

CHARLES STANLEY

“The Equity Risk Premium and its Relevance for Financial Market Practitioners”

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What is Equity Risk Premium?

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- The difference between equity market returns and the return on the “risk-free” asset. Typically a government bond or Treasury bill rate.
- The Premium: The added compensation required to hold the riskier of the two assets – equities.
- All things being held constant the change in the ERP has a straight forward impact on stock prices.
- A rise in ERP depresses stock prices. A fall in ERP raises stock prices.
- A high ERP is thus associated with depressed stock prices, a low ERP with elevated prices.

How to Estimate Equity Risk Premium

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- Estimates of ERP vary according to the model employed
- Financial market practitioners must differentiate between historic and forward-looking measures of ERP.
- The obvious problem with ex-post premiums (the observed difference between past returns on stocks and bonds).

Forward-Looking Equity Risk Premium has Greater Relevance

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- The alternative measure used by most practitioners is an *ex-ante* premium.
- The forward-looking ERP is derived from a DCF model.
- The discount rate is the equilibrating factor.

- Methodologists must discover what investors believed the future would look like at any given point in the past.
- A difficult task therefore makes use of proxies.
- Our approach assumes cash flows grow proportionally to earnings.
- Expected growth rates are given by consensus IBES estimates.
- Time horizon and beyond.

Return to Shareholders

- Dividends...
- Share buy-backs.
- Our proxy (free cash flow to equity)

FCFE= Net Income ((Common Equity % Total Capital) x (Capital Expenditure – Depreciation & Amortisation +(-) Chg Working Capital + Acquisitions)) – Preferred Dividends

A Three Stage Approach

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- Several versions of the DCF model but Gordon Growth Model is too simplistic.
- We attempt to break the DCF model into a more dynamic 3 stages of growth.
- We use IBES 1,3 & 5 year estimates for stages 1-2.
- How we address the tricky stage 3.

- Central to any DCF model.
- Flexibility associated with changes in long-run nominal economic growth.
- Goodbye constants. Hello long-term economic forecasting.

EQUITY RISK PREMIUM IN PRACTICE

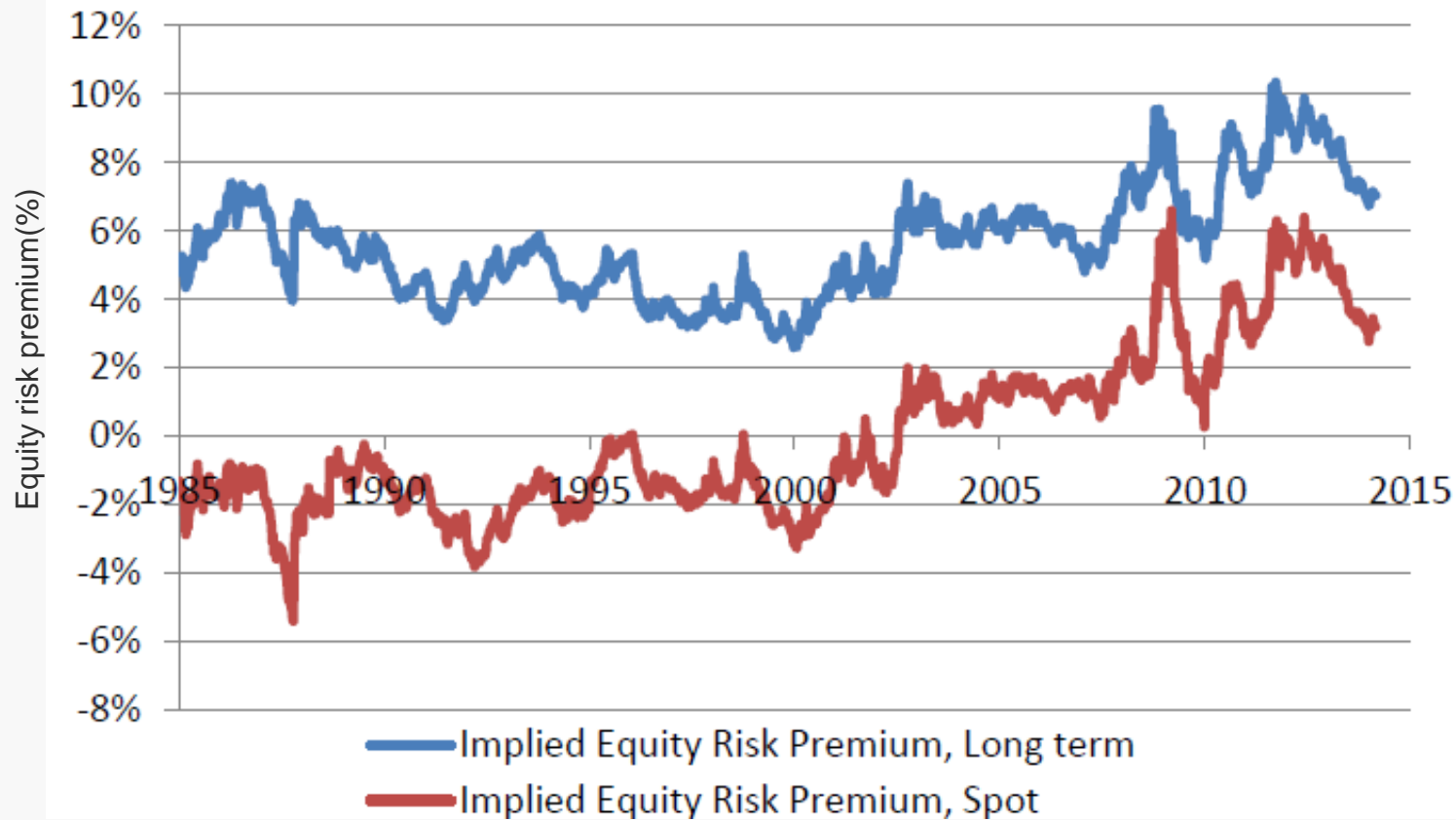
Our Model Implies More Nuanced Equity Returns Going forward

