The Equity Risk Premium in 2018

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ABSTRACT

We analyze the history of the equity risk premium from surveys of U.S. Chief Financial Officers (CFOs) conducted every quarter from June 2000 to December 2017. The risk premium is the expected 10-year S&P 500 return relative to a 10-year U.S. Treasury bond yield. The average risk premium is 4.42% and is somewhat higher than the average observed over the past 18 years. We also provide results on the risk premium disagreement among respondents as well as asymmetry or skewness of risk premium estimates. We also link our risk premium results to survey-based measures of the weighted average cost of capital and investment hurdle rates. The hurdle rates are significantly higher than the cost of capital implied by the market risk premium estimates.

JEL Classification: *G11, G31, G12, G14*

Keywords: *Cost of capital, financial crisis, equity premium, WACC, hurdle rate, long-term market returns, stock return forecasts, long-term equity returns, expected excess returns, disagreement, individual uncertainty, skewness, asymmetry, survey methods, TIPs, VIX, credit spreads*

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Introduction

We analyze the results of the most recent survey of Chief Financial Officers (CFOs) conducted by Duke University and *CFO* Magazine. The survey closed on December 7, 2017 and measures expectations beginning in the first quarter of 2018. In particular, we poll CFOs about their long-term expected return on the S&P 500. Given the current U.S. 10-year Treasury bond yield, we provide estimates of the equity risk premium and show how the premium changes through time. We also provide information on the disagreement over the risk premium as well as average confidence intervals. Finally, we link the equity risk premium to measures used to evaluate firm's investments: the weighted average cost of capital (WACC) and the investment hurdle rate.

1. Method

2.1 Design

The quarterly survey of CFOs was initiated in the third quarter of 1996.[1] Every quarter, Duke University polls financial officers with a short survey on important topical issues (Graham and Harvey, 2009). The usual response rate for the quarterly survey is 5%-8%. Starting in June of 2000, a question on expected stock market returns was added to the survey. Fig. 1 summarizes the results from the risk premium question. While the survey asks for both the one-year and ten-year expected returns, we focus on the ten-year expected returns herein, as a proxy for the market risk premium.

The executives have the job title of CFO, Chief Accounting Officer, Treasurer, Assistant Treasurer, Controller, Assistant Controller, or Vice President (VP), Senior VP or Executive VP of Finance. Given that the majority of survey respondents hold the CFO title, for simplicity we refer to the entire group as CFOs.

[1] The surveys from 1996Q3-2004Q2 were partnered with a national organization of financial executives. The 2004Q3 and 2004Q4 surveys were solely Duke University surveys, which used Duke mailing lists (previous survey respondents who volunteered their email addresses) and purchased email lists. The surveys from 2005Q1 to present are partnered with *CFO magazine*. The sample includes both the Duke mailing lists and the *CFO* subscribers that meet the criteria for policy-making positions.

2.2 Delivery and response

In the early years of the survey, the surveys were faxed to executives. The delivery mechanism was changed to the Internet starting with the December 4, 2001 survey. Respondents are given four business days to fill out the survey, and then a reminder is sent allowing another four days. Usually, two-thirds of the surveys are returned within two business days.

The response rate of 5-8% could potentially lead to a non-response bias. There are six reasons why we are not overly concerned with the response rate. First, we do not manage our email list. If we deleted the email addresses that had not responded to the survey in the past 12 quarters, our response rate would be in the 15-20% range – which is a good response rate. Second, Graham and Harvey (2001) conduct a standard test for non-response biases (which involves comparing the results of those that fill out the survey early to the ones that fill it out late) and find no evidence of bias. Third, Brav, Graham, Harvey and Michaely (2005) conduct a captured sample survey at a national conference in addition to an Internet survey. The captured survey responses (to which over two-thirds participated) are qualitatively identical to those for the Internet survey (to which 8% responded), indicating that non-response bias does not significantly affect their results. Fourth, Brav et al. contrast survey responses to archival data from Compustat and find archival evidence for the universe of Compustat firms that is consistent with the responses from the survey sample. Fifth, Campello, Graham, and Harvey (2011) show that the December 2008 response sample is fairly representative of the firms included in the commonly used Compustat database. Sixth, Graham, Harvey, Popadak and Rajgopal (2017) update the non-response bias test in a survey of 1,900 CFOs and find no evidence of non-response bias.

2.3 Data integrity

In each quarter, implement a series of rules to ensure the integrity of the data. We have, on average, 351 responses each quarter. There are a total of 24,812 survey observations. There are six key pieces of data: 1) the 10-year forecast (LT); 2) lower 10% of 10-year forecast (LLT); and 3) upper 10% of the 10-year forecast (ULT). We collect the analogous information for the one-year

S&P 500 forecasts too (ST). This paper focuses on the 10-year forecasts but the short-term forecasts factor into our data filters.

Our exclusion rules are the following:

1. Delete all missing forecasts, LT, ST
2. Delete all negative LT forecasts (not ST forecasts)
3. Delete all observations that failed to use percentages (forecasts<1.0 for both ST and LT)
4. Delete observations where they failed to annualize, i.e. delete if LT>30% (does not apply to ST)
5. Delete is ST>100%.
6. Delete if lower intervals inconsistent, i.e. LST>=ST or LLT>=LT.
7. Delete if upper intervals inconsistent, i.e. UST<=ST or ULT<=LT.
8. Delete if ST-LST and UST-ST both equal 1 (we call this a lazy answer)
9. Delete if LT-LLT and ULT-LT both equal 1 (again, a lazy answer)

2.4 The 2018 results

The expected market return questions are a subset of a larger set of questions in the quarterly survey of CFOs. The survey usually contains between eight and ten questions. Some of the questions are repeated every quarter and some change through time depending on economic conditions. The historical surveys can be accessed at http://www.cfosurvey.org. Appendix 1 shows the risk premium question in the most recent survey.

