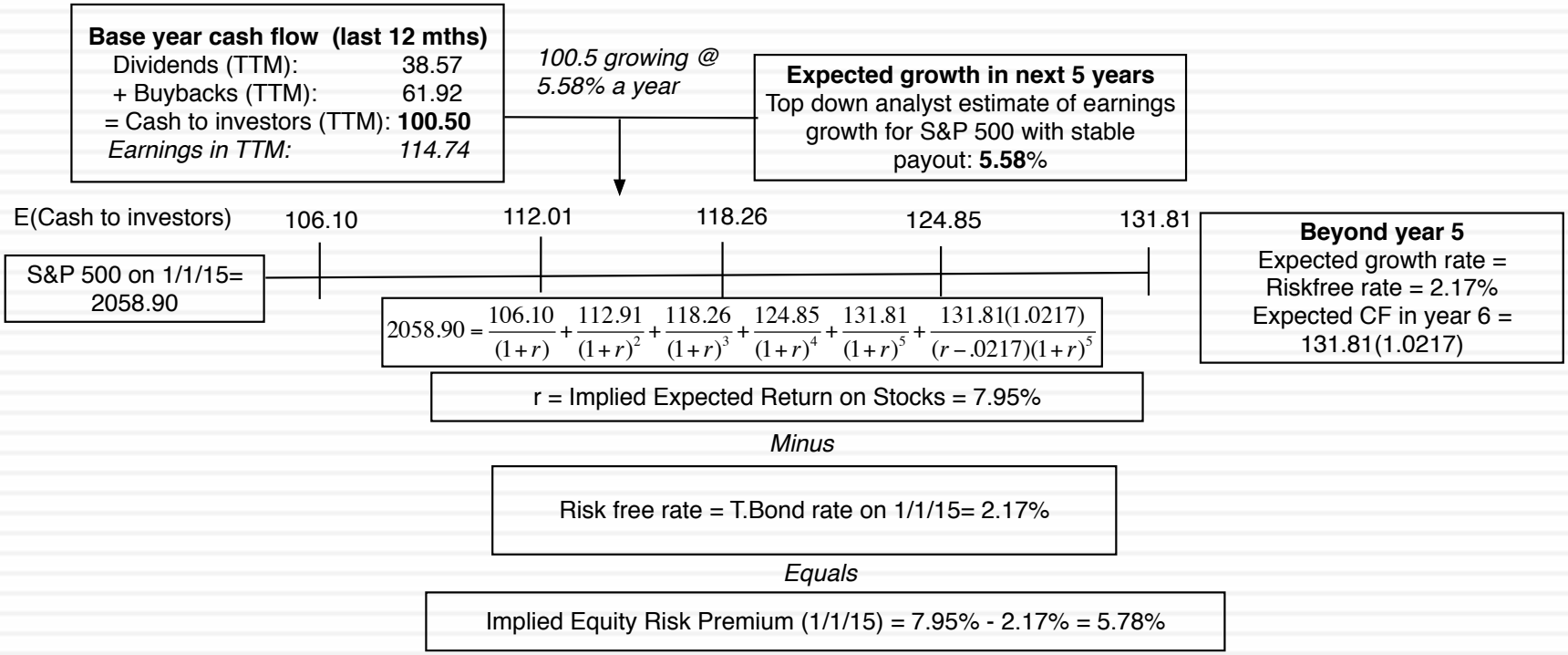
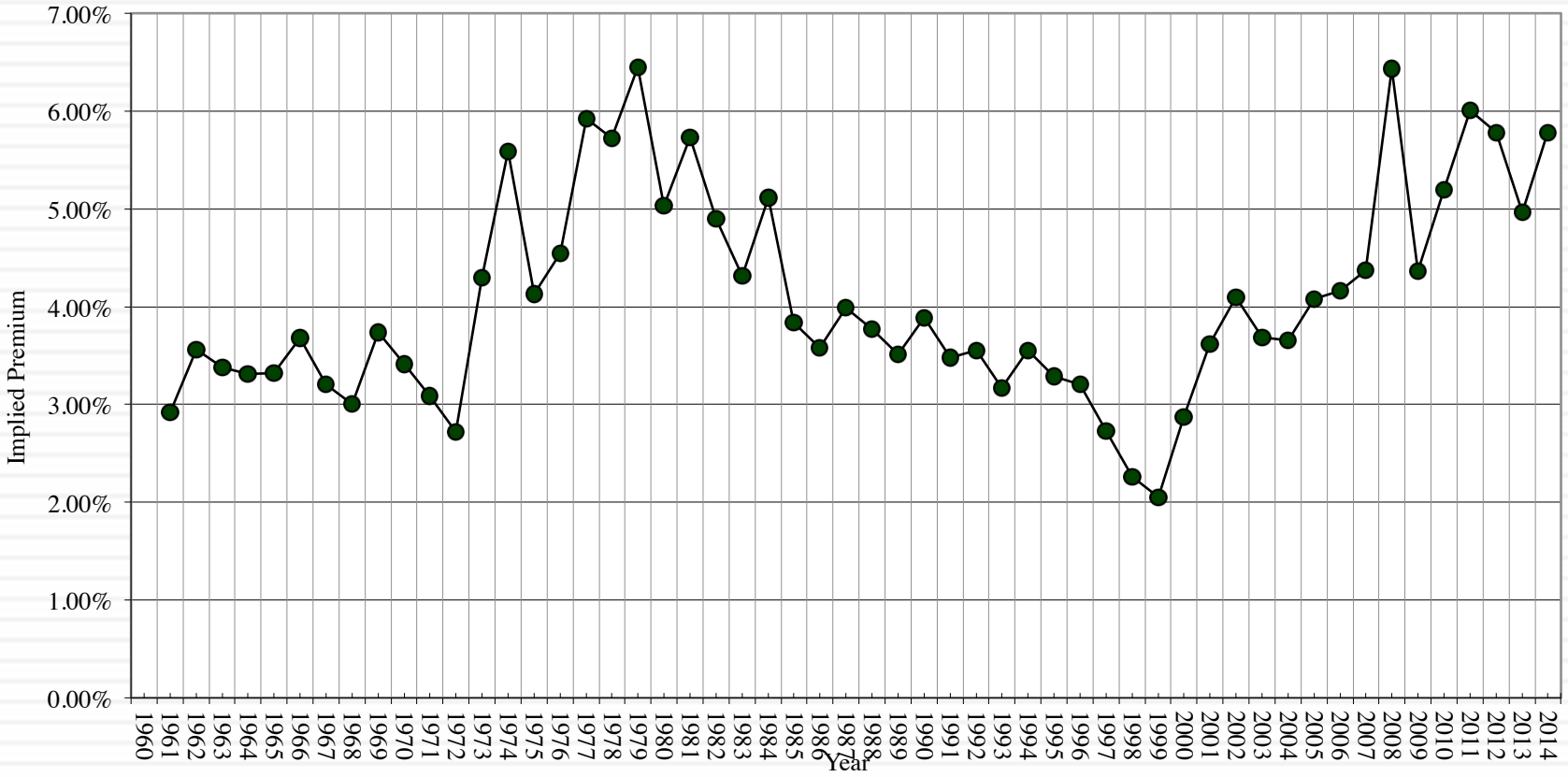
An Updated Equity Risk Premium: January 2015

