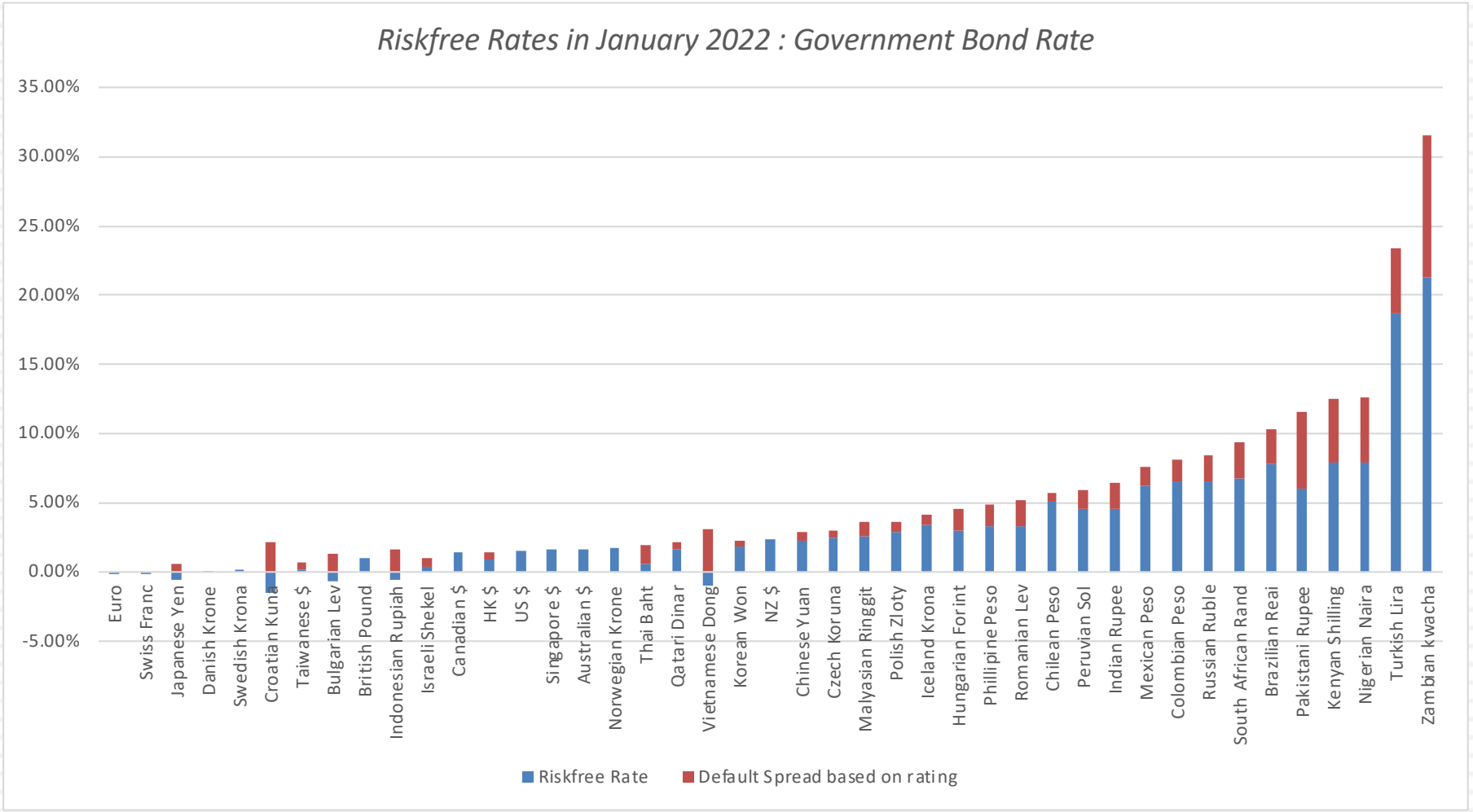
No default free entity: Choices with riskfree rates….