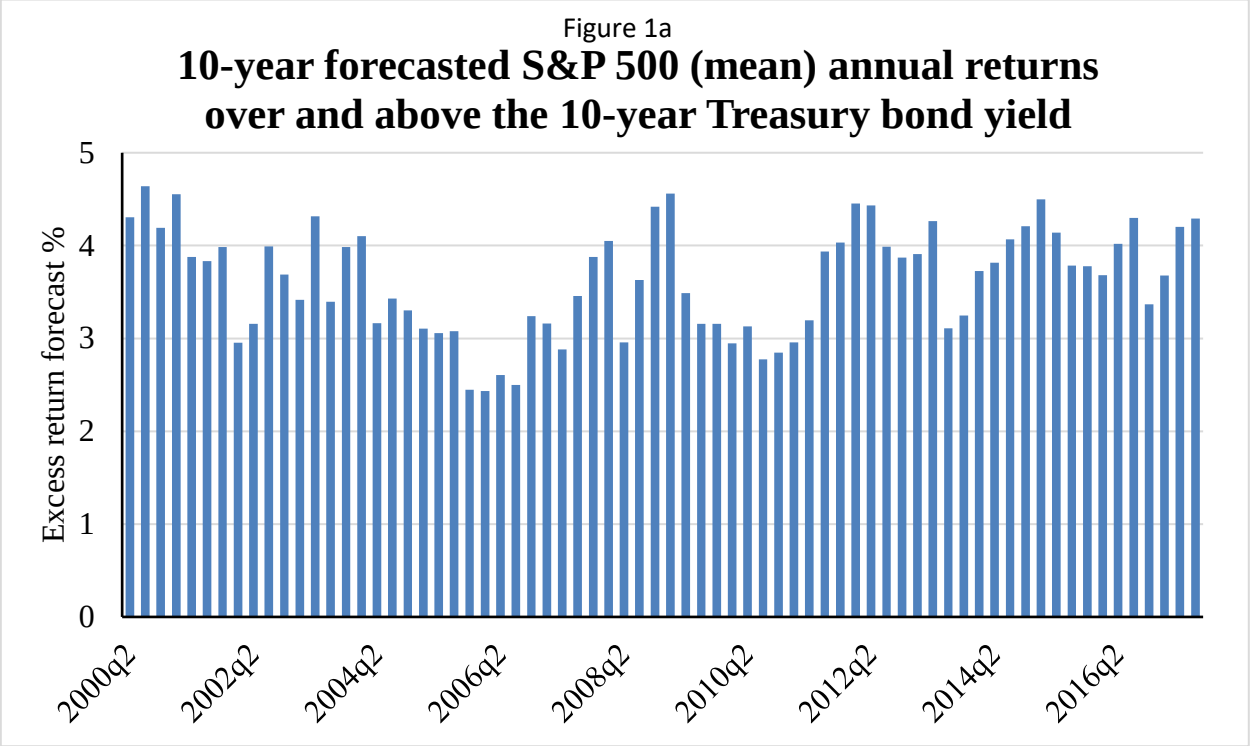
While the survey is anonymous, we collect demographic information on seven firm characteristics, including industry, sales revenue, number of employees, headquarters location, ownership (public or private), and proportion of foreign sales.

During the past 18 years, we have collected almost 25,000 responses to the survey. Panel A of Table 1 presents the date that the survey window opened, the number of responses for each survey, the 10-year Treasury bond rate, as well as the average and median expected excess returns. There is relatively little time variation in the risk premium. This is confirmed in Fig. 1a, which displays the historical risk premiums contained in Table 1. The current premium, 4.42%, is above the historical average of 3.64%. The December 2017 survey shows that the expected

annual S&P 500 return is 6.79%% (=4.42%+2.37%) which is slightly below the overall average of 7.11%. The total return forecasts are presented in Fig. 1b.[2]

Panel B of Table 1 presents some summary statistics that pool all responses through the 18 year history of the survey. The overall average ten-year risk premium return is 3.64%.[3] The standard deviation of the individual responses is 2.93% (see Panel B). The standard deviation of the quarterly risk premium estimates is 0.58%.

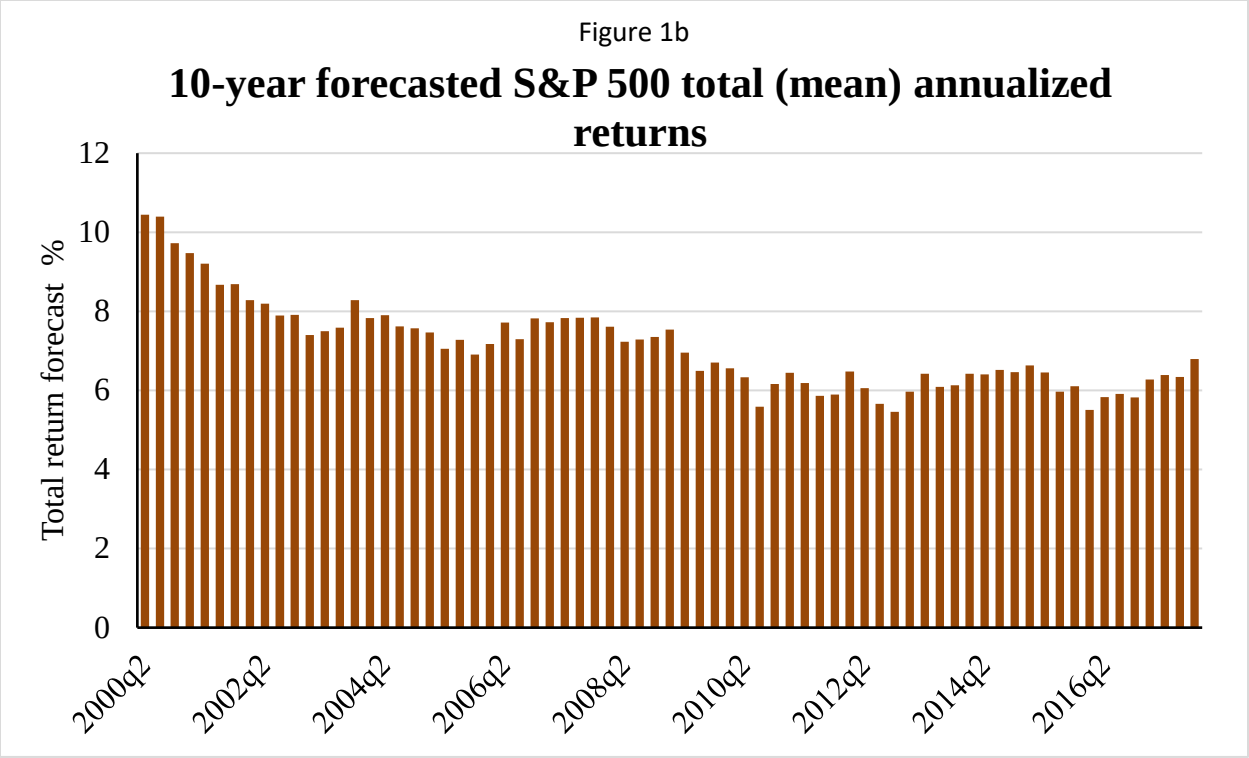
Figure 1a



[2] See, for example, Ghysels (1998), Welch (2000, 2001, 2009), Ghysels (1998), Fraser (2001), Harris and Marston (2001), Pástor and Stambaugh (2001), Fama and French (2002), Goyal and Welch (2003), Graham and Harvey (2003), Ang and Bekaert (2005), Fernandez (2004, 2006, 2009) for studies of the risk premium.

