EQUITIES

Time Variation in the Equity Risk Premium

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The equity risk premium (ERP) refers to the expected (and sometimes realized) return of a broad equity index in excess of some fixed-income alternative. In the past decade, investors have shifted their thinking about whether to use historical average returns or forward-looking valuation indicators in calculating the ERP.

Academics and practitioners alike used to think the ERP was constant over time, in which case the future premium would best be estimated from the long-run average of the realized excess return. If the historical realized outperformance of stocks over bonds was 6%, for example, 6% would also be the best forecast for the future.

Roller-coaster experiences in markets in the first decade of the 21st century, as well as theoretical and empirical lessons, have converted many observers to the belief that expected returns and premiums vary over time. If so, then past average returns are a highly misleading indicator of future returns. Forward-looking valuation indicators are better and may provide useful timing signals.

Low dividend yields or low earnings yields (or their inverse, high price-to-earnings ratios) are now seen as a sign of low prospective stock-market returns, just as low bond yields and narrow yield spreads are interpreted as forecasting low returns in fixed-income markets. This forward-looking logic would have guided investors well during the low equity market yields of 2000 and high market yields of early 2009.

While this paper focuses on the equity risk premium, investors should remember that relying exclusively or primarily on the ERP as the source of long-run expected returns causes portfolios to be inadequately diversified.

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