



THE STOCKVAL EQUITY RISK PREMIUM

Questions, Analysis and Speculation

**James B. (Jerry) Gould
Chairman, Alder Capital
StockVal Founder
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The Conundrum

Each Friday analysts at StockVal calculate a market-implied equity risk premium (K) utilizing the interactive G-Model and a proprietary market benchmark composite called The ACE Portfolio (ACE50). The workings of these analytical tools and the methodology employed to produce the risk premium number are explained in StockVal literature.

Recently, questions have arisen about the nature of the equity risk premium calculation. It has been pointed out that it appears counter-intuitive for K to be high by historical standards at the same time as most other financial market risk premiums are low.

What the financial press and others are talking about when referring to low risk premiums are the narrow yield spreads in the fixed income market regardless of credit quality. To a lesser extent, equity markets reflect narrow valuation spreads among companies of varying size and quality with comparable growth rates. Implicit in this phenomenon is a big reduction in investor perception of risk – until recently. The sub-prime mortgage market problems now have renewed risk awareness in the fixed income markets.

The great irony of the last several years is an enlarged equity risk premium in an era of shrinking risk spreads elsewhere. By our calculation, K has remained above historical norms for the last four years; currently, it is 4.73% compared to a long-term mean of slightly less than 3%. K has centered in a band between 2-4% for fifty years or more. Effectively, equity valuations for high-quality companies currently are much lower than they “should be” given Treasury yields in the 4.50% to 4.70% range. To put it another way, earnings yields reflect a historically high differential to bond yields. This is especially true of long duration equities. The obvious question is: why is this happening?

Analysis

Possible explanations for credit spread shrinkage include:

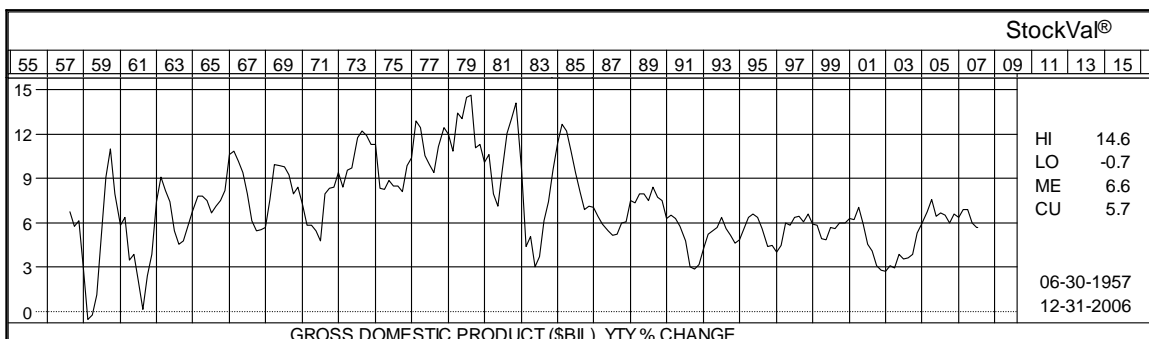
- 1) Interest rate yield spreads have been low partly because Wall Street has packaged what used to be thought of as high risk securities and sold them to yield-conscious investors who believe the risk has been ameliorated by the packaging. Asian investors, particularly, have considered American debt markets to be “safe” and liquid, and also have been comforted by what appears to them to be asset protection from the collateral.
- 2) As we have moved progressively from an industrial economy to a service economy, and in the process have shifted highly cyclical manufacturing to others offshore, the economic cycle has become less pronounced, and therefore seemingly less risky than in prior periods. The 1990-91 and 2001 recessions produced significant earnings gyrations, but few credit

problems compared to prior cycles. The tech bust of 2001 was primarily an equity price deflation stemming from avaricious pricing, inefficient allocation of capital, and franchise failure in companies with little debt. By and large, low-quality debt has not proven to carry the risk original pricing suggested.