[3] Using the Ibbotson Associates data from January 1926 through July 2010, the arithmetic (geometric) average return on the S&P 500 over and above the 30-day U.S. Treasury bill is 7.75% (5.80%). Using data from April 1953-July 2010, the arithmetic (geometric) risk premium is 6.27% (5.12%). The risk premium over the 10 year bond should be reduced by 212 basis points for the arithmetic premium and 174 basis points for the geometric premium. Fama and French (2002) study the risk premium on the S&P 500 from 1872-2000 using fundamental data. They argue that the ex ante risk premia is between 2.55% and 4.32% for 1951-2000 period. Ibbotson and Chen (2001) estimate a long-term risk premium between 4 and 6%. Also see Siegel (1999), Asness (2000), Heaton and Lucas (2000) and Jagannathan, McGratten and Scherbina (2001). A recent treatment is Sharpe and Suarez (2013).

Figure 1b



The cross-sectional standard deviation across the individual CFO forecasts in a quarter is a measure of the disagreement or dispersion of the participants in each survey. Dispersion sharply increased during the global financial crisis. The average disagreement in 2005 was 2.39%. Disagreement increased in 2006 to 2.64%. As the crisis began in 2007, disagreement increased to 2.98 by March 2008. The peak disagreement was recorded in February 2009 (4.13%). The most recent observation is 3.49%.

We also report information on the average of the CFOs' assessments of the one in ten chance that the market will exceed or fall below a certain level. In the most recent survey, the worst case total return is +0.85% which is lower than the historic average of 1.45%. The best-case return is 10.97% which is very close to the historical average of 10.90%.

With information on the 10% tails, we construct a probability distribution for each respondent. We use Davidson and Cooper's (1976) method to recover each respondent's probability distribution:

$$\text{Variance} = ([x(0.90)-x(0.10)]/2.65)^2$$

where $x(0.90)$ and $x(0.10)$ represent the 90^{th} and 10^{th} percentiles of the respondent's distribution,

ULT and LLT. Keefer and Bodily (1983) show that this simple approximation is the preferred method of estimating the variance of a probability distribution of random variables, given information about the 10th and 90th percentiles. Like disagreement, the average of individual volatilities peaked in February 2009 at 4.29%. The current level, 3.80%, is very close to the overall average, 3.52%.

There is also a natural measure of asymmetry in each respondent's response. We look at the difference between each individual's 90% tail and the mean forecast and the mean minus the 10% tail. Hence, if the respondent's forecast of the excess return is 6% and the tails are -8% and +11%, then the distribution is negatively skewed with a value of -9% (=5%-14%). As with the usual measure of skewness, we cube this quantity and standardize by dividing by the cube of the individual standard deviation. In every quarter's survey, there is on average negative skewness in the individual forecasts. The average asymmetry -0.66 which is slightly lower than the average of -0.48.

Table 1

Summary statistics based on the responses from the
71 CFO Outlook Surveys from June 2000 to Sept 2017 (Maximums in red, minimums in green)

