

There are 3 popular explanations for the variability of interest rates by duration:

- Expectations Theory
- Liquidity Preference
- Market Segmentation

*Expectation.* The relative attraction of short or long term investments varies according to the expectation of interest rate movements. If the expectation is that interest rates will fall, then there will be a preference for longer term investments. Investors will want to maintain the higher coupon for the longest possible time. An expectation of higher interest rates will mean a preference for shorter term investments.

*Liquidity.* Longer dated investments are more sensitive to interest rate movements than shorter dated investments. Risk averse investors will require compensation for the greater risk of loss on longer bonds. In general this means they will look for a higher yield.

*Market.* Different investors are interested in different durations. For instance pension schemes and annuity providers are generally looking for long duration investments; banks are normally looking for shorter duration investments (since bank depositors can often withdraw their funds with little notice).