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- ERP informs our overweight equity / underweight bond asset allocation.
- Ultra-low risk-free rates. Truly a journey into the unknown.
 - Are government bonds the short trade of the century?
 - Is something very unusual happening globally?
- The “Golden Rule” goes up in smoke.
- Lower for longer.

Equity risk premium in the US is still at an elevated level

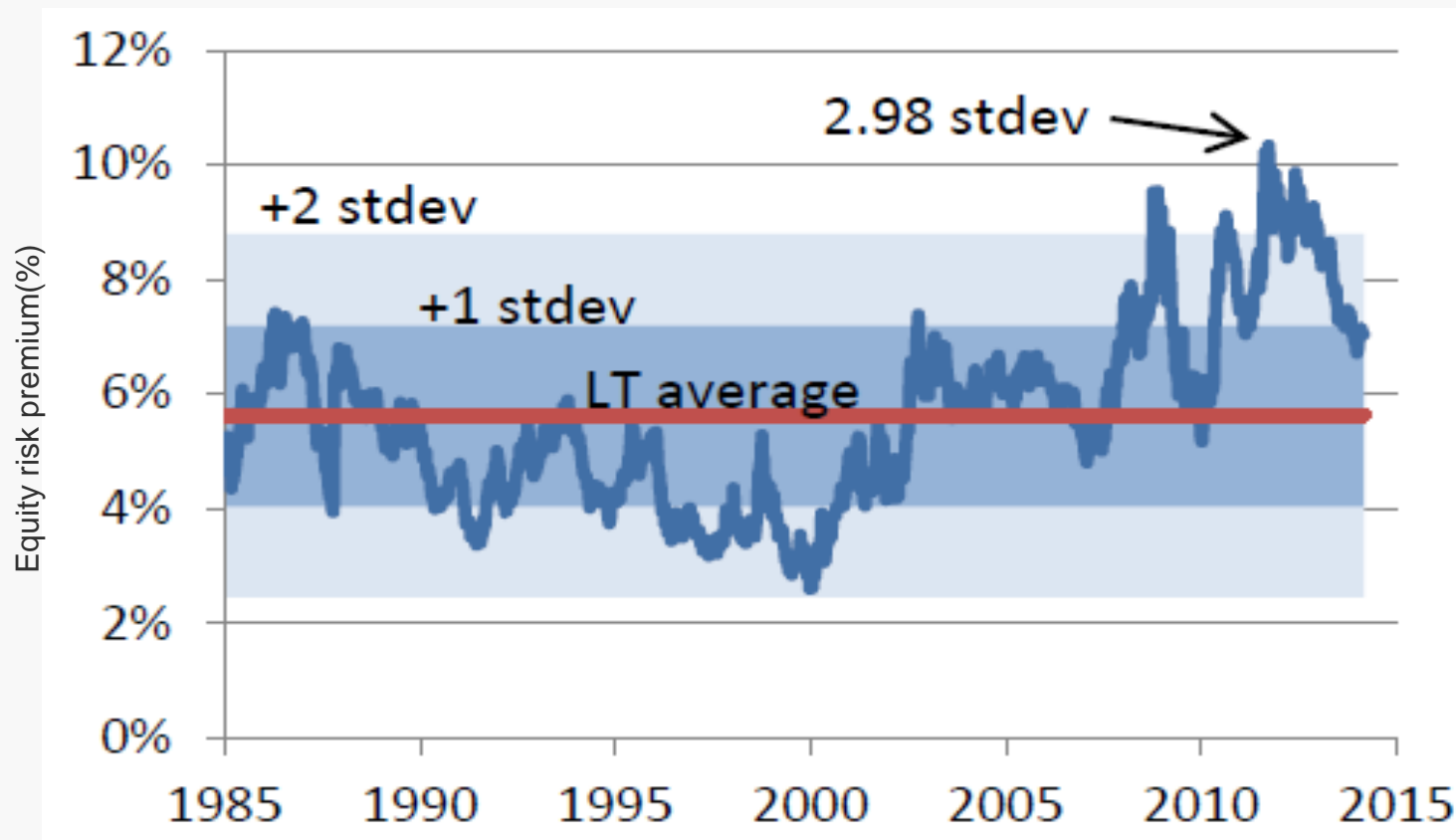
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Source: Bloomberg

