Q: Does an equity risk premium still exist?

Brian Lockhart: The equity risk premium is essentially hanging on by a thread at this point. Over the last 15 years the equity risk premium, the amount of excess return equity investors should receive over a perceived risk-free investment, has been around 5.50% per year. That means a perceived risk-free asset like a U.S. Treasury bond might provide 2.5% per year total return and owning the S&P 500 would average around 8%. The idea of the risk premium is that stock investors take on more risk and should be rewarded with higher expected long-term returns.

When market forces determine which investments win and which investments lose based on the relative merits of the investments, the risk premium can be identified. I am of the opinion that market forces have not determined winners from losers for some time, and Fed policy has been a much greater factor in determining investment success than actual results. This can be seen in how low quality stocks and zombie companies have performed this year. According to CNBC, low quality stocks, the 20% of companies with the worst balance sheet metrics, have outperformed the 20% of companies with the strongest balance sheets. Similarly, zombie companies, defined as a company whose earnings are insufficient to cover their interest payments on debt, continue to issue debt and thrive in many cases. Zombies added more than $1 trillion in debt in 2020, much of it at distinctly low interest rates.

Clint Pekrul, CFA: To be clear, the equity risk premium (ERP) is the extra return you expect to receive by risking your money investing in the stock market. We start with a base-line investment in a risk-free portfolio, perhaps of short-term Treasuries or a money market fund. Your decision to make an investment in equities depends on the excess return you expect to receive from that investment over some time horizon. Based on history, equities have delivered a risk premium, which is why investors have bought stocks and held them for long periods of time. However, the ERP is not a constant and can vary quite significantly.

Much of what determines the ERP is valuations, such as current price-to-book or price-to-earnings ratios. In theory, higher valuations suggest a lower ERP. Since stocks are deemed too pricey, the potential for future returns shrinks (i.e. the premium is reduced). After market corrections like we had in March, the ERP expands. You’re likely to realize an attractive premium going forward since your entry point is at lower valuation (i.e. stocks are cheap). We’ve discussed the possibility that stock valuations are stretched based on historical measures, which would suggest a lower ERP today. However, don’t forget what intervention from the Fed can mean for stock prices and the ERP. While it still exists, the ERP is likely a bit compressed for now, given the incredible rally we’ve had in stocks this year.

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