Market Risk Premium

The Market Risk Premium (MRP) is the additional return expected when making an investment in the equity capital markets on top of that achievable from investing in a risk-free asset. This premium is due to shareholders assuming a substantially higher risk than do investors in government bonds, the least risky investment alternative.

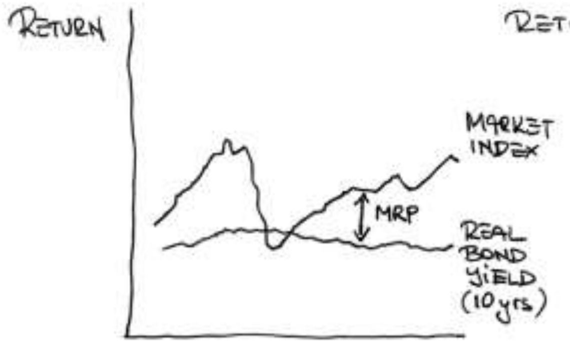
The MRP is defined as the difference between the return of the market (i.e. stock market) and the risk-free rate. As the MRP fluctuates over time, occasionally widely, (rarely, though) even turn negative, its calculation is only meaningful over lengthy time horizons, ideally stretching across several decades. This approach ensures that geopolitical, financial or other shocks as well as periodic abnormal market behaviors – which would distort 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 and vast size with 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 United States stock market over the last more than 100 years amounts to somewhere between 5.5 – 7.5%. Whereby calculations leading to this corridor were based on using historical 10-year US government bonds as benchmark for the risk-free rate, hence assuming a long-time constant average holding period of 10 years for stocks. However, investors´ average holding periods do vary over times, have recently been declining, not least amid technology-driven high-frequency trading. – Comparable analysis undertaken for Germany has resulted in similar MRP corridors of around 5.5 – 8.0 per cent.

Frequently, analysts and investors tend to use the MRP corridor derived for the US market also for other, non-US capital markets. This may seem acceptable, as long as such markets are also reasonably sizable, liquid and well regulated. Besides, in times of globalization with a tendency towards legal harmonization, one may fairly assume that long-term, most regional capital markets eventually trending towards and fluctuating around the MRP corridor of the United States.

A correct approach, though, would require the calculation of a local MRP for each regional capital market and applying that to appropriately account for country-specific risk factors: Next to unique macro-related risks embedded in the local risk-free rate, this would also comprise regional corporate-, governance- and business-related risks.

Without doubt, the MRP for any emerging market tends to be significantly higher than that of the United States. – The case of Russia is a good example in that regards, even though its capital market has only a comparably short history: Recent research undertaken to assess its MRP in local currency – depending upon approach taken - resulted in corridors of between 15-35%. This considerably higher MRP than that of the United States, for instance, is lesser due to the short capital markets history, but foremost due to the numerous shock events Russia encountered during the most recent decades. Besides, the wide MRP corridor is also due to various mathematical approaches applied to derive reasonable results that account for the country´s volatile past.



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