Watson French
WEALTH MANAGEMENT

Term of the Week- Risk Free Rate

The risk-free rate is the theoretical return that you would receive from holding an asset which is entirely free of risk.

This risk-free rate is the foundation of valuing any asset, whether it be stocks, property, alternative assets or a proposed business expansion. It is the minimum you would expect to receive over a given period.

The risk-free rate is also important when evaluating the past performance of assets. When looking at the risk-adjusted returns of investments, we want to know how much return the asset has delivered above this risk-free rate. If the return was below the risk-free rate then we would have been better off holding the risk-free asset.

While no asset is truly free of risk, the proxy for the risk-free rate is generally accepted to be the yield to maturity on a developed market government bond, as highly-rated governments are expected to never default on their debt.

There is debate as to which government bonds are relevant for this purpose. Some prefer to use the yield on a 3-month Treasury Bill (a very short term government bond), while other investors prefer to use the yield on the ten-year Treasury Bond. Generally matching the risk-free asset to the time period in question is appropriate.

Furthermore, a US investor would use US treasury bond yields, while a UK investor would use the UK treasury bond yields. Despite the US debt market being the deepest and most liquid, a UK investor using a risk-free rate based off US bonds introduces currency risk.

This topic is particularly important given the current environment we are in now. The first point is that higher US treasury bond yields mean the return needed from equities (to compensate for the increased risk) will be greater than when yields were low. As we have seen this has resulted in a fall in equity values.

The second point is that if investors doubt the efficacy of US debt (owing to fiscal concerns, political interference and the US dollar remaining the global reserve currency to name a few reasons) assets may be repriced, as a different risk free rate is used over time.

Lastly, this effect is not just unique to the US – movements in US yields often prompt other global yields to move higher, increasing the risk-free rate for investors globally.

Robert Dougherty, Investment Specialist
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