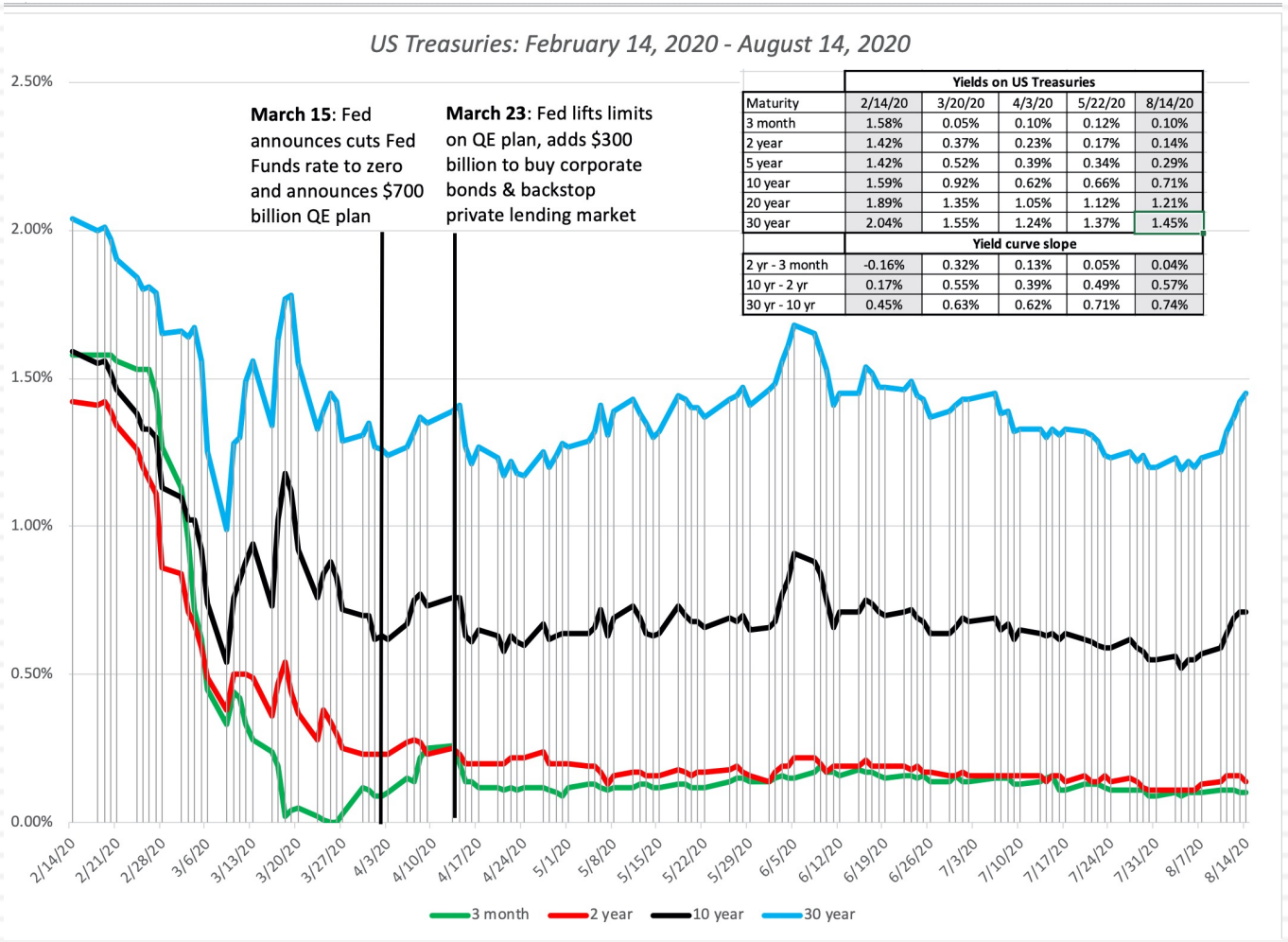
- Estimate a range for the riskfree rate in local terms:
  - Approach 1: Subtract default spread from local government bond rate:

    Government bond rate in local currency terms - Default spread for Government in local currency
  - Approach 2: Use forward rates and the riskless rate in an index currency (say Euros or dollars) to estimate the riskless rate in the local currency.
- Do the analysis in real terms (rather than nominal terms) using a real riskfree rate, which can be obtained in one of two ways –
  - from an inflation-indexed government bond, if one exists
  - set equal, approximately, to the long term real growth rate of the economy in which the valuation is being done.
- Do the analysis in a currency where you can get a riskfree rate, say US dollars or Euros.

