SOCIETY OF ACTUARIES

Article from:

Risk and Rewards

February 2014 – Issue 63

LESSONS LEARNED AND LINGERING QUESTIONS ABOUT THE EQUITY RISK PREMIUM (ERP)

By Tom Anichini

Editor's Note: This article summarizes a session topic on which the author moderated at the 2013 Annual Meeting.

At the 2013 Annual Meeting I enjoyed the privilege of moderating the Equity Risk Premium session with presenters Victor Modugno, FSA, and Brett Hammond, Ph.D. Hammond and Modugno had already presented together twice on this topic previously—for a webcast this past summer and at the Investment Symposium. Both have written on the topic: Hammond co-edited *Rethinking the Equity Risk Premium* (search *cfapubs.org* for "Research Foundation Publications" in 2011); Modugno wrote *Estimating Equity Risk Premiums* (Search *soa.org* for "Completed Research Projects—Pension" in 2012).

In the course of reading the panelists' monographs and exploring their citations I learned some subtleties about the topic I had not previously appreciated, and am left with some lingering questions.

FOUR DIFFERENT DEFINITIONS OF ERP

Pablo Fernandez (cited in Modugno's paper) teaches Finance at University of Navarra in Spain. His working paper, *The Equity Premium in 150 Textbook*, takes textbook authors to task for several sins, including not defining all four ERP types: Historic, Expected, Implied and Required. (Search *ssrn.com*.)

BEST MODEL? DEPENDS ON THE FORECAST HORIZON

In Modugno's paper he compares different models' long horizon (20-, 30-, 40- and 50-year) forecasts of the ERP, using data available beginning some 50 years ago. Keeping in mind it reflects very few data points, I find the visual comparison of the models' accuracy over different horizons enlightening, and question why anyone might rely solely on the Historic ERP.

IS THE ERP A PREMIUM ON A SINGLE RISK, OR ON A MOSAIC OF RISKS?

A theme emerging among risk model vendors (e.g., MSCI, Axioma, Northfield) is to think not of a single ERP but instead of as premia on multiple risk factors, such as Size, Value, Momentum, Credit, Illiquidity, Volatility, etc. Hammond (who is managing director and head of Index Applied Research at MSCI) touched on this briefly. Such factors have long been part of quantitative risk and return models, and they have crept into the investment actuary's world as well. In 2013 the Investment Section awarded the Redington Prize for "LDI in a Risk Factor Framework." In the future perhaps we will regard the concept of a monolithic ERP as an anachronism.

ARE WE TOO OPTIMISTIC RIGHT NOW?

Much ERP literature finds investor sentiment makes for a contrary indicator of future returns. In "Expectations of Returns and Expected Returns" (*Review of Financial Studies*, forthcoming) authors Robin Greenwood and Andrei Shleifer conclude that investors extrapolate recent performance too much to be rational. Does this apply even to actuaries? Prior to the 2013 ERP session the Society of Actuaries (SOA) staff surveyed registered attendees on their expectation of real equity returns over the next 10 years, in a question phrased identically to one we asked attendees to a session in October 2011. In 2011, the mean response was 5 percent; in 2013, it was 6 percent. Perhaps future earnings growth will justify the increase in attendees' optimism.

Thomas M. Anichini, ASA, CFA, is a senior investment strategist at GuidedChoice. He may be reached at tanichini@guidedchoice.com.