



3. Interest rate determination

The real risk-free rate (r^*) is 2.8% and is expected to remain constant. Inflation is expected to be 5% per year for each of the next three years and 4% thereafter. The maturity risk premium (MRP) is determined from the formula: $0.1(t - 1)\%$, where t is the security's maturity. The liquidity premium on all Pettigrew Power Co.'s bonds is 0.75%. The following table shows the current relationship between bond ratings and default risk premiums:

Rating	Default Risk Premium
U.S. Treasury	—
AAA	0.60%
AA	0.80%
A	1.05%
BBB	1.45%

What is the yield on a seven-year, AA-rated bond issued by Pettigrew? Disregard cross-product terms; that is, if averaging is required, use the arithmetic average.

- 9.58%
- 9.68%
- 9.43%
- 9.38%
- 9.33%