Why do risk free rates vary across currencies? January 2022 Risk free rates



Or across time…



	Yields on US Treasuries				
Maturity	2/14/20	3/20/20	4/3/20	5/22/20	8/14/20
3 month	1.58%	0.05%	0.10%	0.12%	0.10%
2 year	1.42%	0.37%	0.23%	0.17%	0.14%
5 year	1.42%	0.52%	0.39%	0.34%	0.29%
10 year	1.59%	0.92%	0.62%	0.66%	0.71%
20 year	1.89%	1.35%	1.05%	1.12%	1.21%
30 year	2.04%	1.55%	1.24%	1.37%	1.45%
	Yield curve slope				
2 yr - 3 month	-0.16%	0.32%	0.13%	0.05%	0.04%
10 yr - 2 yr	0.17%	0.55%	0.39%	0.49%	0.57%
30 yr - 10 yr	0.45%	0.63%	0.62%	0.71%	0.74%

Risk free Rate: Don't have or trust the government bond rate?

1. Build up approach: The risk free rate in any currency can be written as the sum of two variables:

Risk free rate = Expected Inflation in currency + Expected real interest rate

Thus, if the expected inflation rate in a country is expected to be 15% and the TIPs rate is 1%, the risk free rate is 16%.

2. US $ rate & Differential Inflation: Alternatively, you can scale up the US $ risk free rate by the differential inflation between the US $ and the currency in question:

Risk free rate$_{Currency}$= $$(1 + Riskfree\ rate_{US\ \$}) \frac{(1 + Expected\ Inflation_{Foreign\ Currency})}{(1 + Expected\ Inflation_{US\ \$})} - 1$$

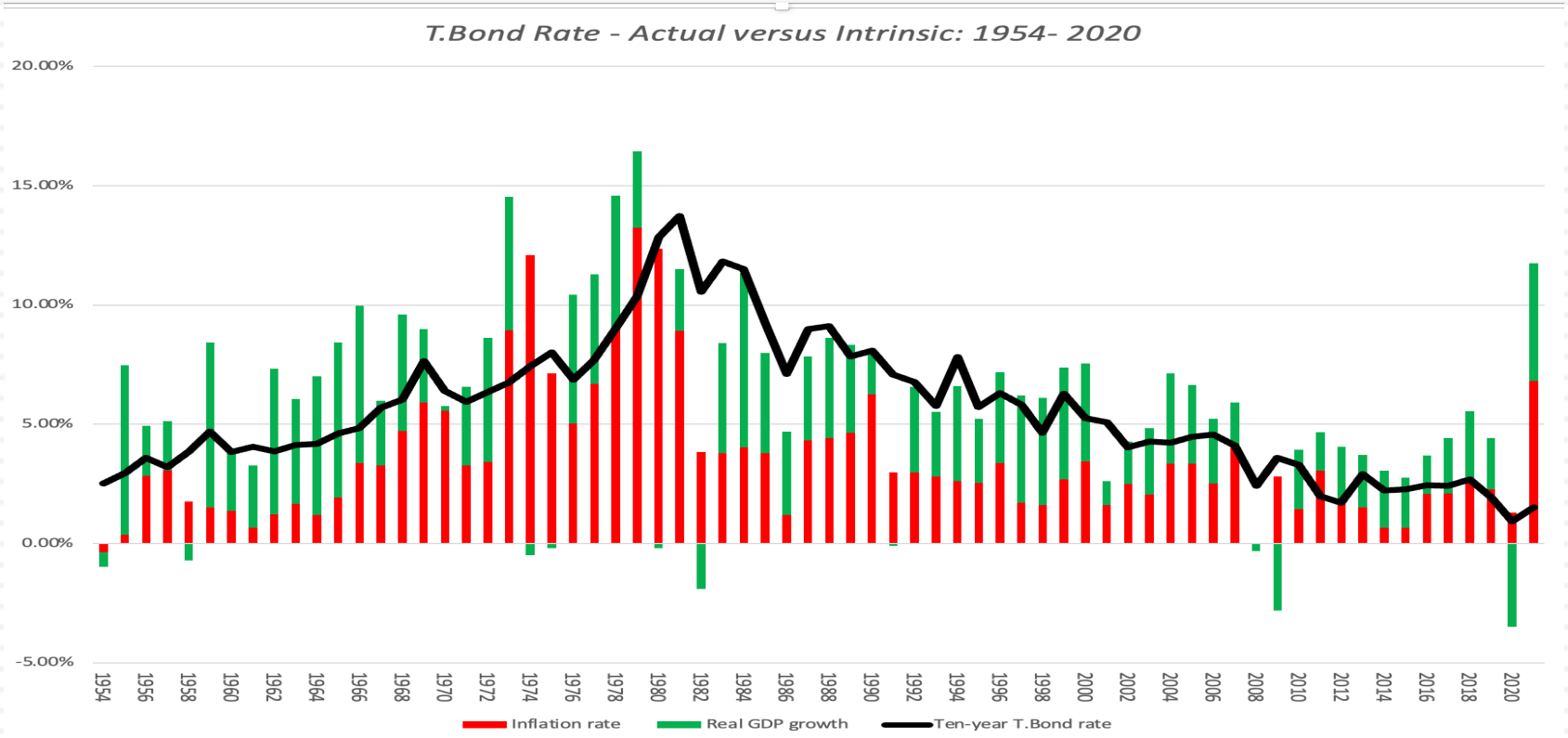
Thus, if the US $ risk free rate is 2.00%, the inflation rate in the foreign currency is 15% and the inflation rate in US $ is 1.5%, the foreign currency risk free rate is as follows:

