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STOCKS

Equity Risk Premiums And Stocks Today

Marek Mscichowski | March 11, 2014



Stocks may appear to be at expensive levels. Looking at Price to Earnings (P/E) multiples of equities and comparing them to their historical averages, however, some commentators (namely, former Federal Reserve Chairman Alan Greenspan and NYU professor Aswath Damodaran) have recently pointed to equity risk premiums as another useful metric for valuing stocks. Unlike P/E multiples, equity premiums take interest rates, some currently at historically low levels historically, into account.

The equity premium is the total expected return (including capital growth and dividends) minus the risk-free rate. The total expected return is currently around 8.5%. The ten-year Treasury yield, an estimate of the risk-free rate, is about 3%. Hence, by our rough arithmetic, the equity premium that compensates investors for the added risk of holding corporate equity over theoretically risk-free U.S. government interest payments is currently about 5.5%.

Historically, the equity premium required by investors has averaged in the range of 3% to 7%. So this premium is about average, while interest rates, in some cases, are at historic lows.

The main reason that interest rates are so low is the Federal Reserve's massive asset-buyback program and abnormally low inflation. Through this lens, the elevated high P/E ratios make more sense, as investors search for returns in a low interest-rate environment. However, the Fed lowered the amount of monthly buybacks by \$10 billion, from \$85 billion to \$75 billion, as 2013 came to a close. It then pared another \$10 billion assets in January of this year. The Fed's efforts should eventually increase interest rates, though the timeframe appears to depend on the depth and breadth of an economic recovery. This has lent more urgency to speculation on Fed moves.

If interest rates go up and the required premium stays the same, this will decrease equity prices, all else being equal, as future cash flows are discounted by greater expected total returns. However, Professor Damodaran, who periodically posts his own equity risk premium estimate, argues that over the past decade, estimated returns have circled around the same mean, with equity risk premiums have largely compensated for falling interest rates, which have been in the hands of the Federal Reserve. Still, there are historical precedents for shifts in the total expected return because of either changes in the risk-free rate or equity premiums.

Besides interest rates and required equity premiums, another variable that can affect returns is earnings growth, which ultimately supplies money for returns in the form of dividends and buybacks. In recent years, corporations have been doing well, and the global economy seems to be firming up. Future earnings figures will also affect valuations. Damodaran provides a model (similar to a dividend discount model for a stock) for one to determine the intrinsic value of the S&P 500 Index by providing estimates for the risk-free rate, equity premium, as well as cash returns in the form of buybacks and their assumed growth rates.

What are some possible scenarios and how would they affect investors? Our previous discussion should shed some light. In the worst case scenario, interest rates will grow sharply, while the pace of earnings slow (compared to expectations, at least). This may mean equities are relatively overvalued now. For investors, the best case would be if earnings continue to grow nicely, while interest rates remain subdued. This may mean that the intrinsic value of equities is above the current price. With markets recently reaching all-time highs in some indexes and many stocks trading at premium P/E multiples compared to recent years, looking at the equity risk premium may provide investors with new insights into equity valuation and where stocks can go from here.

Value Line subscribers can compare our total return estimates with current bond yields for an idea of equity risk premium as they differ for each individual stock (In general, riskier stocks require higher premiums). Investors should also focus on our earnings and dividend estimates and projections, when considering if an investment is right for them on a fundamental basis.

At the time of this article's writing, the author did not have positions in any of the companies mentioned.

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