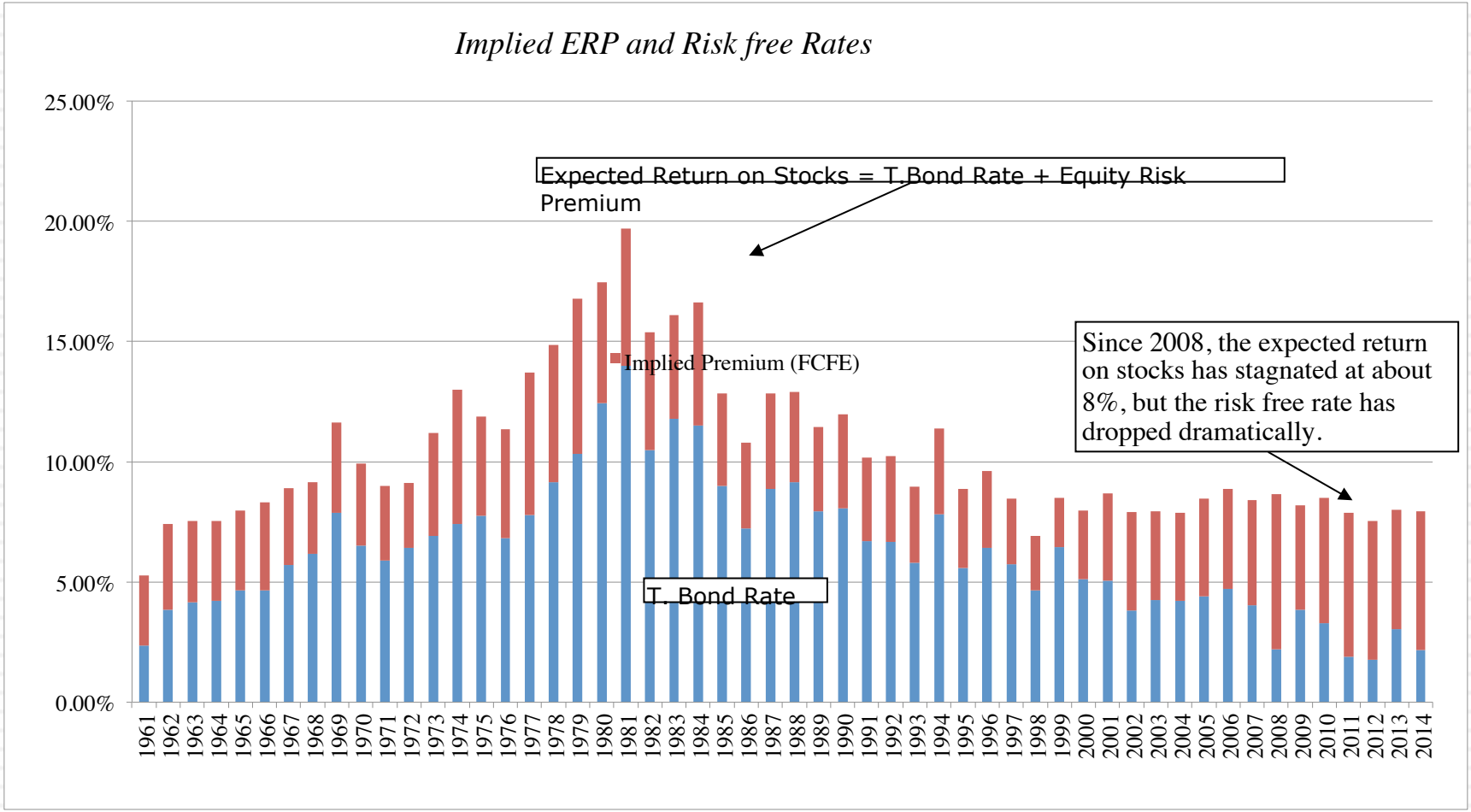


Implied Premiums in the US: 1960-2014

Implied Premium for US Equity Market: 1960-2014

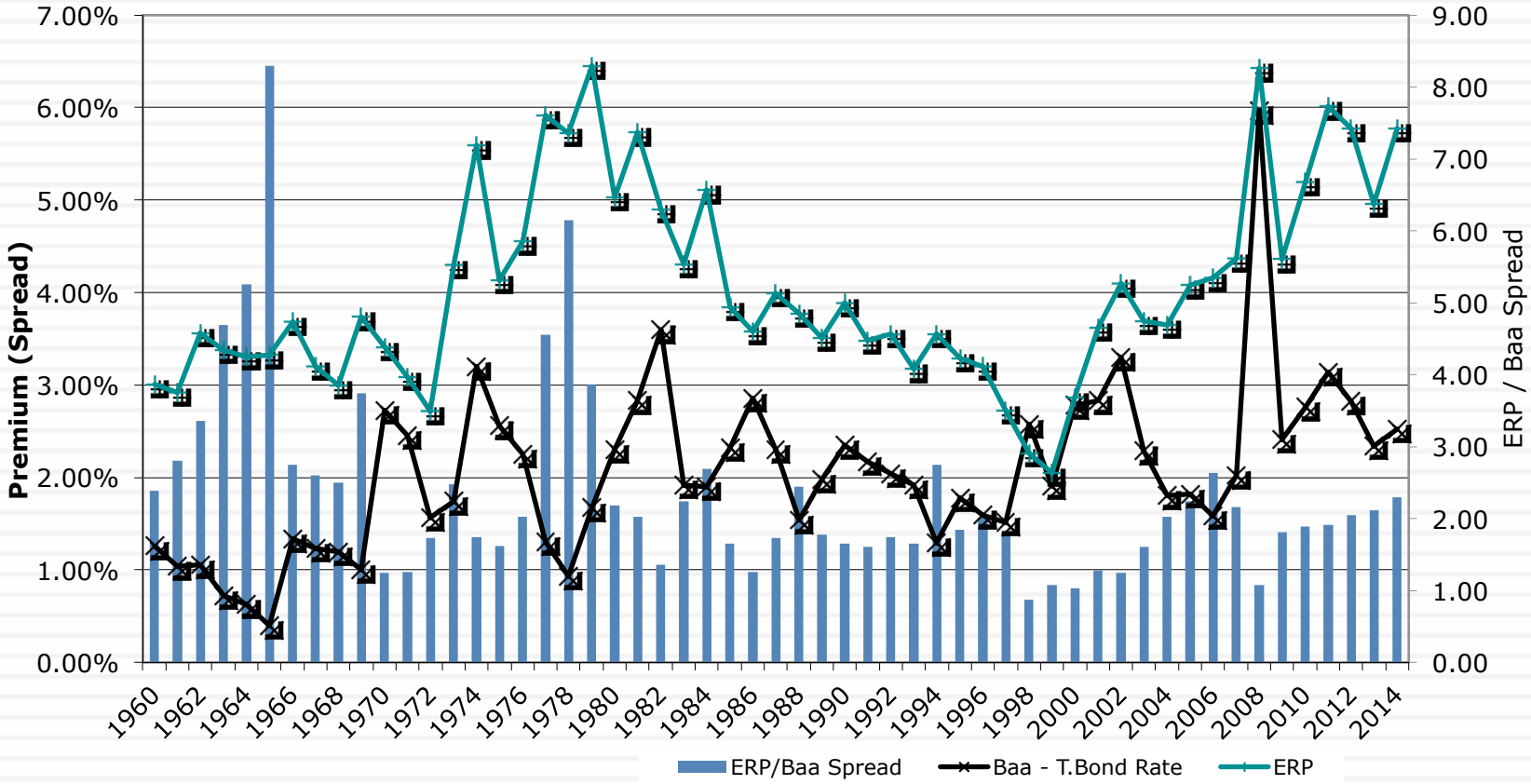


Implied Premium versus Risk Free Rate



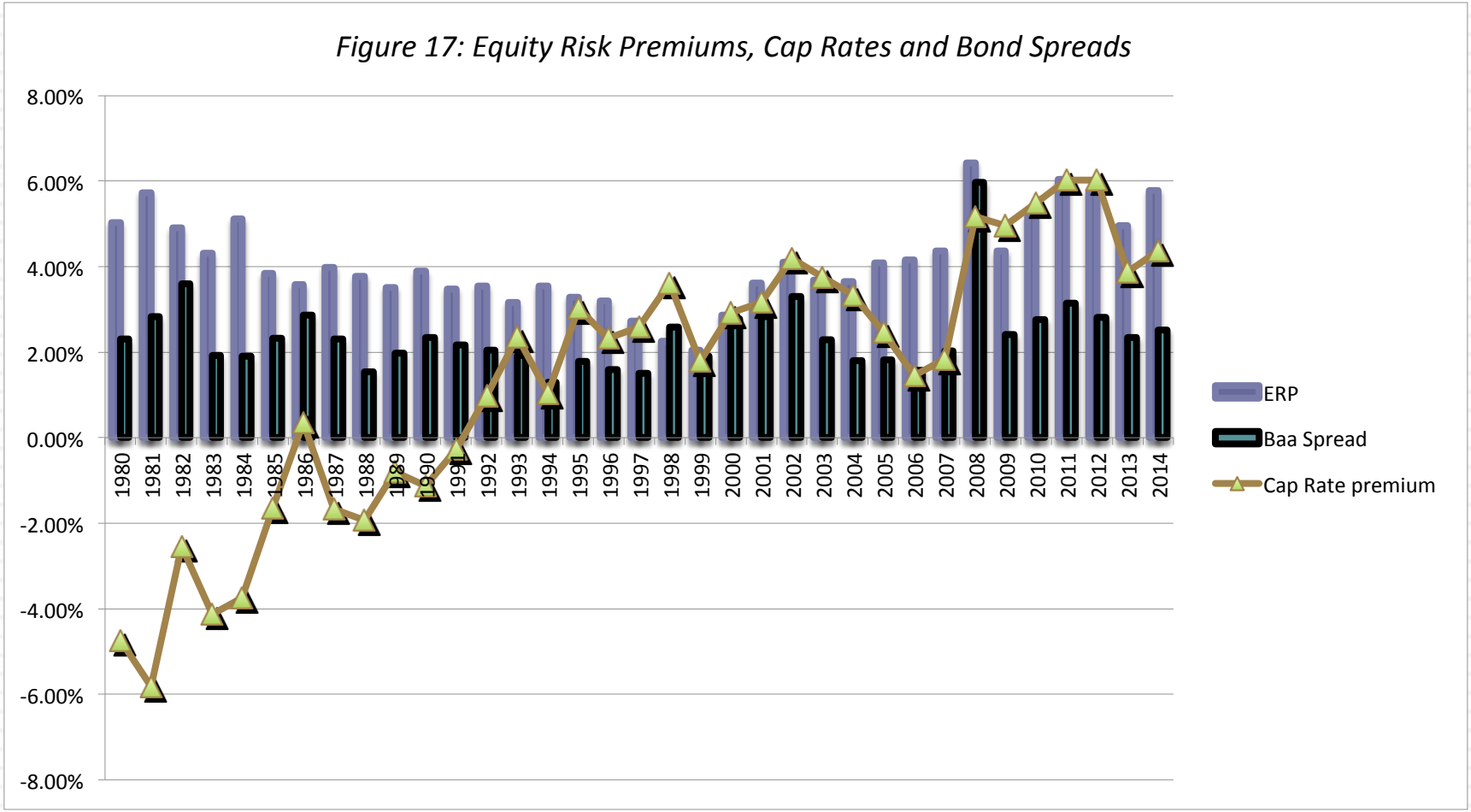
Equity Risk Premiums and Bond Default Spreads

Figure 16: Equity Risk Premiums and Bond Default Spreads



Equity Risk Premiums and Cap Rates (Real Estate)

Figure 17: Equity Risk Premiums, Cap Rates and Bond Spreads



Why implied premiums matter?

- In many investment banks, it is common practice (especially in corporate finance departments) to use historical risk premiums (and arithmetic averages at that) as risk premiums to compute cost of equity. If all analysts in the department used the arithmetic average premium (for stocks over T.Bills) for 1928-2014 of 8% to value stocks in January 2014, given the implied premium of 5.75%, what are they likely to find?

a. The values they obtain will be too low (most stocks will look overvalued)

b. The values they obtain will be too high (most stocks will look under valued)

c. There should be no systematic bias as long as they use the same premium to value all stocks.

Which equity risk premium should you use?

If you assume this	Premium to use
Premiums revert back to historical norms and your time period yields these norms	Historical risk premium
Market is correct in the aggregate or that your valuation should be market neutral	Current implied equity risk premium
Marker makes mistakes even in the aggregate but is correct over time	Average implied equity risk premium over time.

