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U.S. Investing: Are the Best Times Over?

An elevated risk premium for stocks may be a buy signal, but only if you think the U.S. will shake off its current economic difficulties

By Chris Farrell

The stock market isn't for the faint of heart; the volatility is astonishing. But not everyone is a Wall Street plunger or home-based day trader. How should investors with a longer-term time horizon think about value?

There are many metrics for guesstimating stock market values, but the most intriguing is the equity risk premium. It captures the relative attractiveness of stocks vs. bonds over the long haul (typically a decade). The basic insight is that stocks are riskier than bonds since equities reflect the uncertain rewards to entrepreneurship while U.S. Treasury bonds are a contract that spells out when the federal government must pay creditors interest and principal. The premium is the additional return investors demand for owning stocks vs. the U.S. Treasury bond. "The reality is every time you invest in stocks you're taking an implicit stance on the equity risk premium," says Aswath Damodaran, a finance professor at New York University's Stern School of Business.

There's a lot of controversy over how to measure it. The three most popular methods are history, surveys, and forward-looking market estimates. For example, the equity risk premium has averaged about 4 percent since the late 1920s. Specifically, from January 1926 through August 2011 the Standard & Poor's 500-stock index sported an average annual return of 9.8 percent, compared with a 5.6 percent on long-term government bonds, according to Ibbotson Associates, a Morningstar (MORN) company.

Stocks Dogma

The 4.2 percentage-point gap lay behind the finance dogma of the 401(k) generation that owning stocks was less risky than bonds over the long haul. The poor performance of bonds—especially in the 1970s and '80s—largely reflected the impact of inflation. Everyone learned the hard way that the premium is far from a stable number, however. It fluctuates with the ebb and flow of the business cycle and judgments about relative asset values. For instance, bonds did better than

stocks by 5.1 percentage points from 2001 through 2011.

Surveys are another way to get at the premium. Chief financial officers make judgments about the premium when deciding on the economic merits of corporate investments. A high premium hikes the project hurdle rate, making it harder to justify new investments, and vice versa. Campbell Harvey and John Graham, finance professors at Duke University's Fuqua School of Business, have been surveying CFOs about their estimate of the equity risk premium for more than a decade. Their latest reading for September is an average estimate of 3.63 percent, up from 3.09 percent in June and 2.98 percent in March. The trend is bad news for economic growth. It signals greater caution by companies on major expenditures. But for investors "it creates an appetite to buy when the expected return is higher than usual," Harvey said.

Other models rely on market-based forward-looking indicators, such as estimated corporate cash flow, projected dividend payouts, and other market-based data. Among these models is the monthly estimated premium Damodaran calculates every month using a forward-looking model. On Sept. 1 it stood at 6.39 percent, up from 5.20 percent on Jan. 1. (He publishes the number on his website.) The actual number is different from Graham and Harvey's but the direction is the same: up.

U.S. Factor

A major reason behind the high average premium from the early 20th century on is the perception of America's leadership in the world economy, the dynamism of U.S. companies, and Uncle Sam's basic soundness. Unlike many other stock markets, the U.S. market survived two world wars, a Great Depression, severe inflation, and political unrest, notes William Goetzmann, an economic historian at Yale University. For contrarians with an optimistic bent, buying stocks is a bet that the U.S. economy navigates its current tumult with no lasting damage to its innovative spirits. There's no guarantee, of course, but a return to the historic range of a 4 percent to 5 percent equity premium translates into a 30 percent to 40 percent gain in the S&P 500.

Damodaran is skeptical that history will repeat itself, let alone rhyme. He argues that the premium signals an end to the resilience that has marked the U.S. economy. America's equity risk premium is running at a similar pace to major emerging markets, such as China and Brazil. The U.S. political system is so dysfunctional that in July the federal government teetered on the edge of default. Perhaps like Spain and Britain in earlier epochs, an economic empire is losing its wellspring of wealth. Other nations vie for center stage. The message in the market is pessimistic. "The high equity risk premium reflects a shift in the underlying reality," Damodaran says.

So, which is it? Are stocks cheap and bonds expensive? Is it a buying opportunity or a new, dimmer world order for the U.S.? The equity risk premium illuminates only the scope of judgment,

not the eventual outcome. My bet is that the odds favor a U.S. economy with innovative chapters yet to be written. But just in case, diversify.

Farrell is contributing economics editor for *Bloomberg Businessweek.* You can also hear him on American Public Media's nationally syndicated finance program, *Marketplace Money,* as well as on public radio's business program Marketplace.