Risk free rate = $$(1.02)\frac{(1.15)}{(1.015)} - 1 = 15.57\%$$

One more test on riskfree rates…

- On January 1, 2022, the 10-year treasury bond rate in the United States was 1.51%, low by historic standards. Assume that you are valuing a company in US dollars then, but are wary about the risk free rate being too low. Which of the following should you do?
  a. Replace the current 10-year bond rate with a more reasonable normalized riskfree rate (the average 10-year bond rate over the last 30 years has been about 5-6%)
  b. Use the current 10-year bond rate as your riskfree rate but make sure that your other assumptions (about growth and inflation) are consistent with the riskfree rate.
  c. Something else…

Some perspective on risk free rates



	Ten-year T.Bond rate	Inflation rate	Real GDP growth	Intrinsic riskfree rate
1954-2021	5.59%	3.55%	2.94%	6.50%
1954-1980	5.83%	4.49%	3.50%	7.98%
1981-2008	6.88%	3.26%	3.04%	6.30%
2011-2021	2.25%	1.76%	1.70%	3.46%

Negative Interest Rates?

- In 2022, there were at least three currencies (Swiss Franc, Japanese Yen, Euro) with negative interest rates. Using the fundamentals (inflation and real growth) approach, how would you explain negative interest rates?
  - How negative can rates get? (Is there a bound?)
  - Would you use these negative interest rates as risk free rates?
    - If no, why not and what would you do instead?
    - If yes, what else would you have to do in your valuation to be internally consistent?

Discount Rates: II

The Equity Risk Premium

II. The Equity Risk Premium
The ubiquitous historical risk premium

- The historical premium is the premium that stocks have historically earned over riskless securities.
- While the users of historical risk premiums act as if it is a fact (rather than an estimate), it is sensitive to
  - How far back you go in history…
  - Whether you use T.bill rates or T.Bond rates
  - Whether you use geometric or arithmetic averages.
- For instance, looking at the US:

	Arithmetic Average		Geometric Average	
	Stocks - T. Bills	Stocks - T. Bonds	Stocks - T. Bills	Stocks - T. Bonds
1928-2021	8.49%	6.71%	6.69%	5.13%
Std Error	2.05%	2.17%		
1972-2021	8.04%	5.47%	6.70%	4.47%
Std Error	2.44%	2.76%		
2012-2021	16.47%	14.39%	15.89%	14.00%
Std Error	3.88%	4.59%		

The perils of trusting the past…….

