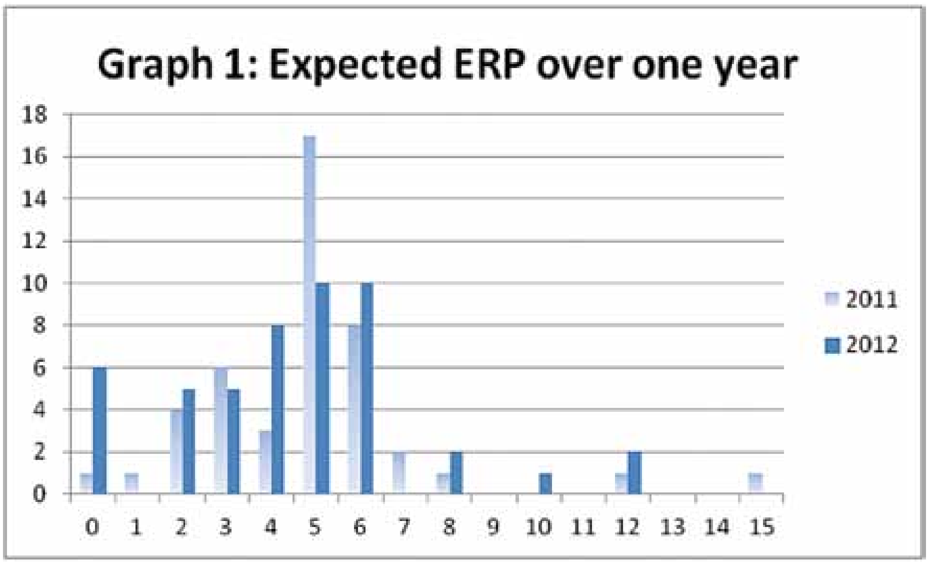
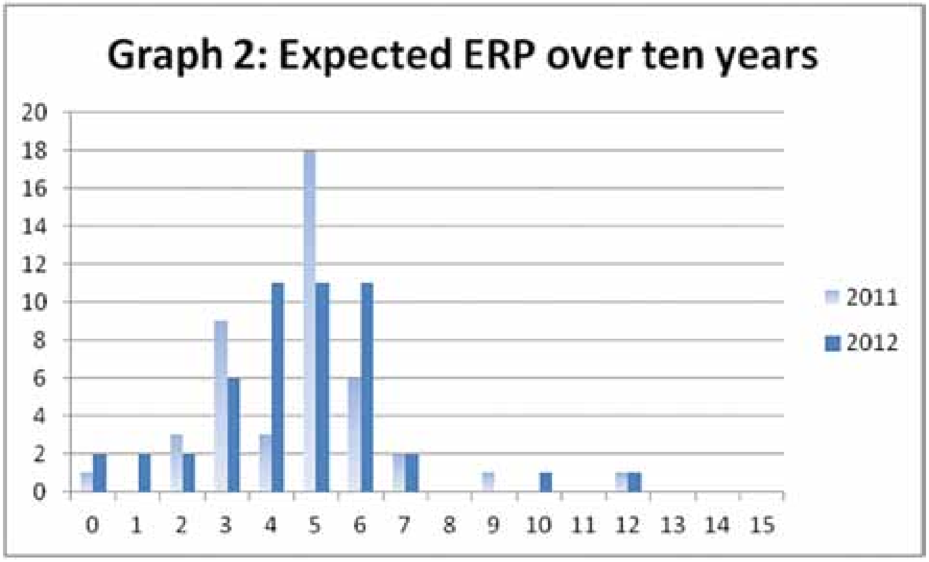
Equity Risk Premium Survey 2012: results and comments

Short surveys like ours may oversimplify the many sources of risk and return; but actuaries have something to offer in the determining the ERP as a whole, and industry needs a good estimate as a base for use in both valuation and asset allocation decisions.

What *expected* Equity Risk Premium (ERP) would you use for Australian equities (over government bonds of the same term)? The Equity Premium Research group again polled the profession in March this year, and obtained the results shown in graphs 1 and 2 for February 2011 and March 2012.

We had 49 usable responses this year as against 45 in 2011, and the results are not far different. The bimodal distribution of 2011 has further polarised when looking forward twelve months, with 6 respondents expecting no equity premium at all in 2012.





One of them wrote: "My view is based on outlook for flattish global growth over coming decade. Positive growth drivers of the past thirty years including the debt super cycle, inflation containment, fall of communism/ rise of capitalism and trade liberalisation are all losing momentum. Add to this headwinds due to ageing populations, bank re-regulation etc..." Another suggestion is that "the return on shareholders' funds currently being experienced in Australia is exceptionally high by historical standards, so it would be reasonable to assume some degree of mean reversion here."

There is however greater consensus for the longer term with over two thirds of the responses falling in the range 4 to 6%. The median for both 2011 and 2012 and both short and long term was 5%.

