What CFOs Think About the Market

Tune into any financial news network and you’ll hear a continuous drumbeat of Wall Street analysts spouting their most recent stock market forecast. I find there is value to these forecasts – entertainment value – especially from the forecasters who foresee grandiose returns or impending doom. In terms of investment value, if these forecasts serve any point at all, it’s to illustrate how far some forecasters will go to get media attention.

Perhaps a more useful stock market forecast is how chief financial officers (CFOs) of publicly traded companies view future stock returns. We’re not implying that investors should slavishly react to the quarterly forecasts of CFOs any more than they should react to any other moving forecasts. But passively minded investors can use these numbers to estimate what their portfolio’s return might be given different asset allocations.

Company boards make capital decisions based in part on their CFOs’ assessments of the cost of equity, and these decisions have an impact on future returns in the equity market. Company boards may issue new stock to take on new projects when they believe the cost of equity capital is low (stock price is high), and may buy back stock to reduce share count when the cost of equity is high (stock price is low). These decisions affect long-term valuations.

Duke University and CFO Magazine conduct the Global Business Outlook Survey each quarter to find out what CFOs think about a lot of economic factors, including their forecasts for interest rates, growth, inflation, the price of oil and stock market returns. Duke University professors John Graham and Campbell Harvey analyzed the data from the March 2015 survey to determine a 10-year equity risk premium forecast, which is the excess return the stock market is expected to earn over a risk-free rate. They published their findings in a paper entitled The Equity Risk Premium in 2015.
Figure 1 is from Graham’s and Harvey’s paper. It highlights the average annualized 10-year expected annualized S&P 500 return forecasts from the Global Business Outlook Surveys conducted from second quarter 2000 through first quarter 2015. The mean CFO forecast using the March data was 6.63% over the next ten years, which is slightly higher than the previous forecasts.

**Figure 1: 10-year Forecast through March 2015**

![10-year forecasted S&P 500 total (mean) annualized returns](image)


The equity risk premium (ERP) is the expected return of equities over a risk-free rate of return. In corporate finance and valuation, the ERP is typically the expected long-term annualized (geometric) return from equities, less an intermediate- to long-term government bond rate. Graham and Harvey computed the ERP using the mean CFO nominal return forecast for the S&P 500 less a 10-year Treasury bond yield. The mean annualized survey forecast for equities was 6.63% and the 10-year Treasury bond was yielding 2.12% in March 2015. This produced a mean forecast ERP of 4.51% for US equities.

There are other numbers to consider in this analysis. CFO equity estimates were more dispersed in early 2015 than in the previous survey and the data was negatively skewed. This means there was more disagreement about future returns among CFOs and the median (middle) estimate was lower than the mean forecast. The median forecast ERP estimate was 3.55%, which was almost a full percentage point less than the mean estimate. Some people interpret this as a sign of increased equity risk.
Last week, the Duke CFO Global Business Outlook survey for June 2015 was published. Based on a survey date of May 18 and an annual yield on 10-year Treasury bonds of 2.3%, the 10-year annualized expected return for the S&P 500 had dropped by an average of 0.6% since the first quarter; however, the mean had less dispersion than the previous quarter, which means there is a growing consensus about the forecast. In a nutshell, CFOs are in greater agreement about lower projected S&P 500 10-year returns.

These numbers are important because they influence corporate behavior. A higher (lower) ERP means investors are expecting greater (lesser) reward for taking equity risk. This affects the overall cost of capital, which affects corporate decision-making.

The ERP is also important to investors trying to reach their financial goals. Part of portfolio management is estimating the expected return of different asset classes. These forecasts are useful when making asset allocation decisions because they help match an investor’s portfolio and its expected returns to the required return they need to meet their financial goal. When expected returns are lower, an investor may have to take on more risk to achieve his or her required return, and vice versa when expected returns are higher. My company, Portfolio Solutions® 30-year asset class forecast was published in Portfolio Solutions® 30-Year Market Forecast for 2015.

CFO estimates of the future ERP are not a guarantee nor should anyone expect them to be. They are a reasonable guide that is used by companies for cost-of-capital planning and by individuals who are managing disciplined investment portfolios, periodically maintained to reflect their return needs. For a detailed review of ERP methodologies, see The Equity Risk Premium: A Review of Models, by Fernando Duarte and Carlo Rosa, Federal Reserve Bank of New York.

Richard (Rick) Ferri is the founder and Managing Partner at Portfolio Solutions®. He writes for Forbes.com, WSJ and Seeking Alpha.