EQUITIES

Stocks vs. Bonds: Explaining the Equity Risk Premium

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From the 19th century through the mid-20th century, the dividend yield (dividends/price) and earnings yield (earnings/price) on stocks generally exceeded the yield on long-term U.S. government bonds, usually by a substantial margin. Anecdotally, investors of this era believed that stocks should yield more than bonds because stocks are riskier investments. Since 1958, the stock yield has been below the bond yield, usually substantially below.

This paper tests the hypothesis that the difference between stock yields and bond yields is driven by the long-run difference in volatility between stocks and bonds.

This model fits 1871–1998 data extremely well. Moreover, it explains the low stock market dividend and earnings yields of the early 2000s. Many authors have found that although both stock yields forecast stock returns, they generally have more forecasting power for long horizons. Using data up to May 1998, I found that the portion of dividend and earnings yields explained by the model presented here has predictive power only over the long term whereas the portion not explained by the model has power largely over the short term.

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