A. By quarter

#	Survey date	Survey quarter	Number of survey responses	10-year bond yield	Total market return forecast	Average risk premium	Median risk premium	Disagreement (standard deviation of risk premium estimates)	Average of individual standard deviations	Average of individuals' worst 10% market return scenario	Average of individuals' best 10% market return scenario	Skewness of risk premium estimates	Average of individuals' asymmetry	% who forecast negative excess return
1	6/6/2000	2000Q2	209	**6.14**	**10.45**	4.31	3.86	3.22				0.95		9.09
2	9/7/2000	2000Q3	188	5.76	10.40	**4.64**	4.24	3.03				0.83		4.79
3	12/4/2000	2000Q4	243	5.53	9.72	4.19	4.47	2.52				0.53		4.12
4	3/12/2001	2001Q1	140	4.92	9.47	4.55	4.58	2.91				0.78		3.57
5	6/7/2001	2001Q2	208	5.33	9.21	3.88	3.67	2.64				0.58		5.77
6	9/10/2001	2001Q3	199	4.84	8.67	3.83	3.16	2.53				**0.13**		3.52
7	12/4/2001	2001Q4	279	4.70	8.68	3.98	3.30	2.43				0.61		2.15
8	3/11/2002	2002Q1	233	5.33	8.29	2.96	2.67	2.43	3.28	**3.68**	12.42	1.06	-0.28	11.16
9	6/4/2002	2002Q2	316	5.04	8.20	3.16	2.96	2.61	3.50	3.00	12.28	1.86	-0.39	10.44
10	9/16/2002	2002Q3	361	3.90	7.89	3.99	4.10	2.31	3.39	3.05	12.03	0.86	-0.25	2.77
11	12/2/2002	2002Q4	285	4.22	7.91	3.69	3.78	2.56	3.23	3.32	11.87	1.24	-0.28	4.91
12	3/19/2003	2003Q1	184	3.98	7.40	3.42	3.02	2.37	3.59	1.95	11.47	0.83	-0.62	4.35
13	6/16/2003	2003Q2	366	3.18	7.50	4.32	**4.82**	2.34	3.74	2.16	12.07	0.90	-0.33	3.28
14	9/18/2003	2003Q3	167	4.19	7.58	3.39	3.81	**2.07**	**2.83**	3.31	10.83	0.35	-0.43	6.59
15	12/10/2003	2003Q4	220	4.30	8.29	3.98	3.70	2.66	3.29	3.40	12.10	1.74	-0.45	2.27
16	3/24/2004	2004Q1	206	3.73	7.83	4.10	4.27	2.37	3.46	2.85	12.02	0.50	-0.29	3.88
17	6/16/2004	2004Q2	177	4.74	7.90	3.16	3.26	2.61	3.10	3.14	11.34	2.14	-0.40	6.21
18	9/10/2004	2004Q3	179	4.19	7.62	3.43	3.31	2.92	3.27	2.61	11.29	2.02	-0.52	8.94
19	12/3/2004	2004Q4	287	4.27	7.57	3.30	3.23	2.66	3.05	3.10	11.17	1.89	-0.37	5.92
20	2/28/2005	2005Q1	272	4.36	7.46	3.10	3.39	2.52	3.06	3.13	11.23	1.29	-0.33	6.62
21	5/31/2005	2005Q2	316	4.00	7.06	3.06	3.00	2.22	3.22	2.39	10.93	0.46	-0.26	6.65
22	8/29/2005	2005Q3	321	4.20	7.28	3.08	2.80	2.61	3.36	2.15	11.06	2.42	-0.52	7.48
23	11/21/2005	2005Q4	338	4.46	6.91	2.45	2.54	2.20	3.48	2.23	11.44	0.41	**-0.23**	9.76
24	3/6/2006	2006Q1	276	4.74	7.17	**2.43**	2.26	2.40	3.44	2.07	11.18	1.02	-0.37	8.70
25	6/1/2006	2006Q2	494	5.11	7.72	2.61	2.89	2.74	3.29	3.00	11.70	1.84	-0.24	**18.02**
26	9/11/2006	2006Q3	460	4.80	7.30	2.50	2.20	2.49	3.32	2.53	11.33	1.32	-0.33	7.83
27	11/21/2006	2006Q4	386	4.58	7.82	3.24	3.42	2.93	3.36	2.94	11.82	1.91	-0.30	6.99
28	3/1/2007	2007Q1	380	4.56	7.72	3.16	3.44	2.39	3.38	2.73	11.67	1.80	-0.39	5.53
29	6/1/2007	2007Q2	419	4.95	7.83	2.88	3.05	2.14	3.21	3.08	11.58	0.56	-0.37	3.58
30	9/7/2007	2007Q3	479	4.38	7.84	3.46	3.62	2.82	3.12	3.33	11.59	1.80	-0.34	5.22
31	11/30/2007	2007Q4	458	3.97	7.85	3.88	4.03	2.75	3.31	2.93	11.70	1.38	-0.32	3.28
32	3/7/2008	2008Q1	381	3.56	7.61	4.05	4.44	2.99	3.21	3.08	11.58	2.23	-0.30	3.94
33	6/13/2008	2008Q2	384	4.27	7.23	2.96	2.73	2.60	3.32	2.44	11.24	1.50	-0.41	9.38
34	9/5/2008	2008Q3	432	3.66	7.29	3.63	3.34	2.79	3.31	2.30	11.06	1.71	-0.42	4.63
35	11/28/2008	2008Q4	534	2.93	7.35	4.42	4.07	3.19	3.73	1.77	11.64	1.94	-0.37	2.81
36	2/26/2009	2009Q1	443	2.98	7.54	4.56	4.02	**4.13**	**4.29**	1.18	**12.54**	1.80	-0.47	5.87
37	5/29/2009	2009Q2	427	3.47	6.96	3.49	3.53	3.12	3.73	1.37	11.26	1.79	-0.42	6.56
38	9/11/2009	2009Q3	536	3.34	6.50	3.16	2.66	2.88	3.87	0.62	10.86	1.82	-0.46	10.82
39	12/11/2009	2009Q4	457	3.55	6.71	3.16	2.45	3.56	3.86	0.64	10.88	2.38	-0.52	9.85
40	2/26/2010	2010Q1	478	3.61	6.56	2.95	2.39	3.28	3.96	0.39	10.86	2.31	-0.68	9.41
41	6/4/2010	2010Q2	444	3.20	6.33	3.13	2.80	3.08	3.90	0.33	10.64	**2.61**	-0.64	9.91
42	9/10/2010	2010Q3	451	2.81	5.59	2.78	**2.19**	2.53	4.21	**-1.16**	9.99	0.77	-0.67	8.65
43	12/10/2010	2010Q4	402	3.32	6.17	2.85	2.68	2.62	3.91	0.26	10.63	1.89	-0.55	10.70
44	3/4/2011	2011Q1	429	3.49	6.45	2.96	2.51	2.92	4.16	-0.27	10.76	2.44	**-0.70**	8.16
45	6/3/2011	2011Q2	406	2.99	6.18	3.19	3.01	2.90	3.90	0.12	10.45	2.09	-0.68	5.17
46	9/9/2011	2011Q3	397	1.93	5.86	3.93	3.07	3.11	3.79	0.04	10.09	2.41	-0.54	**2.02**
47	12/16/2011	2011Q4	439	1.86	5.89	4.03	3.14	2.98	4.07	-0.11	10.68	1.91	-0.36	3.42
48	3/1/2012	2012Q1	406	2.03	6.48	4.45	3.97	2.97	4.07	0.30	11.08	2.25	-0.59	2.71
49	5/30/2012	2012Q2	338	1.63	6.06	4.43	4.37	2.96	3.94	0.00	10.42	1.96	-0.59	2.37
50	9/7/2012	2012Q3	675	1.67	5.66	3.99	3.33	3.00	3.66	-0.01	9.67	2.04	-0.58	2.37
51	12/6/2012	2012Q4	325	**1.59**	**5.46**	3.87	3.41	2.59	3.69	-0.49	**9.25**	1.42	-0.62	3.08
52	3/8/2013	2013Q1	418	2.06	5.97	3.91	3.94	2.73	3.84	-0.14	10.02	2.01	-0.64	4.55
53	5/31/2013	2013Q2	300	2.16	6.43	4.27	3.84	2.91	4.02	0.10	10.76	1.63	-0.67	2.67
54	9/5/2013	2013Q3	404	2.98	6.09	3.11	3.02	2.73	3.41	0.75	9.77	1.71	-0.53	6.68
55	12/5/2013	2013Q4	320	2.88	6.13	3.25	3.12	2.95	3.81	0.18	10.26	1.69	-0.50	7.19
56	3/4/2014	2014Q1	291	2.70	6.43	3.73	3.30	2.63	3.32	1.35	10.13	0.64	-0.69	5.15
57	6/5/2014	2014Q2	325	2.59	6.41	3.82	3.41	3.23	3.76	0.50	10.46	1.89	-0.64	7.08
58	9/4/2014	2014Q3	316	2.45	6.52	4.07	3.55	3.33	3.69	0.90	10.68	2.56	-0.60	3.16
59	12/4/2014	2014Q4	398	2.25	6.46	4.21	4.50	2.51	3.79	0.46	10.51	1.22	-0.59	2.26
60	3/13/2015	2015Q1	414	2.13	6.63	4.50	3.87	3.50	3.72	0.81	10.68	1.92	-0.55	5.80
61	6/4/2015	2015Q2	399	2.31	6.45	4.14	3.69	3.03	3.96	0.20	10.68	1.93	-0.72	4.26
62	9/3/2015	2015Q3	376	2.18	5.96	3.78	2.82	3.17	3.48	0.28	9.49	2.72	-0.72	3.99
63	12/3/2015	2015Q4	347	2.33	6.11	3.78	2.67	3.58	3.55	0.54	9.94	1.92	-0.52	9.22
64	3/3/2016	2016Q1	476	1.83	5.51	3.68	3.17	2.55	3.12	1.04	9.29	0.99	-0.34	3.15
65	6/2/2016	2016Q2	472	1.81	5.83	4.02	3.19	3.24	3.52	0.39	9.71	2.14	-0.63	2.54
66	9/8/2016	2016Q3	372	1.61	5.91	4.30	3.64	2.93	3.45	0.64	9.77	1.90	-0.55	1.61
67	12/1/2016	2016Q4	263	2.45	5.82	3.37	3.55	2.69	3.34	0.56	9.39	2.24	-0.68	5.32
68	3/9/2017	2017Q1	278	2.60	6.28	3.68	3.40	3.31	3.27	1.64	10.31	2.29	-0.42	5.76
69	6/8/2017	2017Q2	300	2.19	6.39	4.20	3.81	3.06	3.60	0.90	10.43	2.60	-0.43	2.67
70	9/7/2017	2017Q3	301	2.05	6.34	4.29	3.95	2.77	3.88	0.20	10.48	1.64	-0.52	2.99
71	12/7/2017	2017Q4	212	2.37	6.79	4.42	3.63	3.49	3.80	0.85	10.97	2.06	-0.66	4.25
	Average of quarters		351	**3.48**	**7.11**	**3.63**	**3.39**	**2.81**	**3.56**	**1.46**	**10.90**	**1.58**	**-0.48**	**5.73**
	Standard deviation			1.20	1.13	0.58	0.62	0.38	0.33	1.29	0.81	0.66	0.14	3.03