The ERP went from almost 3 stdev away from its long term avg, to less than 1 now.

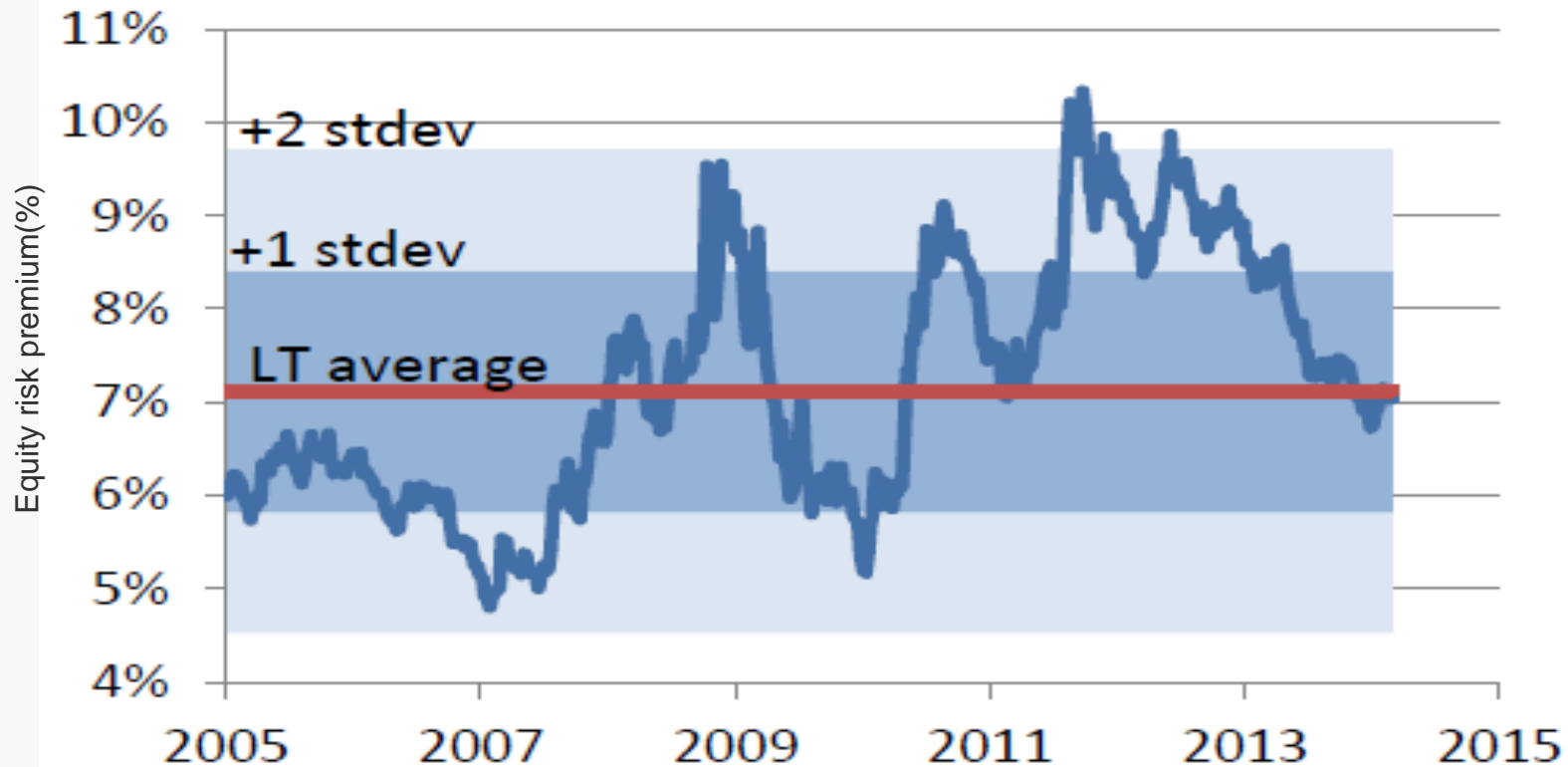
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Source: UBS