Predictor	*Correlation with implied premium next year*	*Correlation with actual risk premium – next 10 years*
Current implied premium	0.712	0.424
Average implied premium: Last 5 years	0.646	0.360
Historical Premium	-0.394	-0.486
Default Spread based premium	0.059	0.174

And the approach can be extended to emerging markets Implied premium for the Sensex (September 2007)

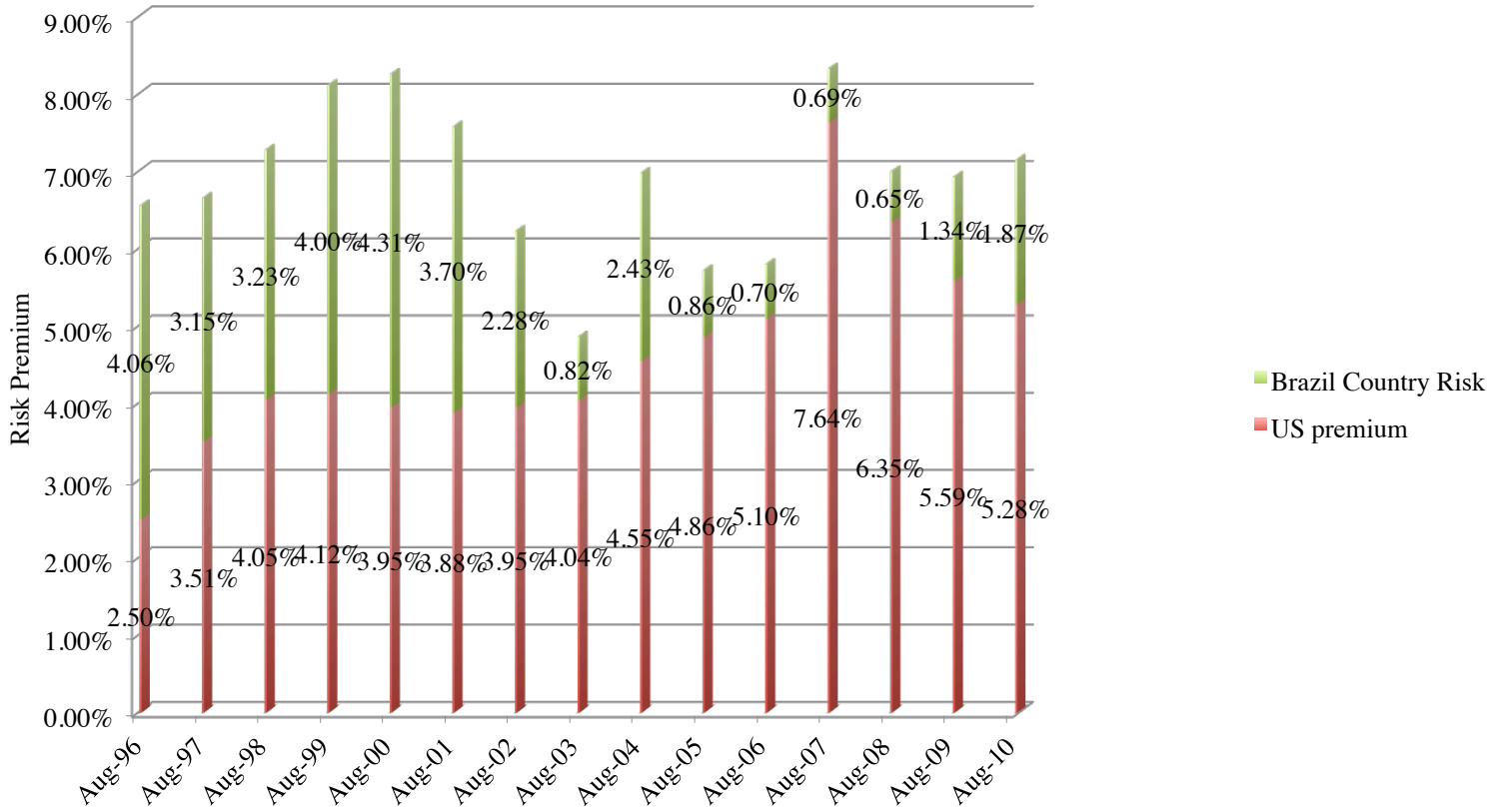
- Inputs for the computation
  - Sensex on 9/5/07 = 15446
  - Dividend yield on index = 3.05%
  - Expected growth rate - next 5 years = 14%
  - Growth rate beyond year 5 = 6.76% (set equal to riskfree rate)
- Solving for the expected return:

$$15446 = \frac{537.06}{(1+r)} + \frac{612.25}{(1+r)^2} + \frac{697.86}{(1+r)^3} + \frac{795.67}{(1+r)^4} + \frac{907.07}{(1+r)^5} + \frac{907.07(1.0676)}{(r-.0676)(1+r)^5}$$

- Expected return on stocks = 11.18%
- Implied equity risk premium for India = 11.18% - 6.76% = 4.42%

