A S S E T A L L O C A T I O N

The Credit Risk Premium

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Despite theoretical and intuitive reasons for a credit risk premium to exist, past research has found little empirical evidence that it is, in fact, real. The authors of this paper argue that this is primarily due to biases in computing the credit excess returns; these biases improperly account for term risk.

Using data spanning 80 years in the U.S. and nearly 20 years in Europe, the authors of this paper find what they characterize as strong evidence of credit risk premium after correctly adjusting for term risk. The credit risk premium is not spanned by other known risk premia and exhibits time variation related to economic growth and aggregate default rates.

These results may have important implications for asset pricing and investment decisions.

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