If we take only the past decade as a benchmark, it is even worse: the ERP is actually back to normal

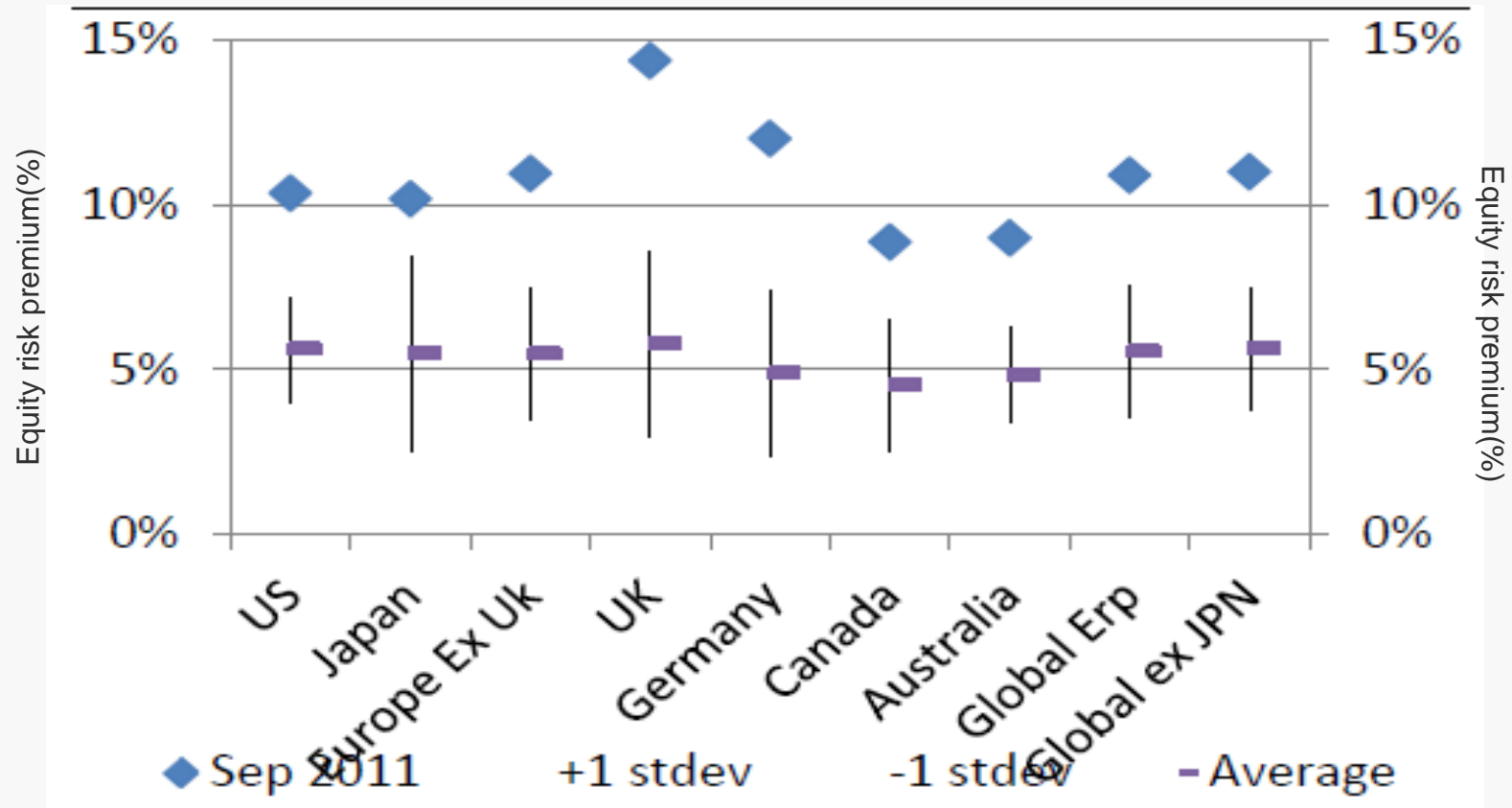
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Source: UBS

