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The IRR, NPV and the Fallacy of the Reinvestment Rate Assumptions

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ABSTRACT

The Internal Rate of Return and Net Present Value decision criteria are probably the most well known economic decision criteria: they are also probably the most misunderstood. The 'reinvestment rate assumptions' attributed by some writers are two such misconceptions and they appear to be the result of a misunderstanding of two fundamental principles of economic decision making: an economic decision should be (1) based on the prospective differences in the (2) real (out-of-pocket) monetary consequences. This paper illustrates the fallacy of the 'reinvestment rate assumptions' numerically, mathematically, and intuitively.

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