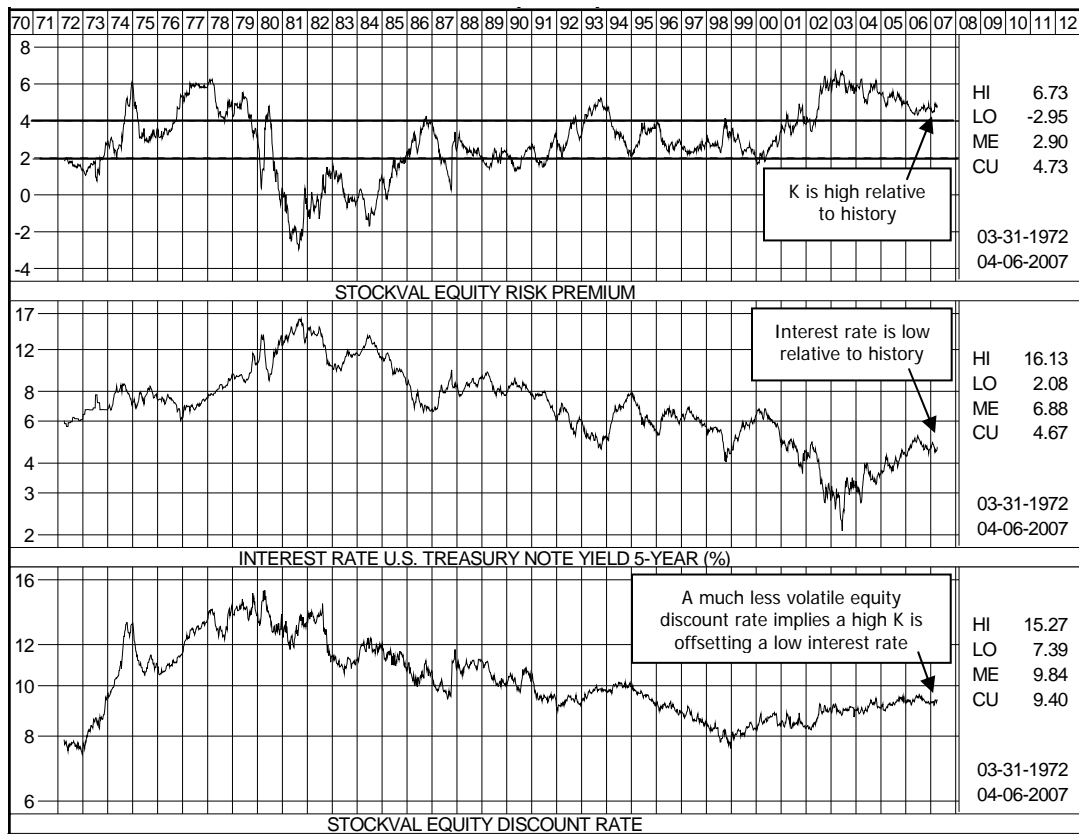
The question at hand, however, is why equity valuations carry high risk spreads relative to “risk free” Treasury yields. This is a complex issue, but some observations follow:

- 1) Equity risk premia reflect a collage of perceived fears, including geo-political and macro-economic risks. Our military dilemma in the Middle-East and associated complications undoubtedly are a factor in equity pricing.
- 2) The uncertainties presented by an unbalanced trade and capital flow world have created some elevated risk acknowledged by equity investors.
- 3) Having spent many years creating forward-looking equity risk premium calculations and, in turn, analyzing the results, I am led to believe the primary propellant behind significant K change is interest rate related. While it is reasonable to expect equity returns to carry some premium to Treasury returns (thus explaining the historical differential of about 3%), swings above and below this mean reflect, in my opinion, interest rate change anticipation on the part of equity investors. When interest rates are below their “natural” rate, K tends to be high, and when they are high relative to the “natural” rate, K tends to be low, even negative in some cases such as in the early 1980s.

The “natural” interest rate is simply the smoothed nominal growth rate of the economy. Economic growth, as measured by nominal (not inflation adjusted) GDP has centered between 5-6% over long periods of time (3-4% real growth plus 2-3% inflation). The 3-4% real growth rate is derived from labor force growth (currently about 1.5% annually) plus productivity growth. Therefore, the natural rate of interest tends to center at 5-6%. However, in periods of sustained rises in inflation, nominal GDP growth is higher, sometimes much higher, and therefore the natural interest rate then is higher. Equity risk premium figures above or below 2-4% reflect the degree to which interest rates actually track the natural rate warranted by GDP growth.



In the mid-to-late 1970s, for example, K was abnormally high because inflation was pushing nominal GDP to double-digit growth rates, but easy Fed policy kept interest rates lower than the natural rate would suggest. When new Fed chairman Paul Volker finally put on the brakes and sent Treasury yields to 17%, K dropped suddenly, and actually went negative in 1981 at the peak of the rate cycle. Effectively, equity investors refused to take equity valuations to the extremes otherwise warranted by large GDP changes produced by an inflation surge, and then an economic contraction which deflated the inflation bubble.



From the mid-1980s through 2000 the equity risk premium traded in its normal band of 2-4% as inflation was tamed and investors became confident it would remain so.