- Noisy estimates: Even with long time periods of history, the risk premium that you derive will have substantial standard error. For instance, if you go back to 1928 (about 90 years of history) and you assume a standard deviation of 20% in annual stock returns, you arrive at a standard error of greater than 2%:

  Standard Error in Premium = 20%/√90 = 2.1%

- Survivorship Bias: Using historical data from the U.S. equity markets over the twentieth century does create a sampling bias. After all, the US economy and equity markets were among the most successful of the global economies that you could have invested in early in the century.

Risk Premium for a Mature Market? Broadening the sample to 1900-2017

Country	*Geometric Mean*	*Standard Error*
Australia	5.00%	1.70%
Austria	2.90%	14.10%
Belgium	2.20%	1.90%
Canada	3.50%	1.70%
Denmark	2.20%	1.70%
Finland	5.20%	2.70%
France	3.10%	2.10%
Germany	5.10%	2.60%
Ireland	2.70%	1.80%
Italy	3.20%	2.70%
Japan	5.10%	3.00%
Netherlands	3.30%	2.00%
New Zealand	4.00%	1.60%
Norway	2.40%	2.50%
Portugal	5.30%	2.90%
South Africa	5.30%	1.80%
Spain	1.80%	1.90%
Sweden	3.10%	2.00%
Switzerland	2.20%	1.60%
U.K.	3.70%	1.60%
U.S.	4.40%	1.90%
Europe	3.00%	1.40%
World-ex U.S.	2.80%	1.30%
World	3.20%	1.40%

The simplest way of estimating an additional country risk premium: The country default spread

- Default spread for country: In this approach, the country equity risk premium is set equal to the default spread for the country, estimated in one of three ways:
  - The default spread on a dollar denominated bond issued by the country. (In January 2021, that spread was % for the Brazilian $ bond) was 2.05%.
  - The sovereign CDS spread for the country. In January 2021, the ten-year CDS spread for Brazil, adjusted for the US CDS, was 1.92%.
  - The default spread based on the local currency rating for the country. Brazil's sovereign local currency rating is Ba2 and the default spread for a Ba2 rated sovereign was about 2.65% in January 2021.
- Add the default spread to a "mature" market premium: This default spread is added on to the mature market premium to arrive at the total equity risk premium for Brazil, assuming a mature market premium of 4.24%.
  - Country Risk Premium for Brazil = 2.56%
  - Total ERP for Brazil = 4.24% + 2.56% = 7.80%

