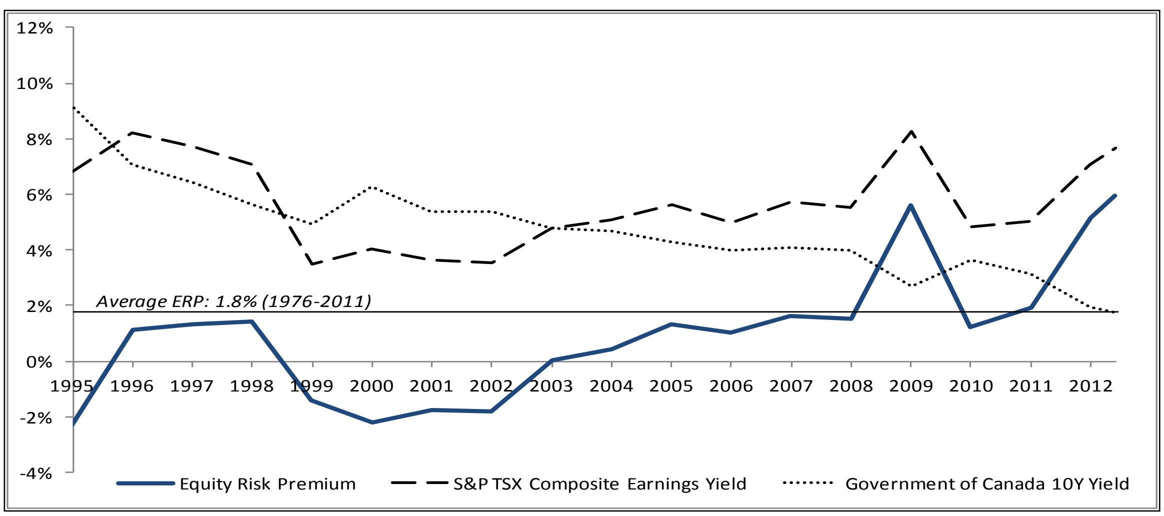
Thursday August 16th, 2012

Good morning,

The Equity Risk Premium (ERP) is defined as the return in excess of the risk-free rate that an investor requires as compensation for taking on the added risk of being exposed to the stock market. It is an important measure because it informs us of how optimistic (or not) the market is at various points in time. However, against the current backdrop of ultra-low interest rates, investors must be wary of compressed Equity Risk Premia; a low ERP could mean investors are taking on excessive risk without a correspondingly sufficient return.

We thought it would be useful to see whether weak market returns and rapidly declining interest rates in the recent past have led to erosion in the ERP. To undertake this study, we used the earnings yield[1] on the S&P TSX Composite to approximate total returns[2] – usually a good proxy over the long term. We subtracted from this figure the Government of Canada 10-year bond yield – a relatively low-risk rate of return. The results are illustrated below and show that, in spite of weak markets and falling rates, the ERP has actually risen since 1995.

Figure 1: Market Return, Risk Free Rate, and Equity Risk Premium



Source: Bloomberg

[1] Earnings yield: Corporate earnings per dollar of stock held.
[2] Total returns: Gains from capital appreciation and dividends.

Because earnings yields have been quite resilient over this past decade while bond yields have slumped, the ERP has actually risen over this period to a relatively high 6% - well above the Canadian market's historical average of approximately 1.8%[3]. Also compare this 6% with the late 1990s and early 2000s, when the ERP was actually negative – stocks were so overbought that government debt offered higher yields than corporations did.

The above-average ERP available today signals an undervalued market – and that equities are cheap. Now that's something value investors like Sionna can't help but get excited about.

The Sionna Team

[3] Incorporating ERP data for the period 1976 to 2001 from Salomons, R. and H. Grootveld, 2003, *The equity risk premium: Emerging vs Developed Markets,* Emerging Markets Review, v4, 121-144.

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