

Discount Rate

The discount rate is the rate at which future dividends (and more generally, future cash flows) of an investment should be discounted in order to determine the present value of that investment.

The discount rate should be tied directly to the risk of the cash flows. The greater the risk is that the future cash flows will not materialize, the higher the discount rate should be. The discount rate is mainly a function of risk.

By discounting future cash flows at this discount rate and summing this discounted stream of future cash flows, an investor can get an estimate of the intrinsic value of the investment in question. Most models of stock valuation recognize these facts and incorporate some type of discount rate into their formulas.