text{real rate of interest} + \text{inflation premium} \quad (2-2)$$

4. The exact relationship between the nominal interest rate, the rate of inflation, and the real rate of interest is expressed by the following equation:

$$(1 + \text{nominal interest rate}) = (1 + \text{real rate of interest})(1 + \text{rate of inflation}) \quad (2-3)$$

or

$$\text{nominal rate of interest} = \text{real rate of interest} + \text{anticipated rate of inflation} + [(\text{real rate of interest})(\text{anticipated rate of inflation})]$$

For example, if the real rate is 5 percent and the expected inflation rate is 4 percent, the nominal rate would then be 9.2 percent, computed as follows:

$$\begin{aligned} \text{nominal rate of interest} &= 0.05 + 0.04 + (0.05)(0.04) \\ &= 0.092 \text{ or } 9.2\% \end{aligned}$$

#### E. Inflation and Real Rates of Return: The Financial Analyst's Approach

1. Practicing analysts and executives employ an approximation method to estimate the real rate of interest over a selected past time frame.
2. This approximation is given in the following equation:

$$\text{Nominal interest rate} - \text{inflation rate} \approx \text{real interest rate}$$

#### F. The Term Structure of Interest Rates

1. The relationship between a debt security's rate of return and the length of time until the debt matures is known as the **term structure of interest rates** or the **yield curve**.

#### G. Shifts in the Term Structure of Interest Rates

1. The term structure of interest rates changes over time, depending on the environment.
2. The particular term structure observed today may be quite different from the term structure one month ago and different still from the term structure one month from now.
3. The term structure reflects observed rates or yields on similar securities, except for the length of time until maturity, at a particular moment in time.

H. What Explains the Shape of the Term Structure?

Three theories are commonly used to explain the term structure of interest rates.

1. The **unbiased expectations theory** says that the term structure is determined by investors' expectations about future interest rates.
2. The **liquidity preference theory** proposes that investors require liquidity premiums (additional returns) to compensate them for buying securities that expose them to a greater risk of changes in market value due to fluctuating interest rates.
3. The **market segmentation theory** proposes that legal restrictions and personal preferences limit investment choices to certain ranges of maturities. Thus, the interest rate observed is determined solely by supply and demand conditions for securities of a given maturity.



## ANSWERS TO END-OF-CHAPTER REVIEW QUESTIONS

- 2-1. The **money market** consists of all institutions and procedures that accomplish transactions in short-term debt instruments (those claims with maturities up to one year) that are issued by borrowers with (typically) high credit ratings. Examples of securities traded in the money market include U.S. Treasury bills, bankers' acceptances, and commercial paper. Notice that all of these are debt instruments. Equities are not traded in the **money market**. The money market is entirely an over-the-counter market. On the other hand, the **capital market** provides for transactions in long-term financial claims (those claims with maturity periods extending beyond one year). The capital market includes both debt and equity securities. Trades in the capital market can take place on organized exchanges or over-the-counter.
- 2-2. Organized stock exchanges provide for the following:
- (1) A continuous market. This means a series of continuous security prices is generated. Price changes between trades are dampened, reducing price volatility, and enhancing the liquidity of securities.
  - (2) Establishing and publicizing fair security prices. Prices on an organized exchange are determined in the manner of an auction. Moreover, the prices are published in widely available media, like newspapers.
  - (3) An aftermarket to aid businesses in the flotation of new security issues. The continuous pricing mechanism provided by the exchanges facilitates the determination of offering prices in new flotations. The initial buyer of the new issue has a ready market in which he can sell the security should he need liquidity rather than a financial asset.
- 2-3. An effective financial system is characterized by taking money from the investors and providing it to the efficient users.
- 2-4. Investors of venture capital firms are active in the private placement market with the objective to sell the firm one day or take it public through an initial public offering (IPO). For this purpose, they raise money from other investors and/or individuals to pool the funds and then invest in companies with high-return potential for 5 to 7 years. Such start-ups and early-stage companies represent the target group of venture capital firms because of the following reasons:
1. Small absolute size.
  2. Very limited or no historical track record of operating results.
  3. Obscure growth prospects.
  4. Inability to sell the stock easily or quickly.

For all these reasons, they expect higher returns. These circumstances will remind us "Principle 3" that forms the foundations of finance—"Risk Requires a Reward".