The ERP was extremely elevated in all parts of the world in mid-2011

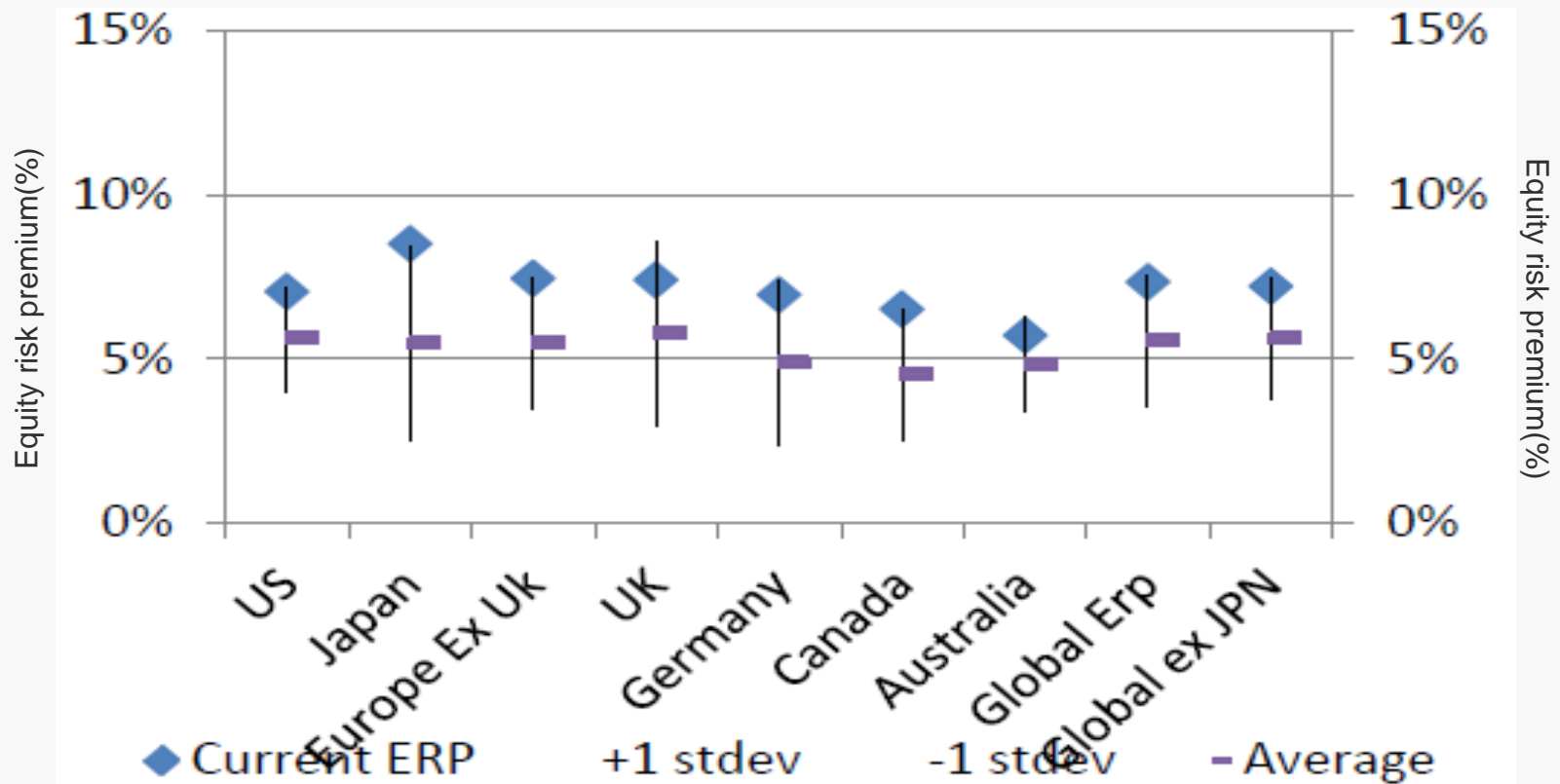
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Source: UBS