Can country risk premiums change? Brazil CRP & Total ERP from 2000 to 2013

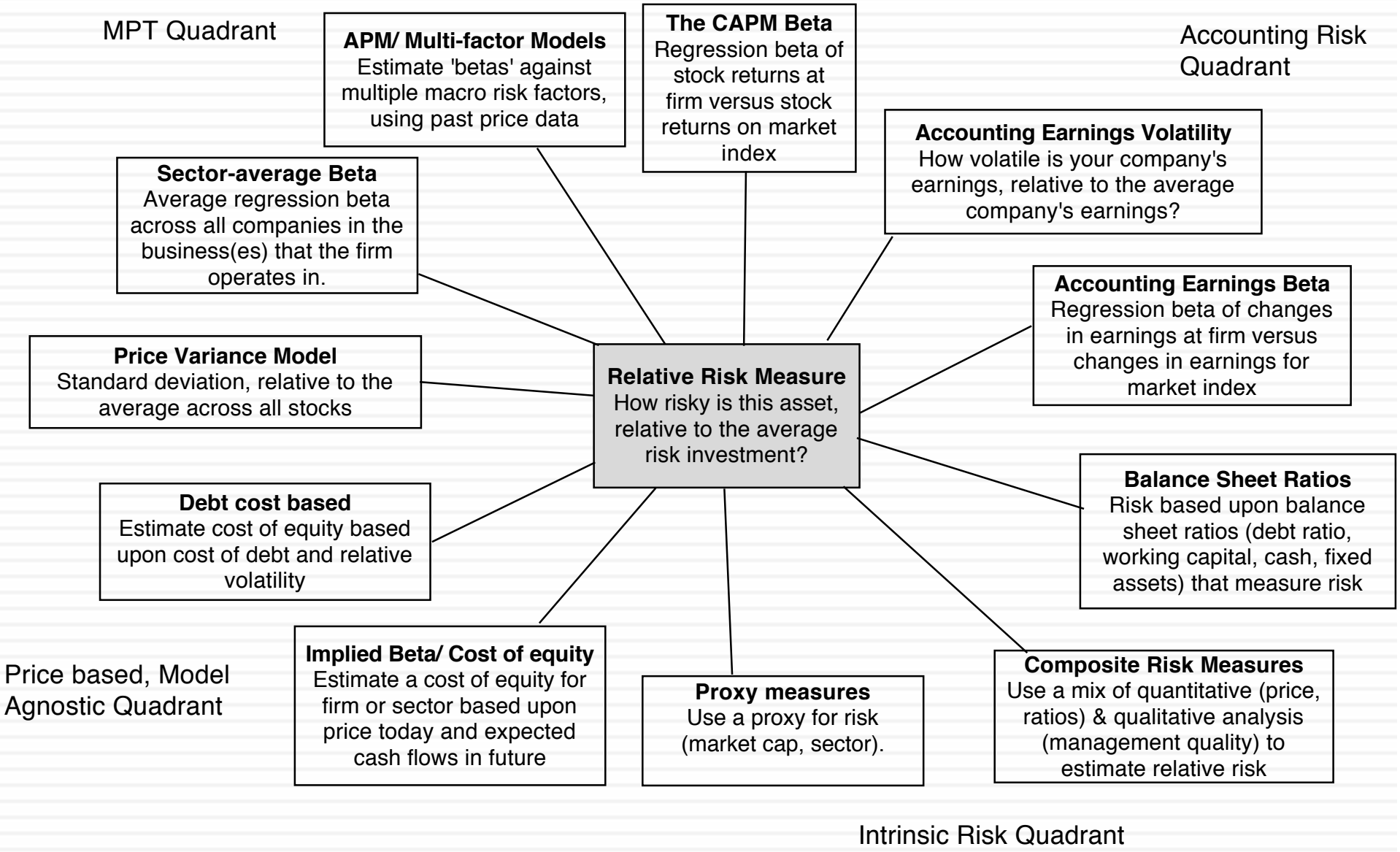
Figure 15: Implied Equity Risk Premium - Brazil



The evolution of Emerging Market Risk

	PBV Developed	PBV Emerging	ROE Developed	ROE Emerging	US T.Bond rate	Growth rate Developed	Growth rate Emerging	Cost of equity (Developed)	Cost of equity (Emerging)	Differential ERP
2004	2.00	1.19	10.81%	11.65%	4.22%	3.72%	5.22%	7.27%	10.62%	3.36%
2005	2.09	1.27	11.12%	11.93%	4.39%	3.89%	5.39%	7.35%	10.54%	3.19%
2006	2.03	1.44	11.32%	12.18%	4.70%	4.20%	5.70%	7.71%	10.20%	2.49%
2007	1.67	1.67	10.87%	12.88%	4.02%	3.52%	5.02%	7.92%	9.73%	1.81%
2008	0.87	0.83	9.42%	11.12%	2.21%	1.71%	3.21%	10.57%	12.74%	2.17%
2009	1.20	1.34	8.48%	11.02%	3.84%	3.34%	4.84%	7.62%	9.45%	1.83%
2010	1.39	1.43	9.14%	11.22%	3.29%	2.79%	4.29%	7.36%	9.14%	1.78%
2011	1.12	1.08	9.21%	10.04%	1.88%	1.38%	2.88%	8.37%	9.51%	1.14%
2012	1.17	1.18	9.10%	9.33%	1.76%	1.26%	2.76%	7.96%	8.33%	0.37%
Jun-13	1.17	1.17	8.79%	9.37%	2.55%	2.05%	3.55%	7.81%	8.52%	0.71%