- 2-5. The investment banker is a middleman involved in the channeling of savings into long-term investment. He performs the functions of (1) underwriting, (2) distributing, and (3) advising. By assuming underwriting risk, the investment banker and his syndicate purchase the securities from the issuer and hope to sell them at a higher price. Distributing the securities means getting those financial claims into the hands of the ultimate investor. This is accomplished through the syndicate's selling group. Finally, the investment banker can provide the corporate client with sound advice on which type of security to issue, when to issue it, and how to price it.
- 2-6. In a negotiated purchase, the corporate security issuer and the managing investment banker negotiate the price that the investment banker will pay the issuer for the new offering of securities. In a competitive-bid situation, the price paid to the corporate security issuer is determined by competitive (sealed) bids, which are submitted by several investment banking syndicates, each hoping to win the right to underwrite the offering.
- 2-7. Investment banking syndicates are established for three key reasons: (1) the investment bank that originates the business probably cannot afford to purchase the entire new issue itself; (2) the risk of loss is spread among several underwriters; and (3) the distribution network is widened.
- 2-8. Private placement is a security offering limited to a small number of potential investors. Its advantages include (1) speed, as funds are obtained more quickly than through a public offering; (2) reduced costs because the lengthy registration statement does not have to be prepared, and the investment-banking underwriting and distribution costs do not have to be absorbed; and (3) financing flexibility on a tailored face-to-face basis with a small number of investors.
- The disadvantages include (1) interest costs on private placements exceeding those of public issues; (2) restrictive covenants with an effect on a firm's dividend policy, working-capital levels, and the raising of additional debt capital by provisions in the private placement debt contract; and (3) the possibility of future SEC registration in case the lender (investor) decides to sell the issue to a public buyer before maturity.
- 2-9. There are two types of flotation costs: (1) the underwriter's spread and (2) issuing costs. The underwriter's spread, which is the larger cost, is the difference between the gross and net proceeds from a given security issue. The costs include (a) the printing and engraving of the security certificates; (b) legal fees; (c) accounting fees; (d) trustee fees; and (e) several other miscellaneous components.
- 2-10. First, savings may be directly transferred from the investor to the borrower. Second, an indirect transfer might use the services provided by an investment banker. Third, an indirect transfer might use the services of a financial intermediary, such as private pension funds and life insurance companies.
- 2-11. As a net user of funds, a firm must raise funds in the financial markets, either in the form of debt or of equity. Because other entities will be in need of funds, including both businesses and governments, the firm must offer the investor a return that is attractive, given the investor's best alternative investment opportunity. Otherwise, the investor will not be interested in purchasing the company's bonds or stocks. Thus, the cost of money to the firm will invariably be determined by the investor's best alternative opportunity for

the given level of risk being assumed—that is, the investor’s opportunity cost. We should never base our decisions on past or historical costs, even when they represent the actual out-of-pocket costs to the firm. Maximizing shareholder wealth means that we make decisions based upon our understanding of the investor’s best alternative opportunities. In the case of investment and financing decisions, the opportunity cost for the firm’s investors is captured in the rates of return available in the financial markets.

- 2-12. According to the liquidity preference theory, investors demand maturity-risk premiums as compensation for buying securities with longer maturities, which involve greater risk of fluctuating interest rates (Modigliani, 1944; Tobin, 1958).
- 2-13. We may think of the difference in the nominal rate and real rate of return as the “inflation premium.” As the expected rate of inflation increases, investors will demand a higher rate of return (a higher inflation premium) to compensate for the potential loss of purchasing power.
- 2-14. The term structure of interest rates represents the relationship between a debt security’s rate of return and the length of time until the debt matures. For the relationship to be meaningful, all factors other than maturity, such as the chance of the bond defaulting, must be held constant.
- 2-15. The chapter gives three theories for explaining the term structure of interest rates: (1) the unbiased expectations theory, (2) the liquidity preference theory, and (3) the market segmentation theory.
  - (1) The unbiased expectations theory states that the term structure is determined by an investors’ expectations about future interest rates. If interest rates are expected to be higher in the future, securities with longer maturities will carry a higher interest rate (and vice versa). Looking at the current term structure of interest rates, we can estimate what investors should expect future interest rates to be. For instance, if we know the current interest rates for securities maturing in one and two years, we can estimate what rate investors expect on a similar security issued one year from now with a one-year maturity date.
  - (2) According to the liquidity preference theory, investors require a liquidity premium to compensate for buying longer-term securities that expose them to the risks of fluctuating future interest rates.
  - (3) The market segmentation theory proposes that legal restrictions and personal preferences limit investors’ investment choices to certain ranges of maturities. For example, commercial banks prefer short- to medium-term maturities as a result of their short-term deposit liabilities. They simply do not like to invest in long-term securities. Life insurance companies, on the other hand, have longer-term liabilities, so they prefer longer maturities when they invest. The market segmentation theory implies that the rate of interest for a particular maturity is determined solely by demand and supply conditions for a given maturity and is independent of the demand and supply conditions for securities having different maturities.

