

A forecast for global ERP



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The equity risk premium will offer institutional investors a lower reward going forward.

The equity risk premium (ERP), which is defined as the 10-year expected return difference between equities and government bonds, is one of the most important numbers in finance. This figure influences strategic asset allocation decisions, pension and retirement plan

funding ratios, optimal manager mix, and the optimal combination of active versus indexed investments. Yet despite its importance, estimates of the ERP vary widely.

Shareholders must still be rewarded for holding risky cash flows, although the reward will not be as high as that delivered in the past. Since 1950, the realised ERP has ranged from 9.0% in the United Kingdom to 3.0% in Canada, with the United States and Japan each registering 5.0%. Looking ahead, the global ERP is forecast by Barclays Global Investors to be 4.0%. Importantly, this forecast is lower than the historic realised global ERP of 6.0% since 1950.

The return of the global equity markets was estimated by forecasting each of the components in the following identity:

$$R = \frac{D}{P} - \Delta S + i + g + \Delta PE$$

Where: $\frac{D}{P}$ is the dividend yield and ΔS is the percentage change in the number of shares outstanding, or repurchase yield. (Together these measure the percentage of market value that the firm gives back to shareholders, therefore the sum of the two is referred to as the “income return.”) The rate of inflation is indicated by i , g is the real earnings growth rate (not earnings per share growth), and ΔPE is the percentage change in the price-to-earnings multiple

over the period. (These terms make up the capital gain.)

To forecast bond returns country by country, the available yields on 10-year government bonds were compared to an equilibrium yield, then the return that would be obtained if the current yield rises (or falls) to the equilibrium yield over the next 10 years was computed. Lastly, these individual equity and bond market forecasts were aggregated up to their global levels by using market cap weights in each of the respective indexes. (See Table I)

The dividend yield forecast simply reflects the starting level as of February 2003. Corporate payout ratios at the time were close to their historic norms thus there was no reason to forecast a higher or lower dividend stream. The forecast for net buybacks reflects a best estimate for gross buyback activity in each market less the dilution that occurs because of employee stock option related issuance. The differences between the markets reflect differences in investment culture, as well as the varied tax consequences of paying dividends versus distributing value via buybacks in each of the markets.

Real earnings growth estimates were calculated by linking corporate profit growth to real economic growth, and using that relatively stable relationship to forecast the outlook for real earnings.

Lastly, the re-pricing or change in P/E was forecasted by evaluating factors that argue for higher or lower stock price multiples. Higher P/E multiples could arise from structural changes like lower inflation, lower real yields, or financial innovation. On the other hand, lower P/E ratios could arise from things like continued accounting scandals or the increased burden of more regulation. In the

end these largely offset each other, resulting in a generally neutral stance on the re-pricing forecast.

In a low-ERP environment the search for consistent sources of alpha becomes more important for plan sponsors. With markets likely to deliver single digit returns, a couple of extra percentage points is much more significant than if the markets provided returns in double figures. ■

| TABLE 1 | USA | Canada | UK | Japan | Aus | Europe |
|--------------------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Dividend Yield | 1.75% | 2.00% | 3.50% | 1.50% | 3.25% | 3.50% |
| Net Buybacks | 0.75% | 0.75% | 0.50% | 0.25% | 0.75% | 0.00% |
| Income return | 2.50% | 2.75% | 4.00% | 1.75% | 4.00% | 3.50% |
| Real earnings growth | 3.50% | 3.25% | 2.50% | 1.50% | 3.00% | 2.50% |
| Inflation | 2.00% | 2.50% | 2.50% | 0.25% | 2.50% | 2.00% |
| PE re-pricing | 0.00% | 0.00% | 0.25% | 0.00% | 0.00% | 0.50% |
| Capital gain | 5.50% | 5.75% | 5.25% | 1.75% | 5.50% | 5.00% |
| Expected equity return | 8.00% | 8.50% | 9.25% | 3.50% | 9.50% | 8.50% |
| Less 10-year bond return | -3.50% | -4.75% | -3.50% | -1.00% | -5.00% | -3.50% |
| ERP | 4.50% | 3.75% | 5.75% | 2.50% | 4.50% | 5.00% |