

RISK, RETURN, AND THE COST OF CAPITAL

The Equity Risk Premium

James P. Weston

Professor of Finance

The Jones School, Rice University

EQUITY RISK PREMIUM

- ▶ Stocks do better in the long run
- ▶ Might need 50 years!
- ▶ Huge volatility
- ▶ Higher discount rates!

STOCK MARKET PERFORMANCE

- ▶ The stock market returns 10-12%
- ▶ Interest rates are typically 5-6%

$$\begin{aligned}\text{Equity premium} &= R_m - r.f. \\ &= 11\% - 5.5\% \\ &= 5.5\%\end{aligned}$$

EQUITY RISK PREMIUM

- ▶ 5.5% is based on historical average
- ▶ Does this seem reasonable?
- ▶ Surveys of market professionals differ
- ▶ Different methods give 4%-8%!

EQUITY PREMIUM

- ▶ 4.5% – 6.5% is a good range
- ▶ Why might this change over time?
 - ▶ Systemic risk
 - ▶ Attitudes toward risk
- ▶ These change the price of risk!

SUMMARY

- ▶ Stock market as a whole is well diversified
- ▶ Equity premium is around 4.5-6.5%
- ▶ Compensates for equity risk
- ▶ 5.5% ballpark “price” of market risk