

The Ambachtsheer Letter

Research and Commentary on Pension Governance, Finance and Investments

Letter #180

January 2001

INVESTING WITHOUT AN EQUITY RISK PREMIUM:

A BRAVE NEW WORLD?

“...appropriate new theories of asset pricing for tech stocks will be developed. These theories will reflect real world experience, and as a result, investors will not be shooting in the dark as much as they have been”.

Difficult Questions

A bedrock of the currently reigning pension fund management paradigm is the assumption that equities are always priced to earn a higher long term return than risk free assets. This assumption is at the heart of the oft-cited mantra that “asset mix is the most important investment decision”, and that as long as asset mix policy includes significant exposure to equities, everything will turn out all right. More subtly, the assumption also permits fiduciaries to turn a blind eye to the reality that most active investment management programs today are not structured to generate the excess returns necessary to justify their cost. A positive equity risk premium covers many sins.

Why is the ‘positive equity risk premium’ assumption so thoroughly embedded in the belief systems of fund fiduciaries and their advisors? Must it necessarily always be true? What if it is not true today? Why is it indeed plausible that it is not? How should pension assets be invested in a zero equity risk premium world? What are the implications for how the investment function should be organized? These are the difficult questions this *LETTER* addresses.

The Falling Equity Risk Premium

We have been among a small band of financial markets observers (Rob Arnott and Jeremy Grantham being two notable others) cautioning investors that rapidly rising equity markets also mean rapidly falling equity risk premiums. The essence of our message has been that there is simply no way around the iron law of total equity returns: over any investment period, total return is always the sum of the dividend yield plus dividend/earnings growth plus dividend/earnings valuation change. It so happens that all three of these equity return elements have been positive over the most popular historical measurement periods. This has been especially the case with the advent of the New Economy in the 1990s. Dividend/earnings growth was strong, and the upward revaluation process of dividends and earnings in the stock markets was even stronger.

By last year, this upward revaluation process reached a point where the simple arithmetic of calculating the prospective equity risk premium netted a zero result. In other words, the sum of the current dividend yield (say 1.5%), plus prospective long term dividend/earnings growth (say