

**Equity Risk Premiums (ERP): Determinants, Estimation and
Implications – The 2015 Edition**

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coefficients to demand these premiums.³⁰ In the years since, there have been many attempts to provide explanations for this puzzle:

1. Statistical artifact: The historical risk premium obtained by looking at U.S. data is biased upwards because of a survivor bias (induced by picking one of the most successful equity markets of the twentieth century). The true premium, it is argued, is much lower. This view is backed up by a study of large equity markets over the twentieth century, which concluded that the historical risk premium is closer to 4% than the 6% cited by Mehra and Prescott.³¹ However, even the lower risk premium would still be too high, if we assumed reasonable risk aversion coefficients.
2. Disaster Insurance: A variation on the statistical artifact theme, albeit with a theoretical twist, is that the observed volatility in an equity market does not fully capture the potential volatility, which could include rare but disastrous events that reduce consumption and wealth substantially. Reitz, referenced earlier, argues that investments that have dividends that are proportional to consumption (as stocks do) should earn much higher returns than riskless investments to compensate for the possibility of a disastrous drop in consumption. Prescott and Mehra (1988) counter that the required drops in consumption would have to be of such a large magnitude to explain observed premiums that this solution is not viable.³² Berkman, Jacobsen and Lee (2011) use data from 447 international political crises between 1918 and 2006 to create a crisis index and note that increases in the index increase equity risk premiums, with disproportionately large impacts on the industries most exposed to the crisis.³³
3. Taxes: One possible explanation for the high equity returns in the period after the Second World War is the declining marginal tax rate during that period. McGrattan and Prescott (2001), for instance, provide a hypothetical illustration where a drop in the tax rate on dividends from 50% to 0% over 40 years would cause equity prices to rise about 1.8% more than the growth rate in GDP; adding the dividend yield to this expected price appreciation generates returns similar to

³⁰ Mehra, Rajnish, and Edward C. Prescott, 1985, *The Equity Premium: A Puzzle*, Journal of Monetary Economics, v15, 145–61. Using a constant relative risk aversion utility function and plausible risk aversion coefficients, they demonstrate the equity risk premiums should be much lower (less than 1%).

³¹ Dimson, E., P. Marsh and M. Staunton, 2002, *Triumph of the Optimists*, Princeton University Press.

³² Mehra, R. and E.C. Prescott, 1988, *The Equity Risk Premium: A Solution?* Journal of Monetary Economics, v22, 133-136.

³³ Berkman, H., B. Jacobsen and J. Lee, 2011, *Time-varying Disaster Risk and Stock Returns*, Journal of Financial Economics, v101, 313-332