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Term Premium vs. Risk Premium

Abstract

Starting from the well-known decomposition of the forward rate into an expectation term, a risk premium, and a convexity term, we derive the expression for the conventional term premium and for an alternative measure of the term premium adjusted for convexity. We argue that, for long maturities, viewing the term premium as the residual term remaining after subtracting estimated expected short rates from fitted yields may understate the "true" risk premium component of yields.