Beginning in 2000, K jumped from 2% to over 6% as Fed policy became highly stimulative with Fed funds dropping all the way to 1%. Since 2003, K has receded to 4.72% because interest rates have risen in that period. However, K remains historically high because rates still don't reflect the natural rate of between 5-6%. In recent years, Asian investors have created an interest rate "subsidy" in the U.S. by their massive purchase of Treasury

and mortgage debt, thereby keeping rates lower than they otherwise likely would be. Even though Fed policy has pushed the Fed Funds rate to 5.25%, the “subsidy” has kept longer rates lower, thereby creating the inverted yield curve. Equity investors, therefore, have not priced equities to reflect 4.5% Treasury yields, but rather something in the range of 50-100 basis points higher.

The StockVal Equity Discount Rate

The StockVal equity risk premium added to the risk-free rate, as measured by the Treasury 5-year note yield, produces the StockVal equity discount rate, the rate at which equities are actually discounted in the G-model, subject to an additional company-specific risk adjustment (K'). As can be seen in the graph, the total equity discount rate is far less variable than either of its components. Effectively, equity investors compensate for, or at least smooth, changes in interest rates that are not “economic” or “natural”. For equity valuation purposes, the equity discount rate is more important to monitor than either interest rates or the equity risk premium.

Speculation

While one can only speculate where K and the equity discount rate are headed from here, I offer my assumptions. For equity investors, it is an important issue because any fall in K, not produced by a rise in interest rates would produce higher stock valuations. Current earnings multiples on high-quality companies of 15-18x forward earnings could move higher if inflation could be contained at or below 2% and economic activity could be sustained at historically normal real growth rates between 3-4%.

The good thing is K already is elevated, so any small rise (50-60 basis points) in interest rates toward the natural rate probably could be absorbed by an equivalent drop in K, thereby not negatively affecting equity valuations as long as earnings growth holds up. That is why the rise in interest rates over the last several years has not had a negative impact on the stock market. Effectively, K has been “anticipating” the rate rise which has occurred in the last several years in an environment of normal economic growth.

However, short of irrational pricing which sometimes happens in the latter stages of the economic cycle, I doubt significant equity valuation enhancement will occur for the following reasons:

- 1) Equity market valuations are determined not only by interest rates and the equity risk premium, but also by the perceived future growth rate of corporate earnings. After five years of above-trend growth following the economic recession of 2001, earnings growth is about to slow as cyclical profit margin expansion comes to an end. Moreover,

the secular profit margin expansion that took place from the early 1990s through 2005 appears to be ending. Economies resulting from lower interest rate expense, lower corporate tax rates, and the wave of technological innovations that fueled productivity growth in that time period (importantly to include much better inventory control) are unlikely to contribute to future profitability growth. Lower revenue growth, together with flat-to-falling profit margins, will crimp future earnings growth. In many operationally-leveraged companies, falling earnings could be the surprise over the rest of this economic cycle.

- 2) Inflation appears to be on the rise again after six months of decline. Rising oil, gasoline, and metals prices most surely will elevate inflation readings over the next several months or quarters. Meanwhile, labor costs are punching above 4% annual rate for the first time since the late 1990s. In such an environment, equity valuation expansion would not be warranted because of the possibility of significant interest rate rise. If inflation numbers turn out to be "sticky", more restrictive Fed action is possible.
- 3) Short of a surprising political breakthrough and/or military successes, the geo-political landscape is still sufficiently threatening so as to keep a lid on equity valuations. A deepening of our entanglement in Iraq and Afghanistan appears more probable than a positive outcome, at least in the short-run. Therefore, a higher than normal equity risk premium is justified for the foreseeable future.
- 4) Many large-cap growth stocks have low valuations relative to historical standards, but that is primarily because their revenue growth rates have been slowing in recent years to mid-single-digit rates. Five-to-seven percent earnings growth does not deserve the valuation that was formerly applied to growth rates of 8-10%.

In summary, I believe an equity risk premium above 4% is warranted and significant equity valuation expansion is unlikely in the near-term. Having made that statement, it is always possible in the latter stages of the economic cycle for investors to become irrationally exuberant. If valuation enhancement begins to happen, it will be critical for equity investors to evaluate the cause(s) of the excitement in an effort to determine its durability. Should inflation subside again below 2% (the Fed alert rate) and real economic growth returns to sustainable rates above 3%, a lower equity risk premium would be warranted. If these events were accompanied by geo-political calm, significantly higher equity valuations would be possible. With these ideas as framework, equity managers may supply their own assumptions and projections.