RISK AND RETURN

Risk Free Rate

The risk-free rate is the rate of return of an investment with no risk of loss. Usually, the respective government bond yield is considered having zero risk.

The risk free rate represents the return one could achieve if investing in a risk free asset: This is an asset which will over the whole investment period meet its obligations, and therefore never defaults or goes bankrupt. – So, in technical terms, the standard deviation of returns - as a proxy for risk - would be zero, or at least close to zero.

Capital markets comprise a wide range of products, such as stocks, bonds or a vast variety of hybrid products, such as convertibles, preferred shares and else. Besides, alternative asset categories such as private equity or hedge fund investments have become very popular over the years as well as investments in real estate or structured products.

Bonds - they belong to the category of fixed income instruments - are by far the largest asset category in the global capital markets. Issuers are foremost public institutions, such as sovereigns (e.g. Federal Republic of Germany), and corporates (e.g. Apple). Usually the issuer of a bond borrows funds from investors for a certain period of time, pays regular interest during the life time of the security and redeems the principle by the end of maturity.

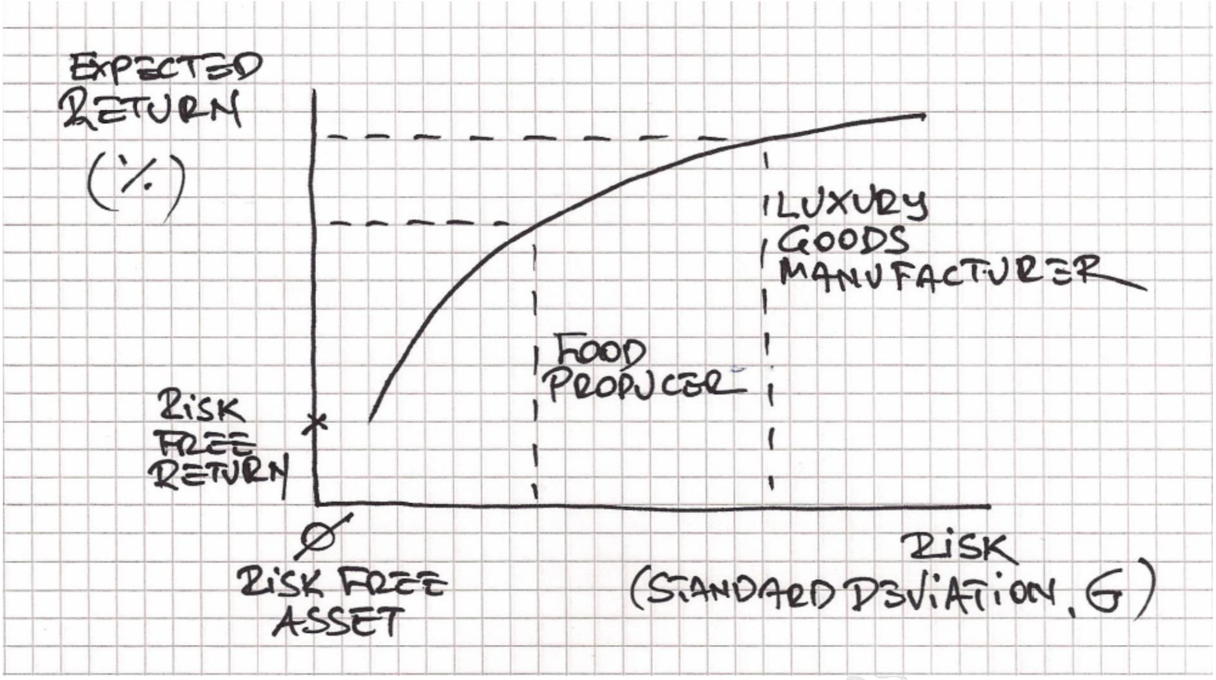
In most developed capital markets, bonds issued by sovereigns are regarded as investment instruments with zero – or close to zero – risk, whereby the reasoning is as follows: If the sovereign issuer defaults on its domestic bonds then all other – especially corporate – bond issuers in that country would default as well. Just imagine that a government in default were unable to pay salaries to its civil servants or cover costs and expenditures related to health care, education or infrastructure: Hence, a sovereign default will probably have a severe, possibly even catastrophic effect on many sectors of a national economy which may even come to a complete stand-still. History is littered with sovereign defaults, especially in emerging markets, but not only.

This concept of an assumed domino effect caused by a sovereign default is also generally applied by credit rating agencies: It is assumed that the credit rating of any local firm could - as a matter of principle - not exceed that of the sovereign. The credit rating of the sovereign issuer is regarded as the “sovereign ceiling”, a sort of “as good as it gets” upper limit for any other firm or institution seeking a domestic credit rating.

Of course, there are also good arguments against this concept: Imagine a sizable, mature, well-diversified, globally operating firm which is - just by coincidence - domiciled in a country going bankrupt. In such case, the sovereign default may not affect this firm at all or just to a very limited extent. The firm may still operate close to normal, still meeting all its bond- and credit-related obligations to best satisfaction.

Nevertheless, the concept of a sovereign ceiling can broadly be backed by empirical evidence: Therefore – as far as most developed markets are concerned - an investment in a local bond issued by the sovereign is regarded as the least risky investment proposition in that country. Therefore, domestic bonds issued in local currency by the governments of countries like Germany or the United States of America are considered risk free.

If one wanted to make an investment in an – anything but risk free – emerging markets environment, even then the local government bonds may serve as proxy for a “risk free rate” in the local currency. In essence the assumption is that investing in a local government bond is still the least risky investment alternative available in this country: Hence, such investment would be considered as “least risky”.


EXPECTED RETURN (%)
LUXURY GOODS MANUFACTURER
FOOD PRODUCER
RISK FREE RETURN
Ø
RISK FREE ASSET
RISK (STANDARD DEVIATION, σ)