B. By individual responses

Survey for											
All dates	24,812	**3.32**	**6.94**	**3.62**	**3.33**	**2.93**	**3.60**	**1.33**	**10.86**	**1.67**	**-0.48**	**5.79**

2.5 Risk premia, weighted average cost of capital and hurdle rates

The risk premia that we measure can be used in the calculation of the cost of capital. In a simple capital asset pricing model, the cost of equity capital would be the product of the company's beta times the risk premium along with the risk free rate. The average firm's cost of equity capital would be 6.79% (assuming a beta=1). Assuming the Baa bond yield (4.22%) is the borrowing rate and a 25% marginal tax rate as well as a 75%-25% debt equity split, the weighted average cost of capital would be about 5.89%.

In previous surveys, we have asked CFOs about their weighted average cost of capital. For example, in March of 2011, companies told us that their internally calculated weighted average cost of capital was 10% (averaged across respondents). At the time, the cost of equity capital was similar to today, 6.45%. The bond yields were higher, with the Baa yielding 6.09%. The average firm (assuming average beta is 1.0) without any debt would have a WACC of 6.45%. When debt is introduced, the WACC would be less than 6.45% -- which is sharply lower than the reported 10%.

Why is there such a divergence? One possible reason is that companies consider other factors in calculating the WACC – perhaps a multifactor model.[4] However, there is no evidence supporting this hypothesis. For example, consultants often add a premium for smaller firms based on the results in many research papers of a size premium. However, in our survey the average WACC for firms with less than $25 million in revenue is 10.6% and the WACC for the largest firms with annual revenue greater than $10 billion is 10.5%.

This analysis was replicated in June of 2012 with similar results. Given the same assumptions, the WACC is 5.37%. However, the average self-reported WACC is 9.3%. Again, there is no evidence of a size premium. The smallest firms reported a WACC of 9.3% and the largest firms 9.7%.

The WACC should not be confused with the investment hurdle rate. The WACC is an analytical calculation that combines a model-based cost of equity (such as the CAPM) and the after-tax cost

[4] Graham and Harvey (2001) find that most companies use a one-factor CAPM model for cost of capital calculations.

of debt (reflected in current borrowing rates). Given capital constraints, firms often impose a higher hurdle rate on their investments. For example, to allocate capital to an investment that promises a projected return exactly at the firm's WACC is equivalent to accepting a zero net present value project.

The June 2012 survey also asked for the investment hurdle rates. They are much higher than the WACCs. The average rate was 13.5% (compared to the survey-reported WACC of 9.3% and the implied WACC from the survey based risk premium of 5.7%. Similar to the WACC results, there is no evidence that the hurdle rates are higher for small firms. Our evidence shows that the reported average hurdle rate for the smallest firms is 13.1% and for the largest firms the rate is 14.2%.

Even though we know from Graham and Harvey (2001) that three quarters of companies use the capital asset pricing model, there is a large gap between an imputed WACC and the WACC that people use. One way to reconcile this is that companies use very long term averages of equity and bond premia in their calculations. For example, suppose the cost of capital is being calculated with averages from 1926. Ibbotson (2013) reports an arithmetic average return of 11.8% over the 1926-2012 period. The average return on corporate bonds is 6.4%. Using the same parameters, we get an imputed WACC of 9.7%. This is very close to the average reported WACC and, indeed, identical to the WACC reported by the largest firms in our survey.

We learn the following: 1) the equity risk premium is much lower today than averages used over long-periods (e.g. from 1926) such as reported in Morningstar (2013) and Duff and Phelps (2015); 2) the survey questions asking directly about a company's WACC is consistent with companies routinely using long-horizon averages for inputs; and 3) WACCs should be thought as lower bounds – the Hurdle Rates used for actual investment decisions are 400bp higher than the stated WACCs.[5]

[5] Also see Sharpe and Suarez (2013) and Jagannathan et al. (2016) who analyze our CFO survey data.

2.6 Recessions, the financial crisis and risk premia

Our survey spans two recessions: March 2001-September 2001 as well as the recession that begins in December 2007 and ends in June 2009. Financial theory would suggest that risk premia should vary with the business cycle. Premiums should be highest during recessions and lowest during recoveries. Previous research has used a variety of methods including looking at ex post realized returns to investigate whether there is business-cycle like variation in risk premia.

While we only have 60 observations and this limits our statistical analysis, we almost no differences. During recessions, the risk premium is 3.52% and during non-recessions, the premium is 3.68%.

