Profsessors John Graham and Campbell Harvey consistently put out great research. One of their innovations in financial research is their annual CFO survey (we've covered this research here, here, and here, if interested).

Get The Timeless Reading eBook in PDF

Get the entire 10-part series on Timeless Reading in PDF. Save it to your desktop, read it on your tablet, or email to your colleagues.

email address

GET THE PDF

See 2017 Hedge Fund Letters.

In their recent piece, the authors describe what a broad cross-section of U.S. CFOs think about the expected equity risk premium.

Bottom line? 4.42% (Expected 10-Year S&P 500 minus the 10-Year Treasury Yield). This is pretty similar to what everyone thought on Tadas’ informal Abnormal Returns survey. If we back out the real equity risk premium we get 6.31% (see below for calcs).
That’s a pretty beefy premium and would suggest a large allocation to the stock market if one is a long-horizon investor (...and trusts the intuition from a bunch of CFOs!).

Below is the time series chart from the paper:

Not sure what the takeaway is on the estimates because 1) everyone is predicting the same thing and 2) the CFOs were predicting a low premium a few years back and the S&P 500 and has rocketed. Go figure.

**Quick notes on Methodology**

To get an expected equity risk premium the authors look at the CFOs’ expected total return forecast for the S&P 500 and back out the U.S. 10-year Treasury bond yield. This “risk premium” is not a measure of the “real,” or inflation-adjusted risk premium, which would require that the authors adjust the expected return forecasts by a TIPS-like instrument to account for inflation. If one were to go after a “real” risk premium, by taking off the 10-year TIP yield at the end of 2017 (to line with the survey results), the real equity risk premium would be pretty compelling at 6.79% – 0.48% = 6.31%.

I did these calcs “back of the envelope,” so feel free to fact check/comment. But the 6.31% certainly seems in the ballpark.

**The Equity Risk Premium in 2018**

- John Graham and Cambell Harvey
Abstract:

We analyze the history of the equity risk premium from surveys of U.S. Chief Financial Officers (CFOs) conducted every quarter from June 2000 to December 2017. The risk premium is the expected 10-year S&P 500 return relative to a 10-year U.S. Treasury bond yield. The average risk premium is 4.42% and is somewhat higher than the average observed over the past 18 years. We also provide results on the risk premium disagreement among respondents as well as asymmetry or skewness of risk premium estimates. We also link our risk premium results to survey-based measures of the weighted average cost of capital and investment hurdle rates. The hurdle rates are significantly higher than the cost of capital implied by the market risk premium estimates.

- The views and opinions expressed herein are those of the author and do not necessarily reflect the views of Alpha Architect, its affiliates or its employees. Our full disclosures are available here. Definitions of common statistics used in our analysis are available here (towards the bottom).
- Join thousands of other readers and subscribe to our blog.
- This site provides NO information on our value ETFs or our momentum ETFs. Please refer to this site.

References

- This approach would also assume that stocks provide a real return, which is true in theory, but now Buffett has me rethinking that theory h.t. Ben Carlson.

The post "What The CFOs Think About The Equity Premium In 2018: 6.31% Real Premium?" appeared first on Alpha Architect.
ValueWalk Comment Policy

No spam, scams, illegal activity, profanity, personal info etc.
Please read our Comment Policy before commenting.

0 Comments ValueWalk

 Recommend Share

Start the discussion…

Be the first to comment.

Subscribe Add Disqus to your site Add Disqus Privacy

LATEST NEWS

Circulation in Atlantic Ocean at weakest point in 1,600 years

Whitney Tilson Going Global; Adds ”another chapter to my ongoing midlife crisis this past weekend”

At Nearly 4X WV, NJ Tops List For Highest Overall Taxes In USA

Cryptocurrency Quiz – Testing Your Knowledge

Bill Ackman Facing Redemption, Longfin Selling Restricted Stocks