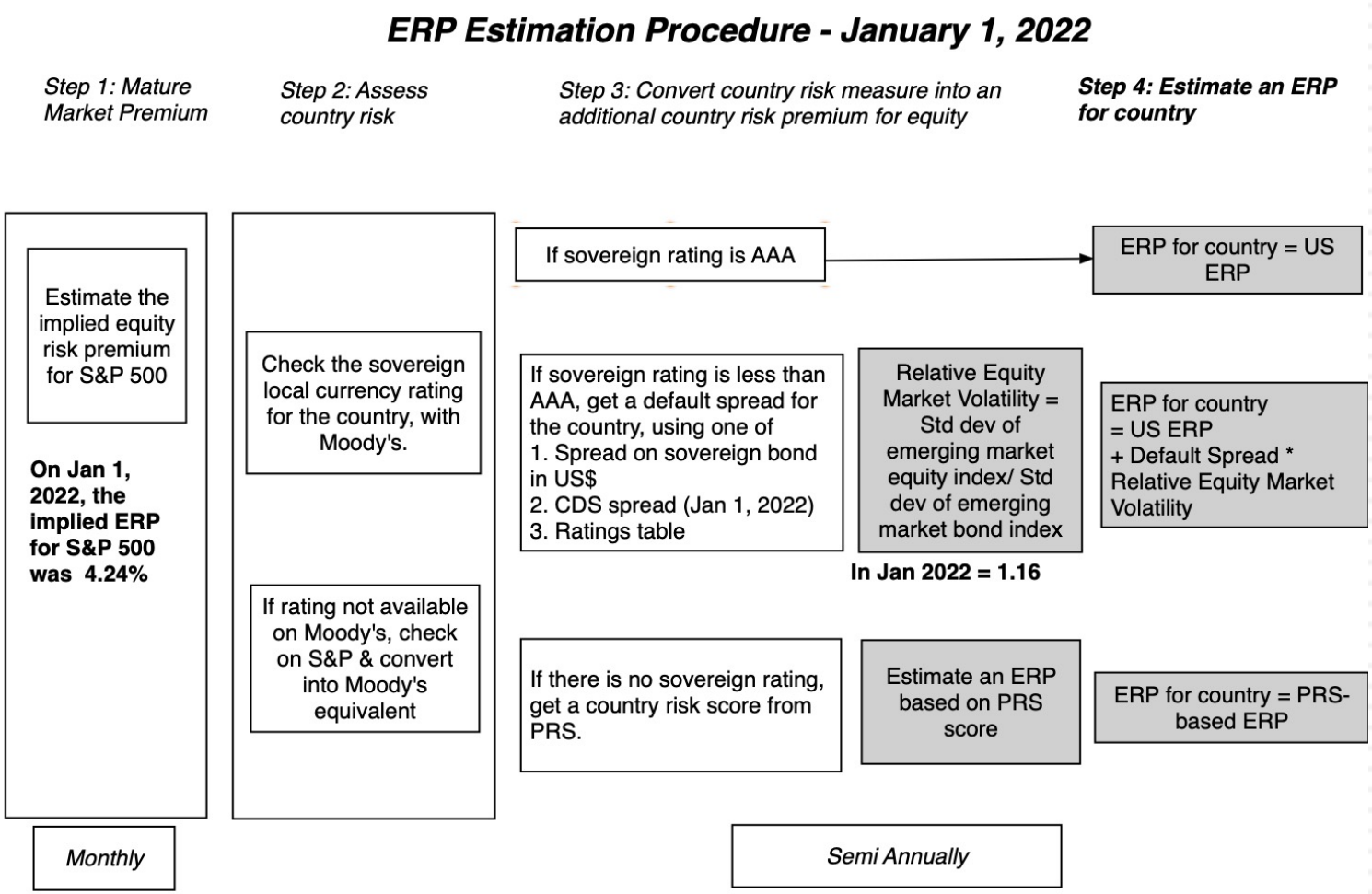
An equity volatility based approach to estimating the country total ERP

- This approach draws on the standard deviation of two equity markets, the emerging market in question and a base market (usually the US). The total equity risk premium for the emerging market is then written as:
  - Total equity risk premium = Risk Premium$_{US}$ * $\sigma_{\text{Country Equity}}$ / $\sigma_{\text{US Equity}}$
- The country equity risk premium is based upon the volatility of the market in question relative to U.S market.
  - Assume that the equity risk premium for the US is 4.72%.
  - Assume that the standard deviation in the Bovespa (Brazilian equity) is 30% and that the standard deviation for the S&P 500 (US equity) is 18%.
  - Total Equity Risk Premium for Brazil = 4.24% (30%/18%) = 7.07%
  - Country equity risk premium for Brazil = 7.07% - 4.24% = 2.83%

A melded approach to estimating the additional country risk premium

- Country ratings measure default risk. While default risk premiums and equity risk premiums are highly correlated, one would expect equity spreads to be higher than debt spreads.
- Another is to multiply the bond default spread by the relative volatility of stock and bond prices in that market. Using this approach for Brazil in January 2022, you would get:
  - Country Equity risk premium = Default spread on country bond* $\sigma_{\text{Country Equity}} / \sigma_{\text{Country Bond}}$
    - Standard Deviation in Bovespa (Equity) = 30%
    - Standard Deviation in Brazil government bond = 20%
    - Default spread for Brazil= 2.56%
  - Brazil Country Risk Premium = 2.56% (30%/20%) = 3.84%
  - Brazil Total ERP = Mature Market Premium + CRP = 4.24% + 3.84% = 8.08%

A Template for Estimating the ERP



ERP : Jan 2022

Andorra	Baa2	1.88%	6.12%
Austria	Aa1	0.39%	4.63%
Belgium	Aa3	0.60%	4.84%
Cyprus	Ba1	2.47%	6.71%
Denmark	Aaa	0.00%	4.24%
Finland	Aa1	0.39%	4.63%
France	Aa2	0.49%	4.73%
Germany	Aaa	0.00%	4.24%
Greece	Ba3	3.56%	7.80%
Guernsey	Aa3	0.60%	4.84%
Iceland	A2	0.84%	5.08%
Ireland	A2	0.84%	5.08%
Isle of Man	Aa3	0.60%	4.84%

