

Asset class investment risk premiums -- your reward for taking investment risk

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Summary: Risk premiums compensate investors for taking some of the risks associated with financial securities. To enable payment of risk premiums, markets set current prices at a discount relative to expected future prices. On average across securities, prices embed a discount in the current market price relative to the potential future value of risky securities. The greater the perceived risk, the greater the embedded discount tends to be. In this sense, the financial markets “price risk.” The higher the risk that is perceived by market participants, then the higher the discount that would be built into the current price of a particular security. It is a matter of elastic supply and demand. Demand is inversely related to the current price of a security, and demand is inversely related to the level of perceived risk. The higher the perceived risk the lower the current market price would be relative to the expected future price. In the scientific investment literature, the discount for risk built into current securities prices is known as a “risk premium.” Risk premiums could vary: a) between different kinds of asset classes, b) across market and business cycles, and c) over much longer stretches of time. Generally, the markets price risk premiums across asset classes, because the securities ownership risks associated with individual business and government entities can be diversified away through a broad portfolio of holdings. The historical or realized equity risk premium measures investors’ past reward for having been exposed to passive business ownership risk. Equity risks are measured by the overall market risk and by certain additional risk factors that have been identified statistically and incorporated in to “multifactor” performance benchmarking models. The primary additional factors that have been identified are risk discounts related to smaller versus larger enterprises and value-based versus growth-based securities. The risk premium associated with longer-term fixed income assets relates to relative default risk and the reinvestment risk upon the maturity of a debt obligation. Shorter-term interest bearing securities also carry some smaller risk associated with default and reinvestment. Individual investors, who are often frustrated with their efforts in the stock market, frequently repeat the “buy low, sell high” tongue-in-cheek joke. This is in fact not a joke at all. “Buy low, sell high” is the reasonable expectation of any rational investor in any risky security. Over time, premiums will tend to accrue, because a myriad of potential opportunities and risks may or may not be realized. Without an expectation that an investor is more likely than not to “sell high,” why would he take on the risk associated with owning a risky security? Note that risk premiums have nothing to do with clever securities selection, which on average tends not to work for investors because of efficient market pricing. Some financial situations involve substantial risk, while others do not. If something of clear value that you want is offered at an acceptable price within your budget and you are highly certain to get it, then you will purchase it with little hesitancy. For example, because you expect to get what you want immediately and see no risk in the transaction, you would willingly hand over a couple of bucks at coffee shop. However, if there were risk associated with a purchase, then you reasonably would want compensation for taking that risk. In particular, if you are required to pay well in advance for a

product or service of uncertain quality from a vendor of uncertain reliability, you could be very hesitant. You would assess the probabilities of being disappointed. For fans of old Popeye cartoons, when Wimpy says, "I will gladly pay you Tuesday for a hamburger today," you know that there is a significant amount of risk in the repayment proposition. Since you are not a cartoon character, would you ever invest in a real-life Wimpy without significant compensation for the risk of non-fulfillment? If you were required to purchase in advance, as you are with an investment security, you definitely would require a current discount to an expected future price. You need this discount to compensate for the risk that your purchase might not live up to expectations or might not be delivered at all. This is the essence of a risk premium. It is compensation to induce you to accept the risk associated with an uncertain outcome. A rational investor would require a discount, when he purchases a risky security. The greater the uncertainty, the greater the compensation the investor would demand. Because expected risk premiums are forward looking, they cannot be measured directly from the current price of a security. However, realized risk premiums can be measured in aggregate historical returns. Historical market data can measure which risks the markets compensated in the past and which risks the markets did not. (See: [What have average investment asset class risk premiums been over long periods?](#)) Generally over the long-term, equity securities markets have had an upward price trend. Some of this equity price growth has been related to economic growth, which drives company level earnings growth. Because the average firm does not pay out all its earnings, equities prices tend to grow due to the market value of retained assets. Furthermore, changes over the long run in the discount rates that investors are willing to accept for a dollar of ordinary returns may also influence market price changes. However, if one were to hold constant all other factors that have caused a general long-term rise in equities prices, an investor would still expect that the price of a particular security would rise over time due to the risk premium or risk discount. There may be substantial variations in realized risk premiums between securities, because specific company opportunities and risks may or may not materialize. Some firms' equity will have large payoffs, and some may be a total loss. However, on average across time and business cycles there should be an upward price movement to pay out the risk premium.

These related articles may also be useful to you: [Returns and Risk Premiums: ->How stable have common stock equity risk premiums been over time?](#) ->[What explains the recent common stock equity risk premium?](#) ->[How are asset class risk premiums and the risk free rate of return related?](#) ->[What might explain the dramatic rise in common stock equity prices during the 1980s and 1990s?](#) ->[How do individual investors' recent portfolio return expectations compare to long-term historical common stock returns and equity risk premiums?](#) ->[To estimate the future common stock risk premium, how might individual investors extrapolate from the past?](#) ->[What common stock returns might individual investors expect going forward?](#) ->[What happens to the expected equity premium, when the common stock P/E ratio reverts toward historical norms?](#) [Securities Valuation: ->Introduction to investment valuation and securities risk](#) ->[How investment securities are valued -- snapshots in time](#) ->[The confusing investment securities market motion picture](#) ->[What is efficient market pricing in the securities markets?](#)