Measuring Relative Risk



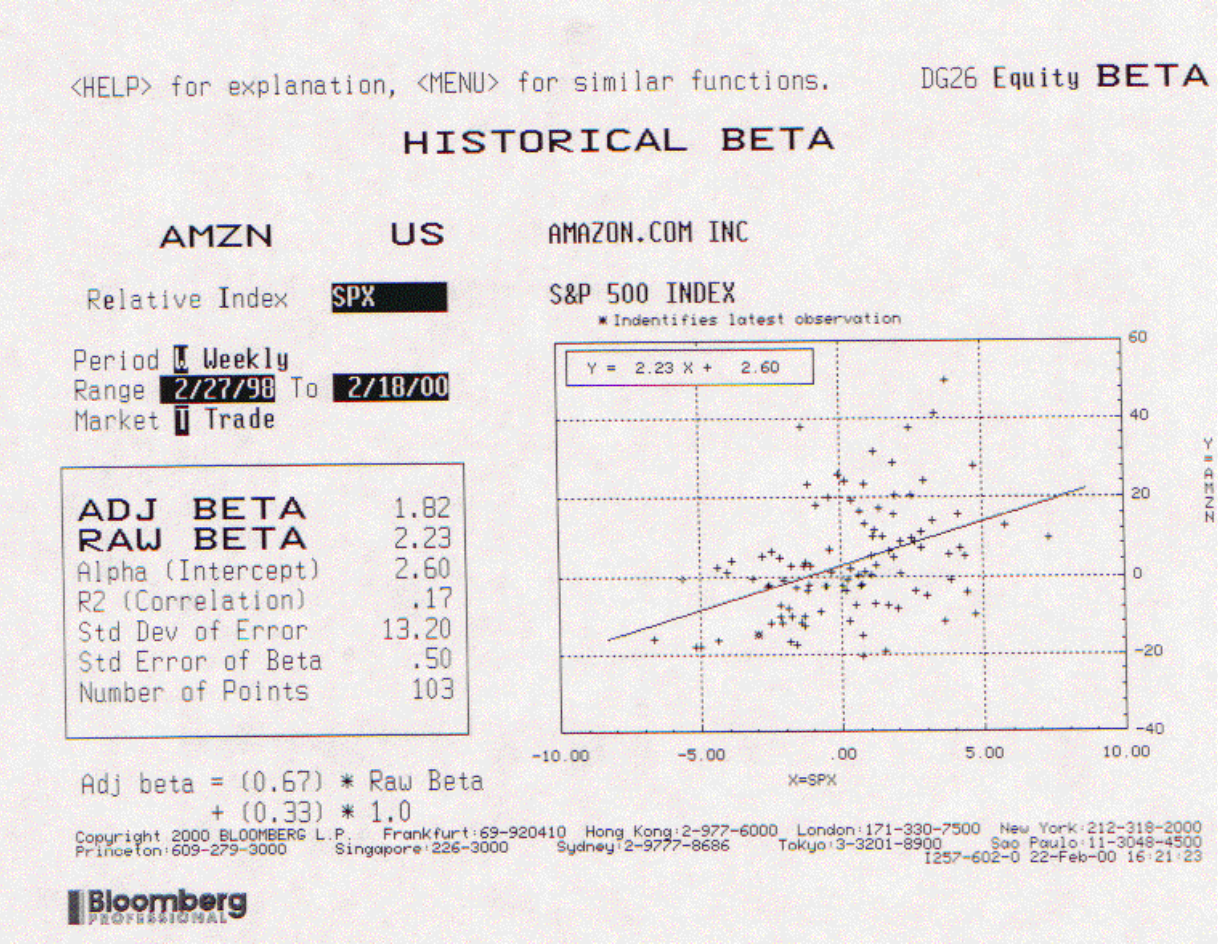
The CAPM Beta

- The standard procedure for estimating betas is to regress stock returns (Rj) against market returns (Rm) -

