VALUEWALK

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VALUE INVESTING

What The CFOs Think About The Equity Premium In 2018: 6.31% Real Premium?

April 11, 2018 5:30 pm by Alpha Architect

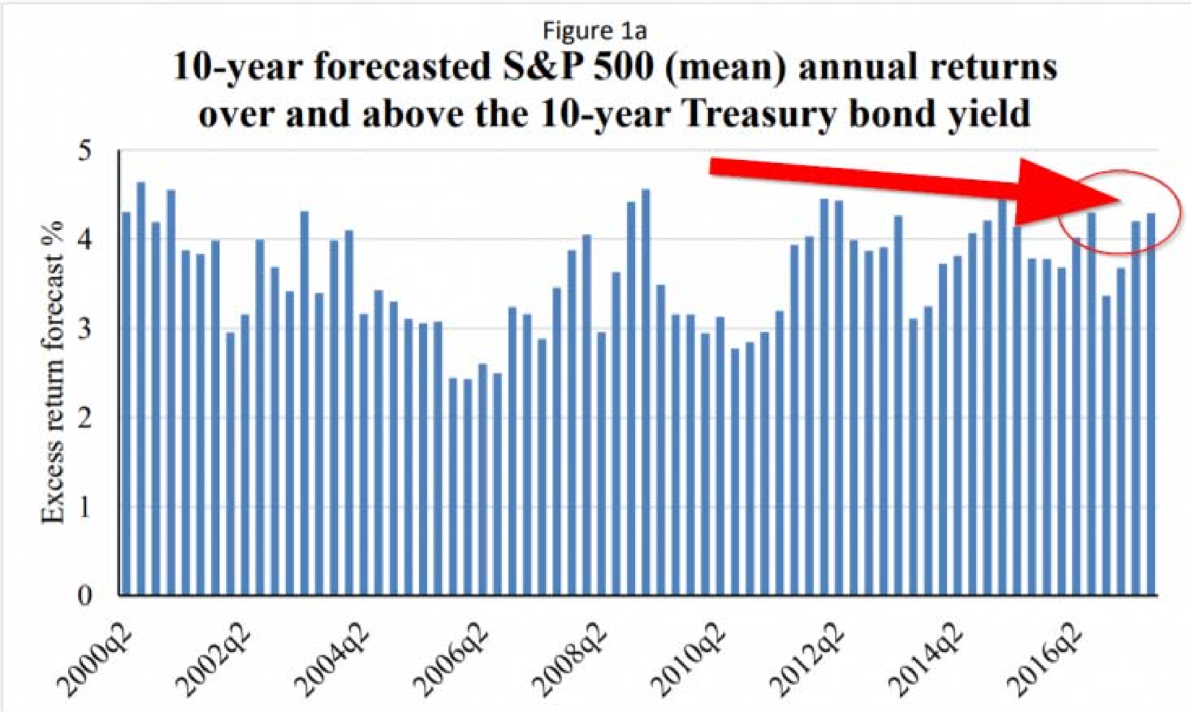
Professors John Graham and Campbell Harvey consistently put out great research. One of their innovations in financial research is their annual CFO survey (we've covered this research **here**, **here**, and **here**, if interested).

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.[(1)] 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%**.[(2)].

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
- A version of the paper can be found **here**.
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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.

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.
- December 31, 2017 TIPS yield, **https://fred.stlouisfed.org/series/DFII10**

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By Capital Group

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