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AN EQUITY RISK PREMIUM FOR THE 21ST CENTURY

“Everything should be made as simple as possible.....but no simpler”.

Investment Fiduciaries and the Equity Risk Premium

The fiduciaries of pension and other long-term trust funds must be conversant with the idea of the equity risk premium. They need to know what the equity risk premium is, where it has been, and have a view on where it may be going. This first ‘2000’ *Letter* helps fiduciaries address all three questions. The first two questions can be dispensed with rather quickly. The third will take somewhat longer. In each case, we will try to be true to Albert Einstein’s adage to make things “as simple as possible...but no simpler”.

First, what is the equity risk premium and why is it important? It is “the excess return on a diversified portfolio of equities over the return on the portfolio of securities which are risk-free in a specific trust fund context”. For example, where the promises being funded are long-term and inflation-indexed, the risk free return can be approximated by that on a portfolio of long-term, inflation-linked Treasury bonds.

Earning an excess return over the relevant risk free return is important to long-term investors. A rule of thumb in pension finance, for example, is that an additional 1% of long-term return can support a 20% higher pension payout or reduce pension expense by 20%. Such is the power of long-term compounding. So earning a long-term equity risk premium as low as 1% can have a bracing impact on the economics of pension funding. Earning higher equity risk premiums

would produce even more economically attractive results for pension plans and other funded institutions with long-term payment obligations.

Where Have Equity Risk Premiums Been?

Over long investment horizons, the equity risk premium appears to have been rather stable, at least in the United States. For example, Wharton Professor Jeremy Siegel reports real equity returns of about 7% over the course of both the 19th and 20th centuries. Real bond returns, on the other hand, fell from about 4.5% in the 19th century to 2.5% in the 20th. Thus over the entire 200 year sweep, a generous equity risk premium of 3.5% prevailed (ie., $7\% - 3.5\% = 3.5\%$).

In the interest of making things as simple as possible, it is tempting to march into the 21st century firmly clasping this 3.5% equity risk premium experience in hand. If it was a good number for the last 200 years, why not for the next 100 years too? Albert Einstein would not approve of this ‘logic’. Unfortunately, it crosses the boundary between making things as simple as possible, and making things so simplistic as to have no meaning. In short, there is no logical basis for believing that history will conveniently repeat itself.