The ERP is still above its long term average, but it is back to normal range

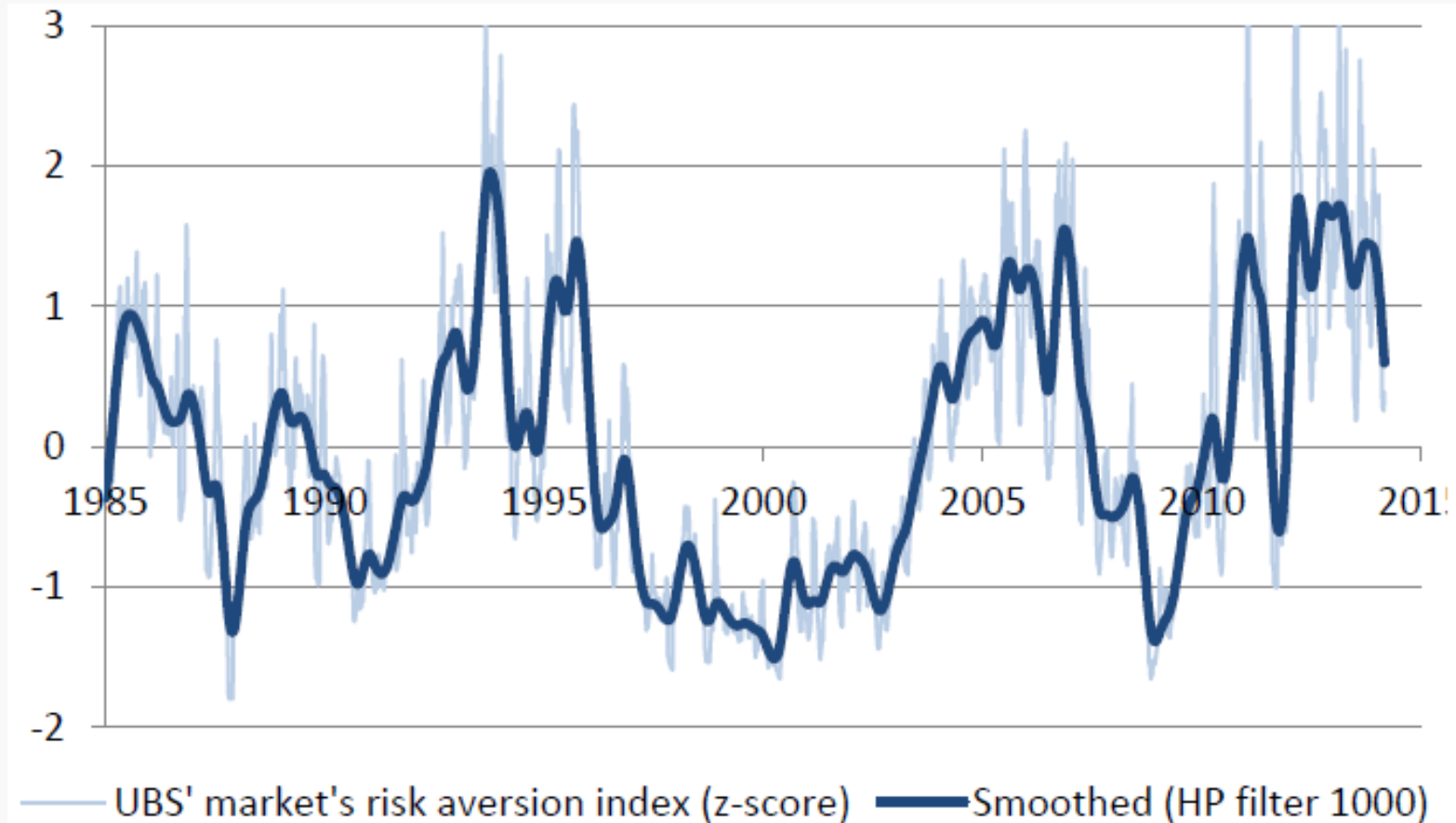
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Source: UBS