Italy	Baa3	2.18%	6.42%
Jersey	Aaa	0.00%	4.24%
Liechtenstein	Aaa	0.00%	4.24%
Luxembourg	Aaa	0.00%	4.24%
Malta	A2	0.84%	5.08%
Netherlands	Aaa	0.00%	4.24%
Norway	Aaa	0.00%	4.24%
Portugal	Baa2	1.88%	6.12%
Spain	Baa1	1.58%	5.82%
Sweden	Aaa	0.00%	4.24%
Switzerland	Aaa	0.00%	4.24%
Turkey	B2	5.44%	9.68%
UK	Aa3	0.60%	4.84%
W. Europe		**0.83%**	**5.07%**

Albania	B1	4.45%	8.69%
Armenia	Ba3	3.56%	7.80%
Azerbaijan	Ba2	2.97%	7.21%
Belarus	B3	6.43%	10.67%
Bosnia and Herzegovina	B3	6.43%	10.67%
Bulgaria	Baa1	1.58%	5.82%
Croatia	Ba1	2.47%	6.71%
Czech Republic	Aa3	0.60%	4.84%
Estonia	A1	0.70%	4.94%
Georgia	Ba2	2.97%	7.21%
Hungary	Baa2	1.88%	6.12%
Kazakhstan	Baa2	1.88%	6.12%
Kyrgyzstan	B2	5.44%	9.68%
Latvia	A3	1.19%	5.43%
Lithuania	A2	0.84%	5.08%
Macedonia	Ba3	3.56%	7.80%
Moldova	B3	6.43%	10.67%
Montenegro	B1	4.45%	8.69%
Poland	A2	0.84%	5.08%
Romania	Baa3	2.18%	6.42%
Russia	Baa3	2.18%	6.42%
Serbia	Ba2	2.97%	7.21%
Slovakia	A2	0.84%	5.08%
Slovenia	A3	1.19%	5.43%
Tajikistan	B3	6.43%	10.67%
Ukraine	B3	6.43%	10.67%
Uzbekistan	B1	4.45%	8.69%
E. Europe & Russia		**2.11%**	**6.35%**

Country	*PRS*	*CRP*	*ERP*
Algeria	62.25	6.43%	10.67%
Brunei	79	0.84%	5.08%
Gambia	65.75	5.44%	9.68%
Guinea	57.5	8.90%	13.14%
Guinea-Bissau	62.75	6.43%	10.67%
Guyana	66.25	4.45%	8.69%
Haiti	56.25	9.89%	14.13%
Iran	63.75	6.43%	10.67%
Korea, D.P.R.	51.5	11.87%	16.11%
Liberia	59	8.90%	13.14%
Libya	66.25	4.45%	8.69%
Madagascar	63.5	6.43%	10.67%
Malawi	59.75	8.90%	13.14%
Myanmar	53	11.87%	16.11%
Sierra Leone	57	9.89%	14.13%
Somalia	51.5	11.87%	16.11%
Sudan	36.25	20.34%	24.58%
Syria	45.5	20.34%	24.58%
Yemen	52.75	11.87%	16.11%
Zimbabwe	61	7.41%	11.65%

Canada	Aaa	0.00%	4.24%
United States	Aaa	0.00%	4.24%
North America		**0.00%**	**4.24%**

Caribbean	NA	6.83%	11.07%

Argentina	Ca	11.87%	16.11%
Belize	Caa3	9.89%	14.13%
Bolivia	B2	5.44%	9.68%
Brazil	Ba2	2.97%	7.21%
Chile	A1	0.70%	4.94%
Colombia	Baa2	1.88%	6.12%
Costa Rica	B2	5.44%	9.68%
Ecuador	Caa3	9.89%	14.13%
El Salvador	Caa1	7.41%	11.65%
Guatemala	Ba1	2.47%	6.71%
Honduras	B1	4.45%	8.69%
Mexico	Baa1	1.58%	5.82%
Nicaragua	B3	6.43%	10.67%
Panama	Baa2	1.88%	6.12%
Paraguay	Ba1	2.47%	6.71%
Peru	Baa1	1.58%	5.82%
Suriname	Caa3	9.89%	14.13%
Uruguay	Baa2	1.88%	6.12%
Venezuela	C	20.34%	24.58%
Latin America		**3.79%**	**8.03%**

