Lecture 1 Summary (1)

LO. Interpret interest rates as required rates of return, discount rates, or opportunity costs.

An interest rate is the required rate of return. If you invest $100 today on the condition that you get $110 after one year, the required rate of return is 10%.
If the future value (FV) at the end of Year 1 is $110, you can discount at 10% to get the present value (PV) of $100. Hence, 10% can also be thought of as a discount rate.
Finally, if you spent $100 on taking your spouse out for dinner you gave up the opportunity to earn 10%. Thus, 10% can also be interpreted as an opportunity cost.

LO. Explain an interest rate as the sum of a real risk-free rate, and premiums that compensate investors for bearing distinct types of risk.

Interest rate = Real risk-free interest rate + Inflation premium + Default risk premium + Liquidity premium + Maturity premium.

Nominal risk free rate= real risk free rate + inflation premium