Equity Price Premiums-The Price of Admission

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There is a debate raging in financial circles right now about the future of equity risk premiums, defined as that amount of incremental return investors expect to earn by investing in stocks. In that sense, stocks are generally thought to be more risky than bonds and if you are expecting to earn 5% on your bonds, you probably would expect to earn more than that in stocks. Incurring "risk" demands the expectation of higher returns - hence the equity risk premium.

What is driving this debate about market risk premiums is the fact that our notion of risk has been shocked. It has been fundamentally shifted in a way that is currently unknown. It will be known, but only after the fact. Prior to 9/11, risk was a car bomb in Israel or Northern Ireland. Today risk includes unknown terror domestically as well.

As the market peaked in January 2000, investors were losing their fear of risk and the risk premium was being driven close to zero. The internet stock boom/bust cycle brings this concept into sharp relief. Many stocks were being priced in the utopian fashion of some hard to define "perfect" world. Investors were in essence saying that they thought the future was so bright that they didn't require any extra return for holding particular stocks. As the market swings the other way, as it has recently, investors once again have an appreciation for risk.

What drives people's perception of risk? The short answer is volatility, and particularly short term volatility. Investors are risk averse. That is, they dislike losses more than they like gains. Volatility is typically measured by a statistical thing called standard deviation, which is the distance of each individual observation from the average observation of the group. Think of stocks versus bonds. In simple terms stocks move up and down more than bonds. Thus the risk of stocks is perceived to be greater. But over time, stocks have generated a higher return than have bonds and they have given us this thing called the risk premium. Is there risk in that? Evidently not over the long term. It doesn't take a genius to figure out that investors want a higher long term return as payment for bearing more short term price fluctuation.

The problem with risk premiums is that there is no way to directly measure them, particularly when you are trying to figure out what they will be in the future. If you think about stocks and bonds strictly from a financial analyst's point of view, stocks are lower in the capital structure of a company than is a bond and therefore stocks should always have some sort of risk premium attached to them. Investors should be paid more for owning the uncertainty of stock returns versus the more certain "contractual obligation returns" of bonds.

For the mathematically inclined, there are three types of risk premiums:

Equity Risk Premium = Equity Return minus T-Bill Return

Horizon Premium = Long Term Bond Return minus T-Bill Return

Default Premium = Corporate Bond Return minus Long Term Bond Return

These added together equal the historical risk premiums that were evident in the market. Financial theory says that the current risk free rate of interest (i.e., T-bills), when added to the historical risk premium, is a good approximation of expected future return.

The current debate says that stocks are too low (the risk premium is not justified) because stocks aren't more volatile than bonds. This logic carried a step further says that investors should be content to accept the same return for both stocks and bonds. I don't believe it, not even for a second. Remember, risk is volatility and volatility comes with a higher expected return. In fact, exactly because of the risk premium, investors have historically been paid handsomely to take risk. I believe this trend will continue - short term volatility being offset by long term reward. What makes it hard in any "current period", and particularly now, is that we don't know with certainty how to price future risk. We only believe, with firm conviction, that we will be compensated. If not, it's still the only real chance of outpacing inflation and maintaining our standard of living. Equity risk premiums are, in fact, the price of admission to earning higher returns.