Market risk aversion has considerably declined,
this is the main driver of the ERP rally

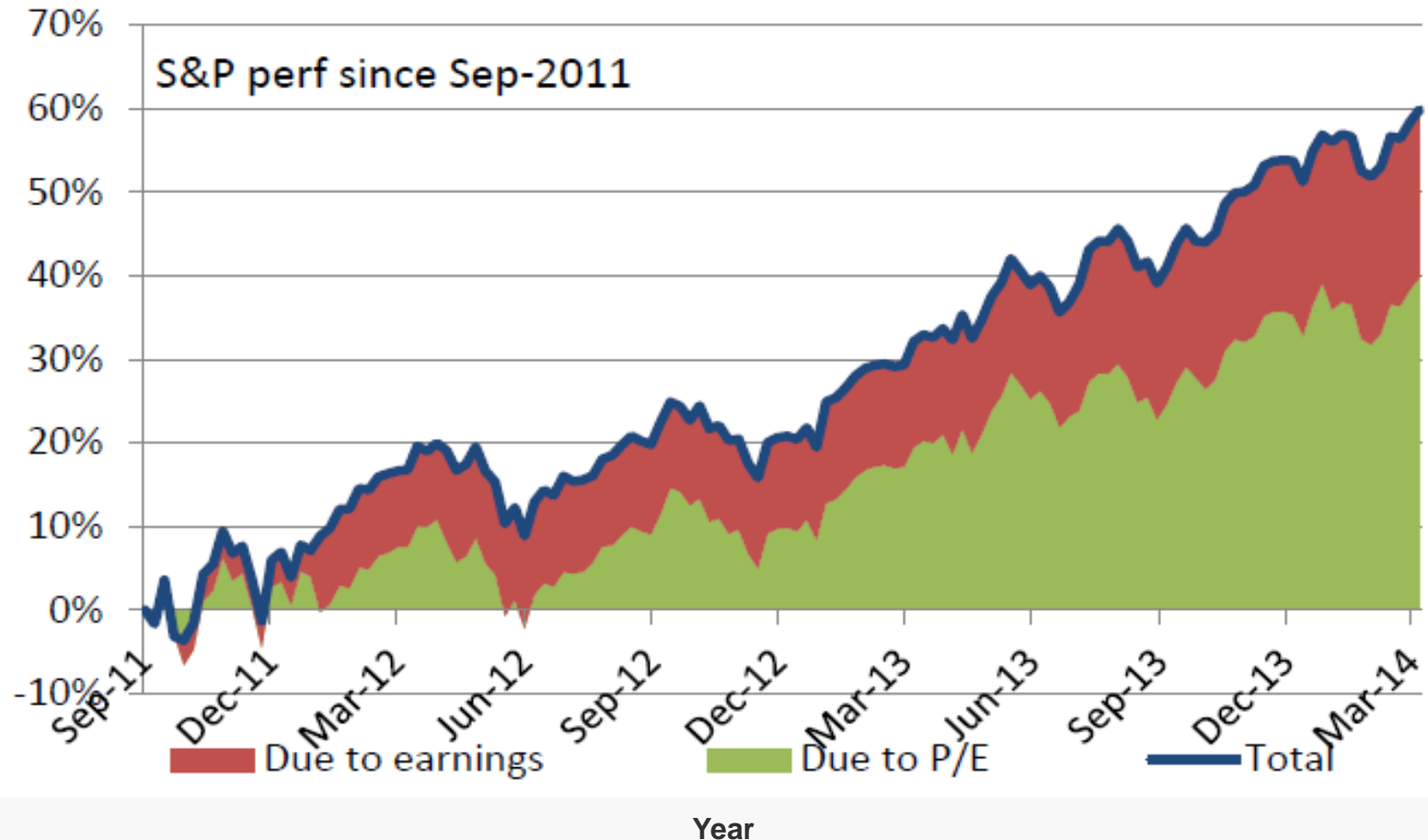
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Source: UBS