## **SOLUTIONS TO END-OF-CHAPTER STUDY PROBLEMS**

2-1.  $NI = RI + IP + DP + MP + LP$ , where:

NI = Nominal interest rate

RI = Real risk-free interest rate

IP = Inflation premium

DP = Default-risk premium

MP = Maturity-risk premium

LP = Liquidity-risk premium

k = Nominal rate of return

$k_{10\text{-years Treasury bond}} = 5\% = RI + IP + DP + MP + LP$ ; where  $DP = 0$  and  $LP = 0$  (remember, this is a Treasury security, so it should have no DP or LP)

Thus,  $k_{10\text{-years Treasury bond}} = 5\% = RI + IP + MP$

$k_{10\text{-years Corporate bond}} = 7\% = RI + IP + DP + MP + 0.5\%$

Since both bonds are 10-year bonds, they should have the same inflation premium (IP) and the same maturity-risk premium (MP). Thus, we can substitute  $5\% = RI + IP + MP$  into the 10-years corporate bond interest rate formula,

$k_{10\text{-years Corporate bond}} = 7\% = RI + IP + DP + MP + 0.5\%$

$k_{10\text{-years Corporate bond}} = 7\% = 5\% + DP + 0.5\%$

Thus,  $DP = 1.5\%$

2-2. Let NI = nominal rate

RI = real risk-free rate

IP = inflation premium

DP = Default-risk premium

MP = Maturity-risk premium

LP = Liquidity-risk premium

Since this is a Treasury security, there is no default-risk premium (DP) or liquidity-risk premium (LP); thus,

$k_{2\text{-year Treasury bond}} = 5.5\% = RI + IP + MP$

$6.5\% = 3\% + 3\% + MP$

Thus,  $MP = 0.5\%$

- 2-3. According to the problem, we are given the following information:  
 Nominal (quoted) rate of return = 8%  
 Real rate of return = 6%

The formula for the calculation of the expected inflation is:  
 $(1 + \text{Expected Inflation Rate}) = (1 + \text{Nominal Rate}) / (1 + \text{Real Rate of Return})$

Solving this, we see that:  
 $(1 + \text{Expected Inflation Rate}) = (1.08) / (1.06)$

$$(1 + \text{Expected Inflation Rate}) = 1.0189$$

Expected Inflation Rate = 0.0189 or 1.89%

- 2-4. If  $k$  = nominal rate  
 $k^*$  = real rate  
 IRP = inflation rate  
 then,  $k = k^* + \text{IRP} + (\text{IRP})(k^*)$   
 $k = 0.04 + 0.07 + (0.07)(0.04) = 0.1128 = 11.28\%$

- 2-5. If  $k$  = nominal rate  
 $k^*$  = real rate  
 IR = inflation rate  
 then,  $k = k^* + \text{IR} + (\text{IR})(k^*)$   
 $k = 0.06 + 0.04 + (0.06)(0.04) = 0.1024 = 10.24\%$

- 2-6. Approximation of the increase in real purchasing power = Mean nominal yield in % – Mean inflation yield in % = Mean real yield in %.

Security	Mean nominal yield in %	Mean inflation yield in %	Mean real yield in %
Treasury bill	4	2	2
Treasury bonds	7	2	5

- 2-7. If the cross-product is ignored, the simple arithmetic calculation, rather than the geometric one, is used:

Real rate (r) = Nominal (quoted) rate of return – Expected inflation rate

$$\text{Real rate (r)} = 4\% - 2\% = 2\%$$

- 2-8. Real risk-free rate = 4%

Rate of inflation = 3%

Expected rate of return = Real risk-free rate + Rate of inflation

Expected rate of return = 4% + 3% = 7%

- 2-9. In this problem, we are implicitly assuming the same inflation premium for each bond and that there are no tax differences between the bonds.

20-year Treasury Bonds:

Yield = 5.1%

Liquidity-risk premium = 0.0%

20-year corporate bonds:

Yield = 9.1%

Liquidity-risk premium = 0.25%

Default-risk premium = 9.1% – 5.1% – 0.25% = 3.75%

- 2-10. Real risk-free interest rate = 4.9% – 2.1% – 0.3% = 2.5%

- 2-11. We are told that

Real risk-free interest rate = 3.5%

Inflation rate = 2.5%

Default-risk premium = 0%

Liquidity-risk premium = 0%

We have learned that  $NI = RI + IP + DP + MP + LP$ , where

NI = Nominal interest rate

RI = Real risk-free interest rate

IP = Inflation premium

DP = default-risk premium

MP = maturity-risk premium

LP = Liquidity-risk premium

As there is no default-risk premium or liquidity-risk premium, the nominal interest rate will be a function of the other three variables.