There are still two outlying respondents at 10% and 12% respectively. The 12% rate may apply to special circumstances being the valuation of unlisted assets. The 10% rate is used for valuation of risky liabilities and portfolio construction/asset valuation – and is based on the respondent's own research as well as being the standard view of the employer. They would appear to be somewhat high particularly if used for longer term cash flows.

Adjustments for franking credits, international equities and emerging market equities were (as might be expected) similar to last year. Average adjustments were 90bp for franking credits and -20bp and +100bp for international and emerging markets respectively.

Table 1 (page 29) shows that the average expected ERP is a little lower than last year's, particular for the one year horizon. Perhaps the negative returns of the last year have coloured our experience? Or is it that the future is going to be less profitable for equities?

Those using the ERP for valuation purposes as compared with investment purposes are using a (statistically) significantly higher rate. Those using their employers' standard rate are also using a significantly higher rate, but the correlation between valuation purposes and the use of the employer's rate is not as significant. It may well be that the survey is also not picking up 'frictional costs' that

Anthony Asher
a.asher@unsw.edu.au

TABLE 1: EXPECTED ERP BY USE AND SOURCE OF OPINION

	One year	Ten years	Count
Valuation of unlisted assets	5.3	5.5	13
Valuation of risky liabilities	5.4	5.2	13
Portfolio construction/asset allocation	4.3	4.5	31
Other uses	4.2	4.4	10
Standard view of my employer	5.6	5.2	15
Own research	3.8	4.2	36
Books or articles	4.4	4.8	24
TOTAL	4.4	4.6	49
2011 total	*4.9*	*4.7*	*45*

provide a wedge between internal returns and those earned by shareholders. It does however appear that employers' standard rates have remained high from before the GFC put a significant damper on expectations of the ERP.

We also asked for sources where respondents had obtained their information. Some of the sources our respondents shared were:

- "Too much risk, not enough reward" *The Economist* March 17 (which suggests an ERP of 4%).
- "The annual *Dimson*, *Marsh and Staunton survey* (110 years of equity, bond and cash real returns) published by Credit Suisse is absolutely essential" (finding an average of about 4%,although higher for Australia).
- Fama, E. F. and French, K. R., 2002, The Equity Premium, *Journal of Finance* 57, 637-659 (which suggests 4.3% was appropriate in 2000).
- *Barclays Equity Gilt Study* (which last year was expecting a 3% ERP over the next decade).
- Damodaran, A. (2012) *Equity Risk Premiums (ERP): Determinants, Estimation and Implications – The 2012 Edition*. http://pages.stern.nyu.edu/~adamodar/. This has been updated annually for the past five years and at over 100 pages, provides a thorough coverage. His view of the current ERP in the USA has recently increased to a range 4% to 6% – not least because of low risk free rates.
- Other sources included the investment course notes, *Shiller data*, (Shane) Oliver's Insights, Benjamin Graham and 'wild guessing'!

Damodaran makes the point that survey results are not reliable, not least because they frequently place too much reliance on recent history – a factor that may be influencing actuaries in their more conservative outlook this year.

Apologies to those who did the survey immediately as the survey initially only accepted whole numbers. We'll attempt to move to basis points for everything next year to avoid a repeat!

Other respondents made the points that short surveys like ours oversimplify the many sources of risk and return; and how the ERP should be considered in the context of asset price volatility – relative to liabilities. Other replies confirmed the view of the Equity Risk Premium research group that actuaries have something to offer in the determination of the ERP as a whole, and that the investment management industry needs a good estimate as a base for use in both valuation and asset allocation decisions.

The Research Group would welcome additional volunteers. Could I suggest that the following areas merit consideration for further research:

- Whether and how to include questions on the risk premia and volatility of different asset classes and equity sectors in future surveys.
- How to entirely dispel the notion that markets, always and everywhere, accurately reflect best estimates of future risk adjusted returns.
- Exploring some more promising alternatives to classic CAPM, particularly those where the risk premium is related by the correlation of assets with consumption. These are more consistent with actuarial thinking in being more realistic in their assumptions and more conscious of investors' objectives. The first few pages of the following link are relatively easy reading and give the gist: http://www.princeton.edu/bcf/newsevents/events/lectures-in-finance/CampbellLecture2.pdf. However, the paper – and the models – get complex later!
- Identifying the respective roles of investment management firms and of the profession and other educational and research institutions in the evaluation of risk premia and volatilities. Education and research are – to some extent at any rate – public goods that are not adequately provided by private firms operating in a competitive market.
- The extent, and the economic and social consequences, of over- and underinvestment as a consequence of failure to correctly identify the long term risk premium associated with different investments. I believe that this is particularly important in the face of peak oil: arguably a major component of the current slowdown in global growth, and clearly a major risk to economic stability and world peace!

If the last point particularly does not provoke some response, nothing will.