

What explains the recent common stock equity risk premium?

Category : Investment Returns and Securities Market Risk Premiums Articles

Published by [The Skilled Investor](#) on Jul/12/2005

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Summary: In a widely referenced scientific investment paper, Professors Fama and French concluded that the average investor lowered his discount rate for equities over the 1980s and 1990s. Much of the extraordinary equity appreciation over this period was the result of investors simply being willing to pay a higher price for an ordinary dollar of returns. In this article, The Skilled Investor discusses “The Equity Premium” study by Professors Eugene F. Fama of the University of Chicago and Kenneth R. French, who was then at MIT, and is now at Dartmouth.¹ In their detailed and methodical study, which has been referenced by many other researchers, Professors Fama and French tried to determine the most reliable models for estimating the equity risk premium. Professors Fama and French provided a very long historical viewpoint. They assembled data for 1872 to 2000 from several sources. For comparisons, they split the data into two periods: 1872 to 1950 and 1951 to 2000. They tested a variety of models and techniques to determine which analytical approaches were more instructive. They evaluated dividend growth, earnings growth, financial ratios, and risk aversion metrics. As predictors of the equity premium, Professors Fama and French contrasted the reliability of the dividend growth model to the earnings growth model. The dividend growth model predicts that the average expected equity return will equal the average expected dividend-to-price ratio (or yield) plus the average expected growth rate of dividends. The earnings growth model predicts that the average expected equity return will equal the average expected dividend-to-price ratio plus the average expected growth rate of earnings. Professors Fama and French found that both the dividend and earnings growth models predicted realized returns for the 1872 to 1950 period reasonably well. However, both models quite significantly underestimated equity returns for the 1951 to 2000 period. For this later period, the earnings growth model did better than the dividend growth model in predicting the realized equity premium. Nevertheless, both measures fell short in that they significantly underestimated the actual realized equity premium. The closest that either of these fundamental models got to explaining equity appreciation in the 1951 to 2000 period was two-thirds of the way. Professors Fama and French were careful in describing their conclusions, and they did not make any predictions about the future. This topic is complex and the potential for misinterpretation is significant. Despite the fact that the fundamental models underestimated realized returns from 1951 to 2000, Professors Fama and French concluded that these fundamental models were the most stable and most consistent predictors to use when estimating expected or future returns. They believed that these models were preferable to simply giving up on fundamentals modeling altogether and just accepting some measure of the recent realized equity premium to project into the future. Based upon a variety of consistency checks, Professors Fama and French concluded that investors had lowered their return expectations during the past couple of decades. In comparison with the earlier 1872 to 1950 period, they argued that much of the stock price appreciation during the 1951 to 2000 period was simply unexpected, when analyzed using financial models based upon fundamentals. Professors Fama and French believe that a reduction in the average investor’s discount rate was largely responsible for the extraordinary equity price appreciation during the last 20 years of the 20th

century. This means that much of the extraordinary equity appreciation over this period was the result of investors simply becoming more willing to pay a higher price for an ordinary dollar of returns. For a discussion of how one might apply the observations of Professors Fama and French, see: [To estimate the future common stock risk premium, how might individual investors extrapolate from the past?](#)

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