0–1 year: 3.5% + 0.10% + 2.5% = 6.10%

1–2 years: 3.5% + 0.25% + 2.5% = 6.25%

2–3 years: 3.5% + 0.50% + 2.5% = 6.50%

3–4 years: 3.5% + 0.70% + 2.5% = 6.70%

- 2-12. We are told that

Real risk-free interest rate = 3.0%

Expected inflation rate = 3.0%

Default-risk premium = 1.5%

Liquidity-risk premium = 0.02%

Furthermore, we have learned that  $NI = RI + IP + DP + MP + LP$ , where:

NI = Nominal interest rate

RI = Real risk-free interest rate

IP = Inflation premium

DP = Default-risk premium

MP = Maturity-risk premium

LP = Liquidity-risk premium

Using the information given above, we come up with the following nominal rates:

0–1 year:  $3.0\% + 3.0\% + 1.5\% + 0.02\% + 0.07\% = 7.59\%$

1–2 years:  $3.0\% + 3.0\% + 1.5\% + 0.02\% + 0.35\% = 7.87\%$

2–3 years:  $3.0\% + 3.0\% + 1.5\% + 0.02\% + 0.70\% = 8.22\%$

3–4 years:  $3.0\% + 3.0\% + 1.5\% + 0.02\% + 1.00\% = 8.52\%$

- 2-13. a. If you invest in the two-year security, you will have saved \$23,328 ( $\$20,000 \times 1.08 \times 1.08$ ) by the end of the second year. If you invest in the one-year security, you will have saved \$21,200 ( $\$20,000 \times 1.06$ ) by the end of the first year. To do as well as you would with the first choice, you would have to earn \$2,128 in interest in the second year ( $\$23,328 - \$21,200$ ). That means you would have to earn 10 percent ( $\$2,128/\$21,200$ ) on the investment purchased in the second year, if you want to be as well off in the second year as you would be from buying the two-year security. Thus, you would invest in the one-year security paying 6 percent only if you believed you could earn at least 10 percent in the second year on a security issued at the beginning of the second year. The forgoing logic is based on the unbiased expectations theory of term structure of interest rates.
- b. If you require an 11 percent rate on the second one-year investment, then the unbiased expectations theory is not fully explaining the term structure of interest rates. The unbiased expectations theory suggests you should accept 10 percent in year two. Thus, you are requiring a liquidity premium on the second-year investment to compensate for the uncertainty of the future interest rates in year two.

2-14. *Internet search*

Unbiased expectation theory:

- This theory suggests that the shape of the yield curve depends on the expected future rates.

Liquidity preference theory:

- This theory suggests that investors prefer more liquid investments. The faster an asset can be converted into money, the higher the liquidity. Money is the most liquid asset.

Market segmentation theory:

- This theory is built on the notion that legal restrictions and personal preferences limit choices for investors to certain ranges of maturities.

- 2-15. If you invest the money for two years at 3.5 percent, you will earn 3.5 percent in year one, so your \$50,000 will grow by \$1,750 (that is 3.5 percent of \$50,000) to \$51,750, and it

will grow another 3.5 percent in year two. Because 3.5% of \$51,750 is \$1,811.25, your total at the end of two years would be \$53,561.25. If you put your money in a one-year security paying 3 percent, you would have \$51,500 at the end of one year. To make these two alternatives equivalent, you would need to earn  $\$53,561.25 - \$51,500$  or \$2,061.25 during year two. Thus, if you begin year two with \$51,500 and need it to grow by \$2,061.25, you would need to earn  $\$2,061.25/\$51,500$  or 4 percent in year two.



## SOLUTION TO MINI CASE

Real risk-free interest rate  The real risk-free rate of interest is the difference between the average yield on 3-months Treasury bills and the inflation rate.	1%
+ Inflation premium  The inflation rate has been provided.	2%
+ Default-risk premium  The default-risk premium is estimated by the difference between the average yield on bond and 30-years Treasury bonds.	2%
+ Maturity-risk premium  The maturity-risk premium is estimated by the difference between the average yield on 30-years Treasury bonds and 3-months Treasury bills.	2%
+ Liquidity-risk premium  1 basis point is one one-hundredth of 1 percent.	0.05%
= Nominal interest rate	7.05%