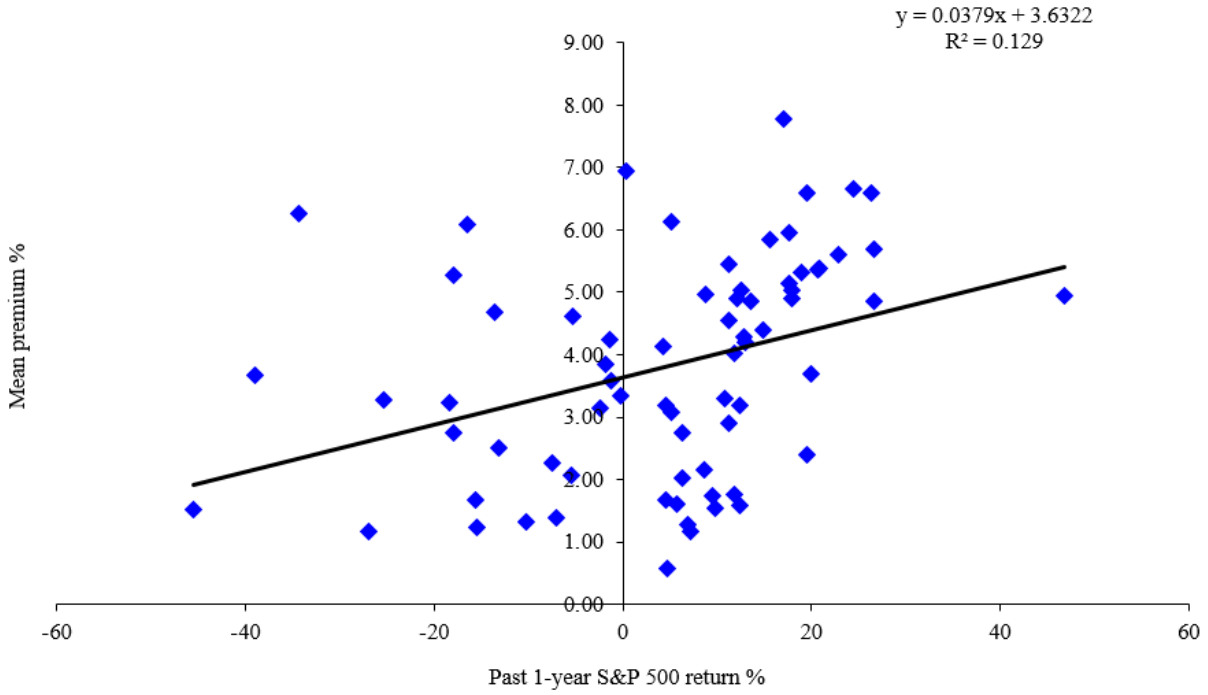
2.7 Explaining variation in the risk premium

While we document the level and a limited time-series of the long-run risk premium, statistical inference is complicated by the fact that the forecasting horizons are overlapping. First, we have no way of measuring the accuracy of the risk premiums as forecasts of equity returns. Second, any inference based on regression analysis is confounded by the fact that from one quarter to the next, there are 36 common quarters being forecasted. This naturally induces a moving-average process.

We do, however, try to characterize the time-variation in the risk premium without formal statistical tests. Figure 2 examines the relation between the mean premium and previous one-year returns on the S&P 500.

Figure 2

The mean one year premium and past one-year returns on the S&P 500 index



The evidence suggests that there is a weak negative correlation between past returns and the level of the long-run risk premium. This makes economic sense. When prices are low (after negative returns), expected return increase.

An alternative to using past-returns is to examine a measure of valuation. Figure 3 examines a scatter of the mean premium versus the forward price-to-earnings ratio of the S&P 500.

Figure 3

The equity risk premium and the S&P 500 forward price-to-earnings ratio

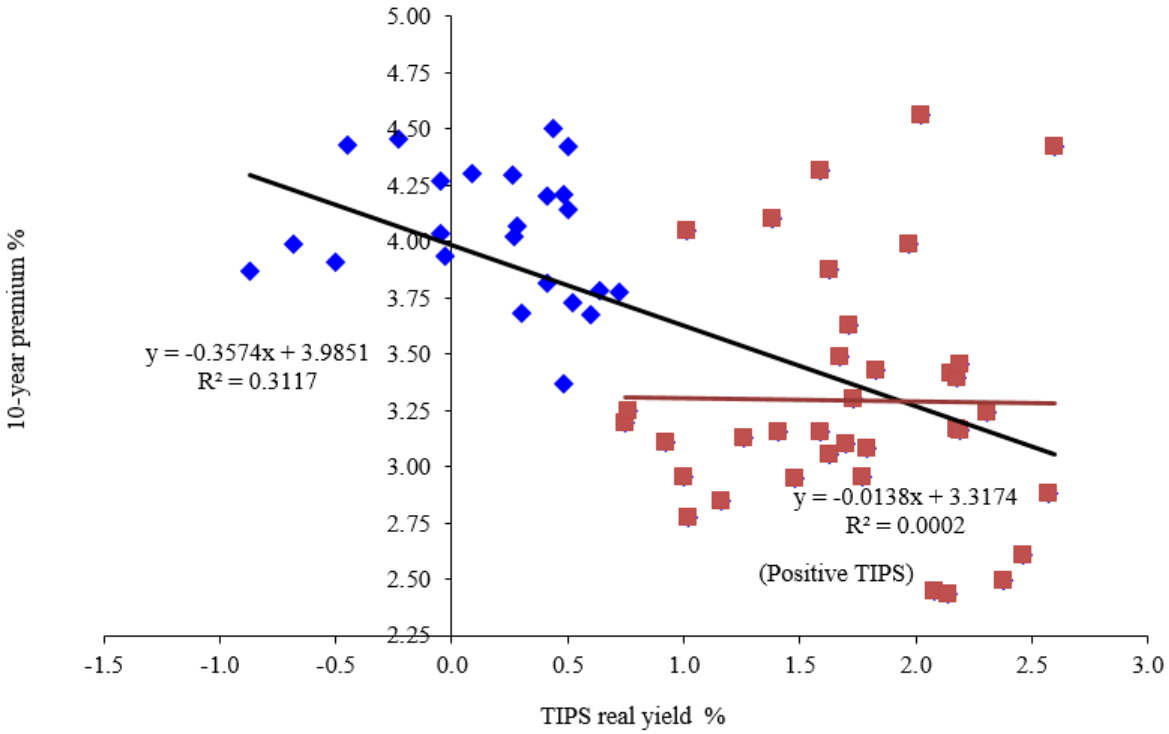
Looking at the data in Figure 3, it appears that the inference may be complicated by a non-linear relation. At very high levels of valuation, the expected return (the risk premium) was low.

We also examine the real yield on Treasury Inflation Indexed Notes. The risk premium is like an expected real return on the equity market. It seems reasonable that there could be a correlation between expected real rates of return stocks and bonds. Figure 4 examines the 10-year on the run yield on the Treasury Inflation Indexed Notes.

Overall, there is a negative correlation of -0.517. However, this correlation is driven by the negative TIPS yields. This is consistent with the idea that in periods of heightened uncertainty, investors engage in a flight to safety and accept low or negative TIPS yields – and at the same time demand a high risk premium for investing in the equity market.

