The *Ambachtsheer* Letter

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THE *POST-BUBBLE BLUES DECADE*:

A PROGRESS REPORT

Another Nail in the *IID* Coffin

University of Toronto researchers John Maheu and Tom McCurdy have hammered another nail in the once-popular notion that the equity risk premium (ERP) is independently, identically distributed *(IID).* By using a Baysian learning procedure, their working paper ("How Useful Are Historical Data for Forecasting the Long-Run Equity Premium?") documents the finding that over the course of the last 100 years, the excess returns of U.S. stocks over T-bills come from a series of statistically differing return regimes. The strongest structural regime breaks in the excess return series occurred in 1929, 1940, and the late 1990s.

Why should we care whether the equity risk premium is *IID* or not? Simply put, because if it is, we can project the historical 5% ERP realization forward at any point in time, regardless of whether stock market prices are 'high' or 'low'. Indeed, in an *IID* world, there are no 'high' or 'low' stock prices. In this world, the expected ERP was the same 5% in 1929, in 1940, and in 2000, as it is today. This is not the case in a non-*IID* world. Now the expected ERPs in 1929, 1940, 2000, and today are allowed to be predictably low in 1929, predictably high in 1940, and once again predictably low in 2000. The goal of this *Letter* is to see what we can say about the expected long term ERP at the start of 2006.

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