Term Structure of Interest Rates

Term structure of interest rates (also known as the yield curve) is the relationship between the interest rate and the maturity (timing) of the cash flow. The term structure is normally upward sloping. Long rates of interest are usually higher than short rates. This situation is called a “normal” yield curve. A downward sloping yield curve is an “abnormal” yield curve.

This upward sloping tendency is usually credited to a maturity risk premium (MRP). All things equal, investors prefer to hold securities of lower maturity, and they must be induced with higher rates to hold securities of higher maturity.

The MRP is very hard to measure. And it seems to vary over time, rising when interest rates are more volatile and falling when they are more stable. However, the MRP for 30-year T-bonds is usually assumed to be between one or two percentage points.

Excellent sources to consult about the MRP are publications such as *Stocks, Bonds, Bills, and Inflation Yearbook 2005*. In recent years, the name of this publication has changed. You can find the most recent numbers in publications such as *Ibbotson SBBI Classic Yearbook 2014.*

It is important to understand and quantify this maturity risk premium. If you can do this, then you can determine what investors’ expectations are about future interest rates based upon the current term structure of interest rates.