Advisory Committee on the Auditing Profession

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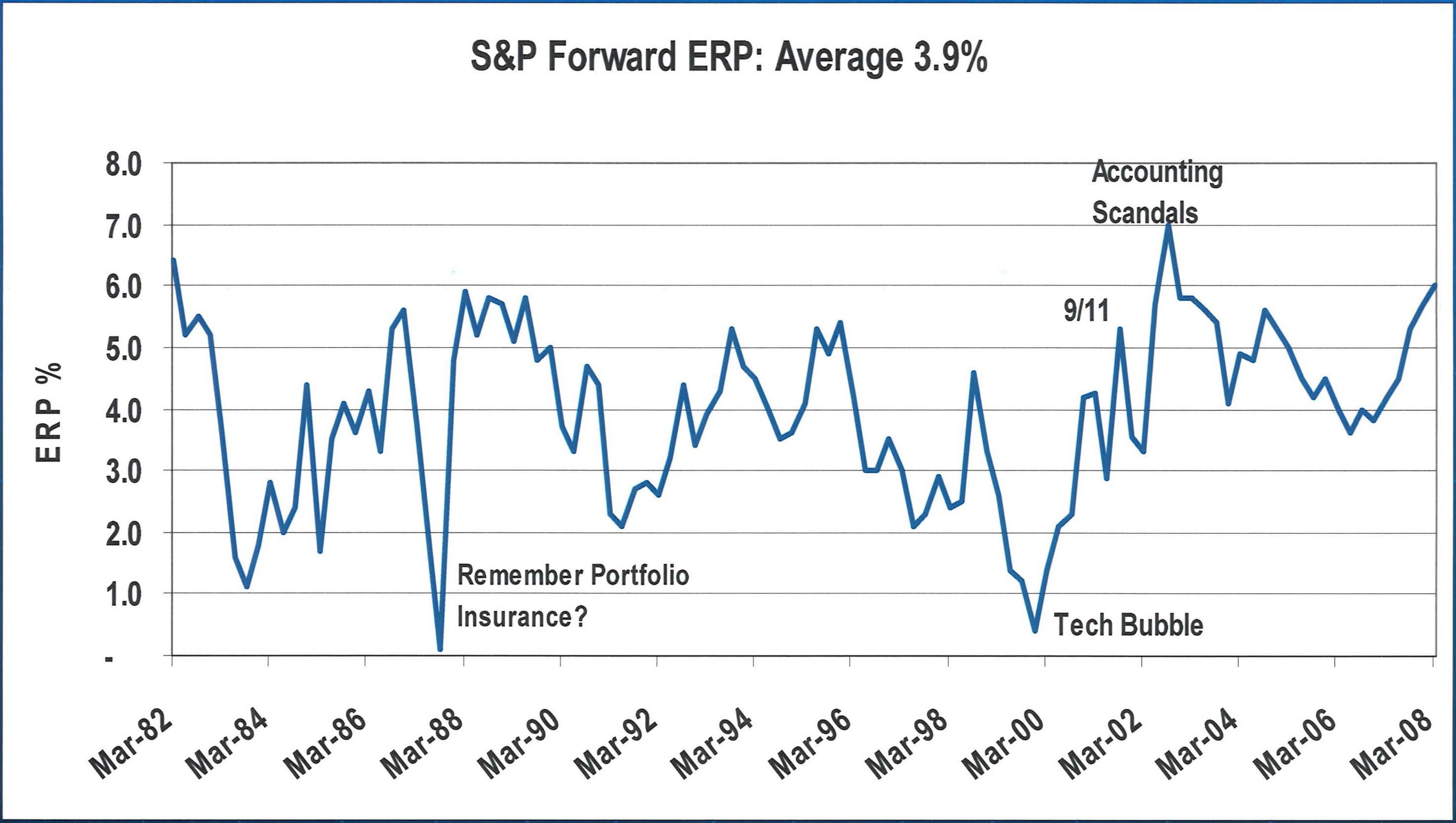
The Equity Risk Premium

- The Equity Risk Premium (ERP) is the additional return that investors must earn to hold stocks over bonds.
  - It is a forward looking calculation that measures whether the stock market is over or undervalued.
  - The ERP is ***implied*** by current market valuations—it is not directly observable—but you can "back out" the ERP using current stock market valuations.

- How do you calculate the ERP?

1) Forecast future earnings for the stock market.
2) Then it becomes a present value calculation:
   a) Determine the discount rate necessary to equate:
   b) discounted forecast earnings = current stock market value.
3) Subtract the return of the 10 year Treasury bond from the discount rate calculated in Step 2.
4) The remainder is the ***ERP***—that additional premium for holding stocks over bonds.

Equity Risk Premium: 1982-2008



What lessons can we learn from the ERP?

The ERP has approached zero twice:

- October 1987. But risk, like energy, cannot be eliminated—it has to land on someone's balance sheet as it did with a vengeance that month.
- The height of the Tech Bubble in 2000—when the "clicks" were going to take over the "bricks."
- In each case, the valuation of stocks was so inflated that investors viewed stocks as no more risky than US Treasury Bonds—this cannot be!

The highest point of the ERP came in 2002:

- This demonstrates the highest level of investor risk aversion over the last 28 years.
- The cause was a flood of corporate accounting scandals.

A lack of transparent accounting destroyed investor confidence, raised the equity risk premium, eroded stock market values, and wiped out a Big 5 accounting firm.