

COST OF CAPITAL

Risk Free Rate - Applied

We have already looked into the concept of the Risk Free Rate (RFR), when dealing with risk and return. Here, we will further expand this concept and apply it in building the framework for determining the cost of equity.

As mentioned before, the RFR is the return achieved for an investment with basically zero volatility, or zero risk. Applied to any capital market, sovereign bonds are assumed to be the least risky investment opportunity in that sovereign's domestic capital market. Hence, if one considers buying shares of a company operating in Austria, one may use the yields of Austrian government bonds as the regionally applicable RFR. However, there are dozens of domestic government bonds outstanding - especially with different maturities - and the question arises: Which one to choose?

Logic - supported by empirical observation - implies that bonds with shorter maturities are deemed to be less risky than those with longer maturities. Obviously, with longer maturities the likelihood of a default increases: Whilst one can be reasonably certain to get the money back from an investment which is due within a month or so, such is less certain if the payback is intended to be in thirty years or so. Therefore, in ordinary markets - exceptions sometimes occur - longer-maturity bonds carry a higher yield than shorter ones.

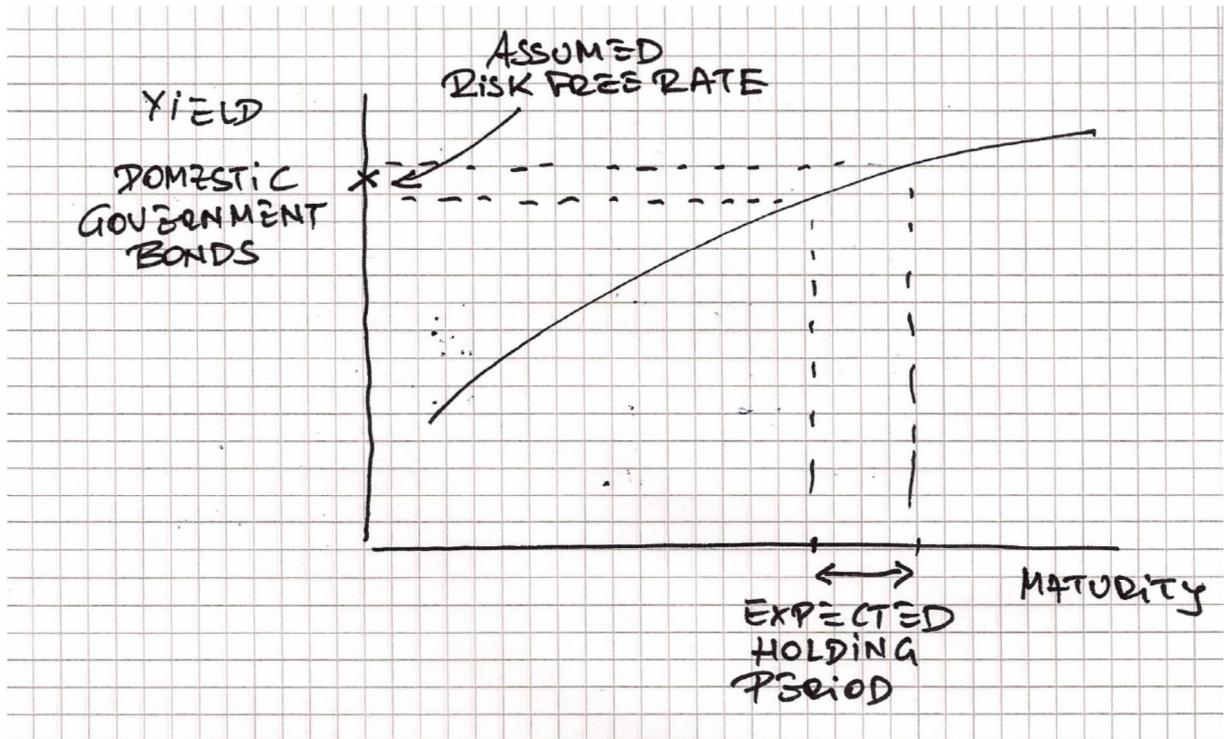
Why is it then, that in literature and practice everybody seems so fixed on the ten-year

government bonds to determine the RFR - and not (less risky) shorter ones? - Now, a shareholder may actually keep shares for months, or maybe even years. Therefore, the correct benchmark for picking the "right and appropriate" RFR would be a sovereign bond matching the maturity of the expected holding period of the shares held. Hence, a pension fund with a long investment horizon may use a longer-dated sovereign bond as a benchmark, as compared to a hedge fund flipping stock positions in a matter of weeks.

Research suggests that - on average - shareholders hold on to shares for a period of approximately ten years. Therefore, the benchmark sovereign bonds for determining the RFR are ten-year government bonds. - Consequently, an investor acquiring shares in an Austrian firm may use as a RFR benchmark for the investment an Austrian domestic government bond with a remaining maturity of ten years.

This concept can also be applied in any emerging market: Also there, the local, regional sovereign bond is deemed the least risky investment alternative, even if the country may be considered anything but risk-free and has already defaulted several times over the last decades, such as Russia. - Government bonds are still as safe as it gets.

Nevertheless, there are numerous tricky constellations in determining the "right" RFR: What, if there isn't a ten year local sovereign bond of the country one intends to invest available? What, if the firm one intends to invest is a global player with hardly any economic activity in the country it is registered in, such as Swiss-based Nestle? What, if the firm operates in an environment of extreme inflation? - These issues will be separately dealt with.



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