Figure 4

The equity risk premium and the real yield on Treasury Inflation Indexed Notes

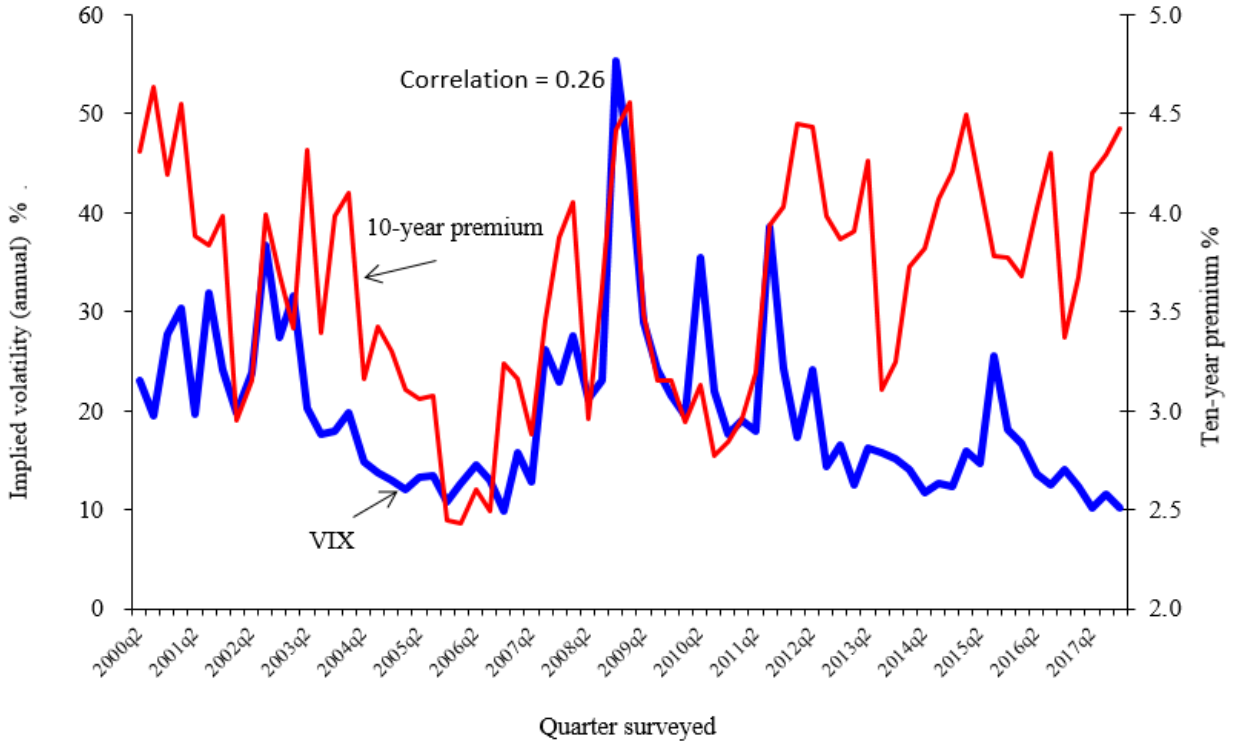


Finally, we consider two alternative measures of risk and the risk premium. Figure 5 shows that over our sample there is evidence of a strong positive correlation between market volatility and the long-term risk premium. We use a five-day moving average of the implied volatility on the S&P index option (VIX) as our volatility proxy. The correlation between the risk premium and volatility is 0.26. If the closing day of the survey is used, the correlation is roughly the same. Asset pricing theory suggests that there is a positive relation between risk and expected return. While our volatility proxy doesn't match the horizon of the risk premium, the evidence, nevertheless, is suggestive of a positive relation. Figure 5 also highlights a strong recent

divergence between the risk premium and the VIX.

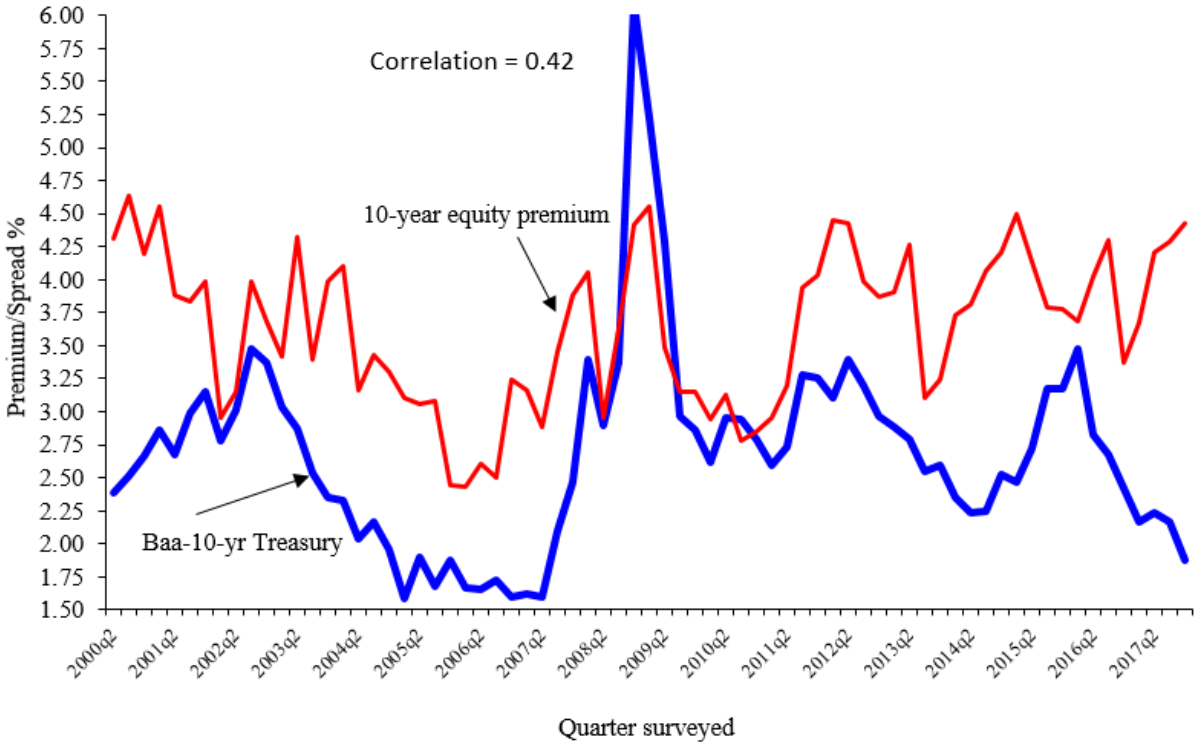
Figure 5

The equity risk premium and the implied volatility on the S&P 500 index option (VIX)



We also consider an alternative risk measure, the credit spread. We look at the correlation between Moody's Baa rated bond yields less the 10-year Treasury bond yield and the risk premium. Figure 6 shows a highly significant relation between the time-series with a correlation of 0.42. Similar to Figure 5, there is a strong recent divergence.

