COST OF CAPITAL

Market Risk Premium

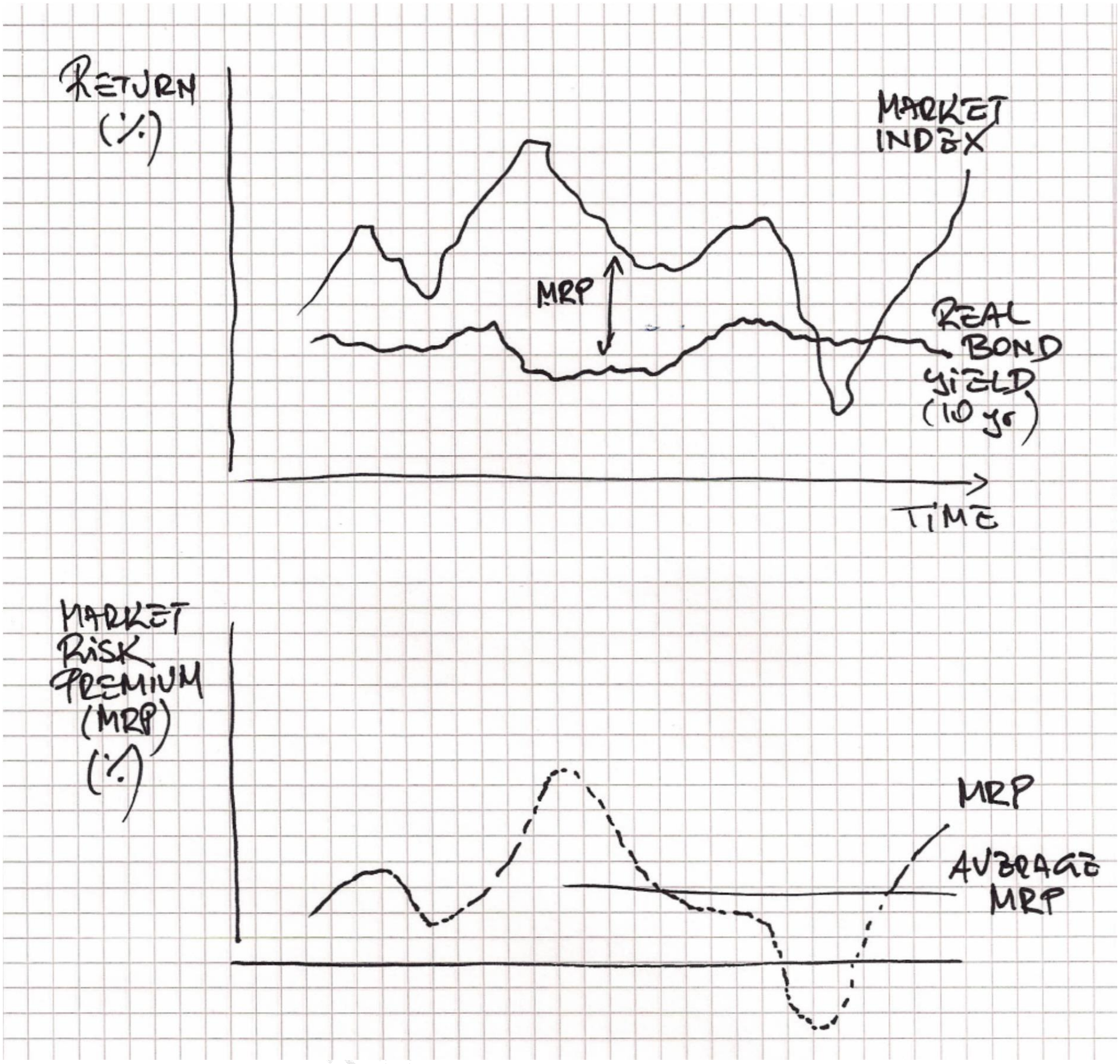
The Market Risk Premium (MRP) is the additional return expected from an investment in the equity capital markets on top of that achievable from investing in a risk-free asset. This premium is justified as shareholders assume a substantially higher risk than investors in a government bond, the least risky investment alternative.

The MRP is defined as the difference between the return of the market – to be precise: the stock market - and the risk free rate. As the MRP fluctuates over time, sometimes even widely, a calculation of the MRP is only meaningful over long historical time horizons, certainly dozens of years. This approach ensures that geopolitical, financial or other shocks as well as potentially abnormal market behaviors distorting calculations over shorter periods can be smoothed out. Having said this, there aren´t many capital markets, besides the one of the United States, combining a long track record, high liquidity, substantial size and a fairly proper and tested regulatory framework: That´s why most of the research undertaken on the MRP refers to the equity capital markets of the United States.

Depending upon the methodology used and how long one reaches back in history, the MRP for the US stock market over a period of approximately 100 years amounts to somewhere between 5.5 – 7.5%.

Now, analysts and investors tend to use MRP corridor for the US market also for capital markets other than that of the US. This may seem acceptable, as long as such market is also reasonably sizable, liquid and well regulated. Besides, in times of globalization with tendencies of legal harmonization, one may assume that long-term, most of the regional capital markets may eventually tend towards, eventually fluctuating around the same MRP corridor, as the one required from shareholders in the US.

However, the correct approach would be to calculate and apply an individual MRP for each regional capital market. This individual MRP would next to regionally relevant macro-related risks embedded in the local risk free rate also focus on regional corporate-, governance- and business-related risks. Therefore, the MRP in an emerging market is usually considerably higher than that of the US. – The case of Russia is a good example in that regards, even though its capital market has only a very short history: Recent research undertaken to assess the MRP for Russia in local currency resulted in corridors spanning a range of between 15-35%. These widely fluctuating results were not only due to the short capital markets history, but especially due to numerous shock events Russia was confronted with during this time. Further, whether to use rather the lower or the higher end of mentioned range depends - as per the research undertaken - foremost upon the assumed holding period of a specific investment.


RETURN (%)
MARKET INDEX
MRP
REAL BOND YIELD (10 yr)
TIME
MARKET RISK PREMIUM (MRP) (%)
MRP
AVERAGE MRP