Country	*Rating*	*CRP*	*ERP*
Angola	B3	5.53%	10.67%
Benin	B1	3.83%	8.69%
Botswana	A3	1.02%	5.43%
Burkina Faso	B2	4.68%	9.68%
Cameroon	B2	4.68%	9.68%
Cape Verde	B3	5.53%	10.67%
Congo (Democratic Republic of)	Caa1	6.38%	11.65%
Congo (Republic of)	Caa2	7.66%	13.14%
Côte d'Ivoire	Ba3	3.06%	7.80%
Egypt	B2	4.68%	9.68%
Ethiopia	Caa2	7.66%	13.14%
Gabon	Caa1	6.38%	11.65%
Ghana	B3	5.53%	10.67%
Kenya	B2	4.68%	9.68%
Mali	Caa1	6.38%	11.65%
Mauritius	Baa2	1.62%	6.12%
Morocco	Ba1	2.13%	6.71%
Mozambique	Caa2	7.66%	13.14%
Namibia	Ba3	3.06%	7.80%
Niger	B3	5.53%	10.67%
Nigeria	B2	4.68%	9.68%
Rwanda	B2	4.68%	9.68%
Senegal	Ba3	3.06%	7.80%
South Africa	Ba2	2.56%	7.21%
Swaziland	B3	5.53%	10.67%
Tanzania	B2	4.68%	9.68%
Togo	B3	5.53%	10.67%
Tunisia	Caa1	6.38%	11.65%
Uganda	B2	4.68%	9.68%
Zambia	Ca	10.21%	16.11%
Africa		**5.25%**	**9.49%**

Abu Dhabi	Aa2	0.49%	4.73%
Bahrain	B2	5.44%	9.68%
Iraq	Caa1	7.41%	11.65%
Israel	A1	0.70%	4.94%
Jordan	B1	4.45%	8.69%
Kuwait	A1	0.70%	4.94%
Lebanon	C	20.34%	24.58%
Oman	Ba3	3.56%	7.80%
Qatar	Aa3	0.60%	4.84%
Ras Al Khaimah	A3	1.19%	5.43%
Saudi Arabia	A1	0.70%	4.94%
Sharjah	Baa3	2.18%	6.42%
United Arab Emirates	Aa2	0.49%	4.73%
Middle East		**1.60%**	**5.84%**

Bangladesh	Ba3	3.56%	7.80%
Cambodia	B2	5.44%	9.68%
China	A1	0.70%	4.94%
Fiji	B1	4.45%	8.69%
Hong Kong	Aa3	0.60%	4.84%
India	Baa3	2.18%	6.42%
Indonesia	Baa2	1.88%	6.12%
Japan	A1	0.70%	4.94%
Korea	Aa2	0.49%	4.73%
Laos	Caa2	8.90%	13.14%
Macao	Aa3	0.60%	4.84%
Malaysia	A3	1.19%	5.43%
Maldives	Caa1	7.41%	11.65%
Mongolia	B3	6.43%	10.67%
Pakistan	B3	6.43%	10.67%
Papua New Guinea	B2	5.44%	9.68%
Philippines	Baa2	1.88%	6.12%
Singapore	Aaa	0.00%	4.24%
Solomon Islands	Caa1	7.41%	11.65%
Sri Lanka	Caa2	8.90%	13.14%
Taiwan	Aa3	0.60%	4.84%
Thailand	Baa1	1.58%	5.82%
Vietnam	Ba3	3.56%	7.80%
Asia		**1.04%**	**5.28%**

Australia	Aaa	0.00%	4.24%
Cook Islands	B1	4.45%	8.69%
New Zealand	Aaa	0.00%	4.24%
Australia & NZ		**0.00%**	**4.24%**

Aswath Damodaran

Blue: Moody's Rating
Red: Added Country Risk
Green #: Total ERP