Figure 6
The equity risk premium and credit spreads



2.8 Other survey questions

The June 2016 survey contains a number of other questions. http://www.cfosurvey.org presents the full results of these questions. The site also presents results conditional on demographic firm characteristics. For example, one can examine the CFOs views of the risk premium conditional on the industry in which the CFO works.

2.9 Risk premium data and corporate policies

Research by Ben-David, Graham and Harvey (2013) uses the one-year risk premium forecasts as a measure of optimism and the 80% confidence intervals as a direct measure of overconfidence. By linking email addresses that respondents provide to archival corporate data, Ben-David et al. find that the tightness of the confidence intervals is correlated with corporate investment. Overconfident managers invest more.

Campello, Graham and Harvey (2010) use the survey during the financial crisis and the higher risk premiums to examine the implications of financial constraints on the real activities of the

firm. They provide new evidence on the negative impact of financial constraints on firms' investment plans.

Campello, Giambona, Graham and Harvey (2011) use the survey during the financial crisis to study how firms managed liquidity during the financial crisis.

Graham, Harvey and Puri (2013) administer a psychometric test using the survey instrument and link CEO optimism and risk aversion to corporate financial policies.

Graham, Harvey and Puri (2015) use survey data to study how capital is allocated within the firm and the degree to which CEOs delegate decision making to CFOs.

Graham, Harvey and Rajgopal (2005) use survey data to study how managers manipulate earnings. Dichev, Graham, Harvey, and Rajgopal (2013) study earnings quality.

Graham, Harvey, Popadak and Rajgopal (2017) use a similar survey sample to study corporate culture.

2.10 CFO Survey compared to other surveys

Table 2 compares the predictive ability of the Duke-CFO survey with other popular surveys. The table reports the correlations between the current quarter Duke-CFO survey of either optimism about the economy or optimism about the firm's prospects with the subsequent quarter's realization for five surveys: UBS-Gallup, CEO Survey, Conference Board Consumer Confidence, University of Michigan Consumer Confidence and ISM Purchasing Manager's Index. Both of the Duke-CFO optimism measures significantly predict all five of these popular barometers of economic confidence. Related analysis shows that our CFO survey anticipates economic activity sooner (usually one quarter sooner) than do the other surveys.

Table 2
The ability of the Duke CFO survey to predict other surveys

	Predictive correlations	
Survey	Optimism about economy	Optimism about firm's prospects
UBS-Gallup	0.289	0.380
CEO Survey	0.814	0.824
Conference Board Consumer Confidence	0.513	0.767
University of Michigan Consumer Confidence	0.341	0.253
ISM Purchasing Managers Index	0.694	0.497

3. Conclusions

We provide a direct measure of ten-year market returns based on a multi-year survey of Chief Financial Officers. Importantly, we have a 'measure' of expectations. We do not claim it is the true market expectation. Nevertheless, the CFO measure has not been studied before.

While there is relatively little time-variation in the risk premium, premia are higher during recessions and higher during periods of uncertainty. We also link our analysis to the actual investment decisions of financial managers. We are able to impute the weighted average cost of capital given the CFO estimates of equity risk premia, current corporate bond yields and marginal tax rates. This imputed measure is significantly less than the WACCs that CFOs report using in project evaluation. One way to reconcile this is that CFOs use very long-term averages of equity premia and bond rates when calculating WACCs. We provide evidence on the actual hurdle rates used by companies. These hurdle rates are, on average, 400bp higher than the reported WACCs.

While we have nearly 25,000 survey responses in 18 years, much of our analysis uses summary statistics for each survey. As such, with only 71 unique quarters of predictions and a variable of interest that has a 10-year horizon, it is impossible to evaluate the accuracy of the market excess return forecasts. For example, the November 30, 2007 10-year annual forecast was 7.85% and the realized annual S&P 500 return through December 7, 2017 is approximately 6%. Our analysis shows some weak correlation between past returns, real interest rates and the risk premium. In contrast, there is significant evidence on the relation between two common measures of economic risk and the risk premium. We find that both the implied volatility on the S&P index as

well as a commonly used measure of credit spreads are correlated with our measured equity risk premium.

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Appendix A

Excerpt from the Survey Instrument

10. On November 14, 2017 the annual yield on 10-yr treasury bonds was 2.37%. Please complete the following:

a. Over the next 10 years, I expect the average annual S&P 500 return will be:

Worst Case: There is a 1-in-10 chance the actual average return will be less than:	**Best Guess**: I expect the return to be:	Best Case: There is a 1-in-10 chance the actual average return will be greater than:
☐ %	☐ %	☐ %

b. During the next year, I expect the S&P 500 return will be:

Worst Case: There is a 1-in-10 chance the actual return will be less than:	**Best Guess**: I expect the return to be:	Best Case: There is a 1-in-10 chance the actual return will be greater than:
☐ %	☐ %	☐ %

Please check one from each category that best describes your company:

a. Industry (choose best option)

- ○ Retail/Wholesale
- ○ Banking/Finance/Insurance/Real Estate
- ○ Mining/Construction
- ○ Transportation & Public Utilities
- ○ Energy
- ○ Services, Consulting
- ○ Agriculture, Forestry, & Fishing
- ○ Public Administration
- ○ Communication/Media
- ○ Tech [software/biotech/hardware]
- ○ Manufacturing
- ○ Healthcare/Pharmaceutical
- ○ Other: ☐

b. Sales Revenue

- ○ Less than $25 million
- ○ $25-$99 million
- ○ $100-$499 million
- ○ $500-$999 million
- ○ $1-$4.9 billion
- ○ $5-$9.9 billion
- ○ More than $10 billion

c. Number of Employees

- ○ Fewer than 100
- ○ 100-499
- ○ 500-999
- ○ 1,000-2,499
- ○ 2,500-4,999
- ○ 5,000-9,999
- ○ More than 10,000

d. Where are you personally located?

- ○ Northeast U.S.
- ○ Mountain U.S.
- ○ Midwest U.S.
- ○ South U.S.
- ○ South Atlantic U.S.
- ○ Pacific U.S.
- ○ Canada
- ○ Latin America
- ○ Europe
- ○ Asia
- ○ Africa
- ○ Other

e. Ownership

- ○ Public, NYSE
- ○ Public, NASDAQ/AMEX
- ○ Private
- ○ Government
- ○ Nonprofit

f. Foreign Sales

- ○ 0%
- ○ 1-24%
- ○ 25-50%
- ○ More than 50%

g. Return on assets (ROA=operating earnings/assets) (e.g., -5%, 6.2%)

☐ % Approximate ROA in 2017
☐ % Expected ROA in 2018