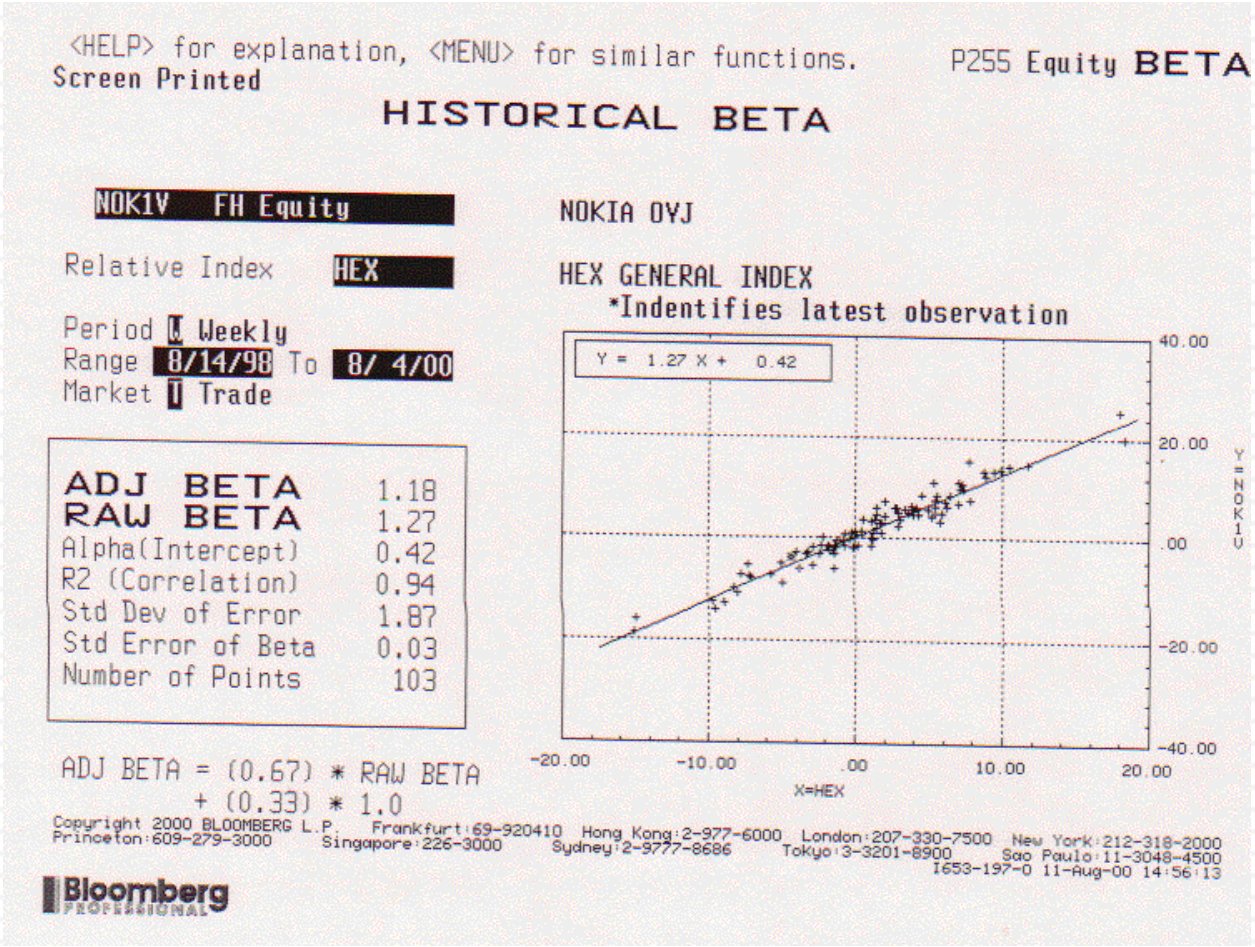
  Rj = a + b Rm

  where a is the intercept and b is the slope of the regression.
- The slope of the regression corresponds to the beta of the stock, and measures the riskiness of the stock.
- This beta has three problems:
  - It has high standard error
  - It reflects the firm's business mix over the period of the regression, not the current mix
  - It reflects the firm's average financial leverage over the period rather than the current leverage.

Beta Estimation: The Noise Problem



Beta Estimation: The Index Effect



Stock-priced based solutions to the Regression Beta Problem

- Modify the regression beta by
  - changing the index used to estimate the beta
  - adjusting the regression beta estimate, by bringing in information about the fundamentals of the company
- Estimate the beta for the firm using
  - the standard deviation in stock prices instead of a regression against an index
  - Relative risk = Standard deviation in stock prices for investment/ Average standard deviation across all stocks
- Estimate the beta for the firm from the bottom up without employing the regression technique. This will require
  - understanding the business mix of the firm
  - estimating the financial leverage of the firm
- Imputed or implied beta (cost of equity) for the sector.

Alternative measures of relative risk for equity

- Accounting risk measures: To the extent that you don't trust market-priced based measures of risk, you could compute relative risk measures based on
  - Accounting earnings volatility: Compute an accounting beta or relative volatility
  - Balance sheet ratios: You could compute a risk score based upon accounting ratios like debt ratios or cash holdings (akin to default risk scores like the Z score)
- Proxies: In a simpler version of proxy models, you can categorize firms into risk classes based upon size, sectors or other characteristics.
- Qualitative Risk Models: In these models, risk assessments are based at least partially on qualitative factors (quality of management).
- Debt based measures: You can estimate a cost of equity, based upon an observable costs of debt for the company.
  - Cost of equity = Cost of debt * Scaling factor

Determinants of Betas & Relative Risk