Valuation changes account for about 2/3 of the S&P rally since Sep 2011

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Source: Bloomberg

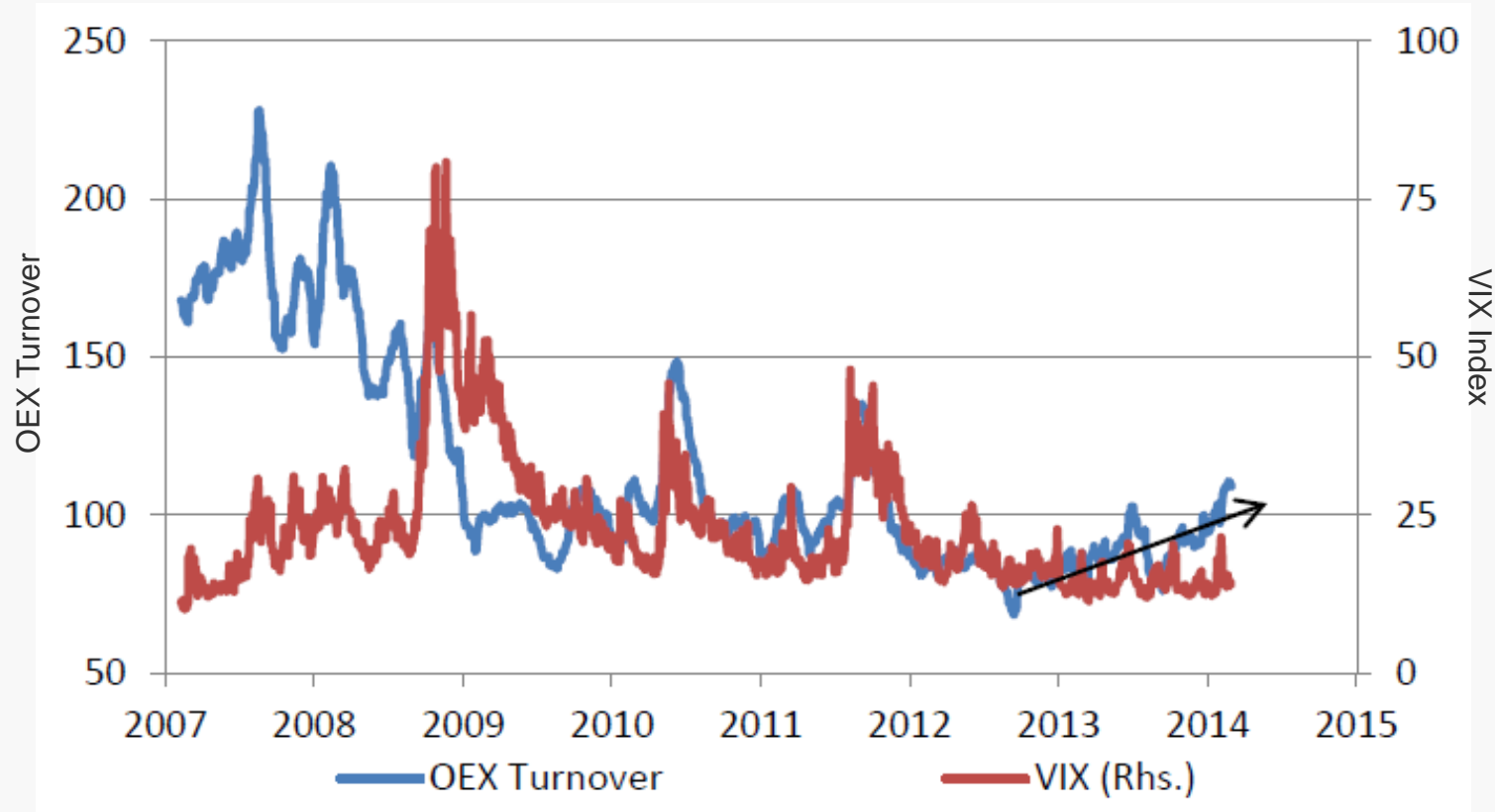
“A More Volatile Outlook for Equities”

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- Simplistically, the low yield environment argues for a very aggressive overweight equity position.
- What if the sleeping volatility dragon awakens?
- First stage: An upward move at the short end of the bond yield curve.
- Second stage: Positive correlation between Volatility (VIX) and median dollar turnover of each stock in the market.

The median daily dollar turnover of stocks in the S&P 100 (OEX Index) and the volatility in the market are usually linked

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Source: UBS

Historical Perspective. What Might Happen Next?

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Source: Bloomberg

Will We Ever Learn?

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Source: Bloomberg

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