

The Ambachtsheer Letter

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REPRICING RISK:

IS THE EQUITY RISK PREMIUM BIG ENOUGH NOW?

“History, properly interpreted, suggests that macro risk is currently being re-priced from a zero risk premium in 2000 to a materially positive premium. Indications are, as we write this in the summer of 2008, that this re-pricing process has yet to run its full course”.

The Ambachtsheer Letter, August 2008

Minsky Moments

We noted in 2008 that the Global Financial Crisis had yanked economist Hyman Minsky out of the shadows of obscurity into the global limelight. In a matter of months, his Financial Instability Hypothesis became common wisdom. It was suddenly obvious to all that prolonged periods of economic stability carry their own seeds of destruction. Greed eventually trumps fear, fostering a mindset Minsky called “a radical suspension of disbelief”. Everyone, from investors to homeowners to financiers to entrepreneurs to regulators and legislators, gets caught up in it. The toxic combination of ‘irrational exuberance’ and financial leverage produces asset bubbles. These bubbles eventually burst, causing havoc first in financial markets, and then in real ones.

Without knowing it, Minsky and this writer had been kindred spirits for many years prior to that fateful year of 2008. That pricing in financial markets is driven by alternating eras of investor optimism and pessimism had been a key component of our structure of investment beliefs all the way back to the “Scary Seventies”. This framing suggested to us in the early 1980s that pervasive pessimism had pushed risk premiums up to attractive levels. Almost twenty years later, as the Dot.Com bubble was about to burst in 2000, we were

moved to write “we have already collected the equity risk premium of the next decade without having to live through it” (*Paradigm Lost*, The Ambachtsheer Letter, December, 2000). A further eight years later, in August of 2008, the same ‘era’ framework led us to conclude that the process of re-pricing risk had not yet fully run its course (in *Investing for the Long Run: a ‘Macro’ Perspective*, cited above).

The goal of this *Letter* is to turn to this ‘era’ framework once again and take a new look at the equity risk premium question as the first decade of the 21st Century ends, and the second one commences.