ECONOMIC VIEW

Why Do Stocks Pay So Much More Than Bonds?

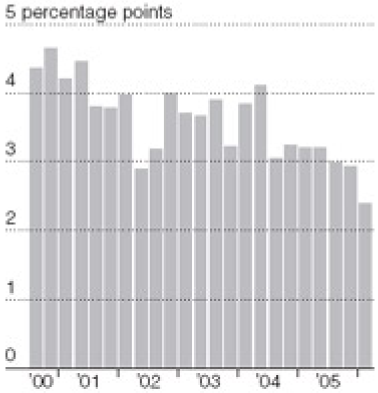
By DANIEL ALTMAN
Published: February 26, 2006

YOU might think that the nation's high priests of finance would have agreed by now on why stocks have paid much higher returns than bonds over the years.

Worth the Risk?

The premium for investing in stocks — their expected return, minus the return of Treasury bonds — has been declining, according to a long-running survey of financial executives.

Expected annual return of the S.&P. 500 over the next 10 years, minus the return of the 10-year Treasury note.



Source: Campbell R. Harvey, Duke University

You'd be wrong. But depending on whose explanation you believe, there are some important implications for the economy's future. The outlook may not be so good, at least not for everyone.

As every first-year finance student knows, there is a not-easily-measurable number called the equity risk premium. Simply put, this premium is the extra return that stocks have to pay, because they're riskier than safe government bonds, in order to attract investors. It's the same reason that individual numbers on a roulette wheel pay more than odds or evens: higher risk, higher return.

For decades, the returns on stocks have usually been much higher, relative to bonds, than risk alone would seem to justify — perhaps as much as six or seven percentage points higher. If risk were the only explanation, the difference would suggest that investors were extremely risk-averse, to the point that they would never leave the house for fear of having to cross the street.

Some economists have suggested that the equity risk premium is reasonable, if you account for very rare but very costly events, like depressions and wars. But there is still much debate, and there are other explanations for the gap in returns.

Think about the two types of securities in terms of supply and demand. The market for safe government bonds includes investors who can't buy stocks at all: foreign central banks, other government agencies, some institutional money managers and certain kinds of trusts. Moreover, financial planners may be too eager for their clients to buy safe government bonds. If their paychecks depended solely on whether their clients made or lost money, they might try to avoid losses at all costs.

In other words, it may just be ridiculously easy to raise money for bonds. Or investors' expectations of stock returns may be irrationally low, focused more on crashes than booms. Either way, the equity risk premium wouldn't explain the entire gap in returns. .

We do know, though, that the risk premium must be some part of that gap. According to research by William N. Goetzmann and Robert G. Ibbotson, two finance professors at Yale, that premium has stayed fairly constant over long periods through virtually all of American history. For lack of a better reason, there may just be something special about American capital markets, so that a high equity premium would tend to revert to some sort of long-run average. In other words, the equity premium may be a partial predictor of future stock returns and even the future growth of the economy.

Yet many financial economists believe that the equity risk premium has been dropping in recent times. "Over the last 20 or 30 years there have been dramatic changes in the financial markets," said John C. Heaton, a professor of finance at the University of Chicago. "Investors have become just more comfortable with the stock market. Part of that is education. The other thing is sort of a classic finance effect, which is that the level of diversification that investors have available to them has increased."

Professor Heaton said that with the coming of age of American financial markets, many types of investors have found it easier to diversify their assets. For example, it's easier now for entrepreneurs to bring their businesses to the market, and after selling off shares or partnerships, they can invest in other securities. The same goes for homeowners, who can take equity out of their houses and then diversify their holdings.

The ability to diversify makes the buying of risky assets, like stocks, more palatable. "It makes wealthier people more comfortable holding positions in the stock market," Professor Heaton said. He suggested that the equity risk premium might now be around three or four percentage points. A result is more money available to the corporate sector. "The cost of capital is going down, and therefore we're going to see more investment," he added. "The riskier projects that investors would have shied away from are now going to be taken on."

But does this mean more economic growth? It may in the long term, if those risky investments pay off at a higher rate than less-risky alternatives. In the shorter term the effects may be quite different.

In addition to the long-term decline in the equity risk premium, there may be changes over the course of the business cycle, said Campbell R. Harvey, a professor of international business at Duke University. "If you're in the depths of a recession, to get people to use some of their income and invest in the stock market, you have to offer a larger premium to do that," he said. When times improve, the necessity of paying a premium fades a bit; people are more willing to take on risk when they're feeling more comfortable in general.

THE last couple of business cycles have been pretty mild, Professor Harvey noted. But he said that the reduction in the equity risk premium could actually mean lower growth in the near future. "It's true that we've got lower volatility, but with the lower volatility, there's a lower expected return," he said. "The lower expected return translates into a lower growth rate in the economy." Professor Harvey predicted that the economy would expand at a rate of about 3.25 percent annually in the next several years, well below its long-term average in boom times.

Yet even if the economy's growth slows down, people could feel better off than they did before. "In my opinion, the lower volatility of economic growth helps the people that are less advantaged," Professor Harvey said. "Those are the people that are most likely to be laid off in a recession. There's less disruption in the part of our population that's less well off."

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