seed investments

## The Premium for Equity Risk

Most investors understand the basic concept that aiming for higher returns involves taking on more risk. This principle – commonly summarised as "*there is no free lunch*" – is embodied in what is officially known as the **Equity Risk Premium (ERP).**

The ERP represents the **additional return** investors should expect from owning ordinary shares in companies compared to much safer government bonds. However, this additional return is **not guaranteed**, nor is it a blanket compensation for simply taking on risk. Instead, it represents compensation for a **range of interconnected risks** that companies face in a globally competitive market.

### Key Risks Faced by Equity Investors

Investors in ordinary shares must be prepared to bear the full brunt of various risks, including but not limited to:

**1) Governance Risk -** Poor governance can lead to misallocation of company resources, resulting in the erosion of shareholder value.

**2) Operational Risk -** Weak internal processes or systems can result in financial losses or even business failure.

**3) Regulatory Risks -** Changes in laws or policies can erode profitability, affecting returns.

**4) Strategic Risk -** Poor decision making at the executive level can waste shareholder capital and diminish a company's competitive position.

**5) Financial Risk -** Excessive leverage (debt) during an economic downturn can erode capital as companies struggle to meet obligation.

**6) Competitive Risk -** Increased competition may squeeze margins and reduce profitability.

**7) Technology Risk -** New technologies can disrupt established business models, potentially rendering them obsolete.

**8) Political Risk -** Changes in government policy or legislation, such as tax reforms can have significant financial impacts.

**9) Geographic Risk -** Companies operating in certain regions are exposed to local economic volatility, natural disasters, or political instability.

**10) Product / Service Risk -** Shifts in consumer preferences can quickly impact a company's revenue streams.

**11) Employee Risk -** The loss of key talent can impede business operations or growth prospects.

**12) Vendor Risk -** Disruptions in the supply chain or changes in a key supplier can hurt profitability.

**13) Customer Risk -** The loss of a key customer can sharply reduce profitability.

**14) Currency Risk -** Rapid fluctuations in currency exchange rates can hurt profits for companies operating internationally.

### The US Market Equity Risk Premium

The chart below reflects one method of calculating the implied risk premium for US shares and shows how it has evolved over the last 30 years. At certain points, such as during the dot-com bubble in the late 1990's, valuation of equities relative to lower risk government bonds became **very expensive**, resulting in a low risk premium. Conversely, post the global financial crisis and again during the 2020 pandemic, stock prices fell significantly, increasing the expected risk premium.

Currently, market valuations relative to bonds appear neither excessively high nor extraordinarily cheap, using this one metric.

Chart Source/s: Yardeni Research (2024)

*S&P 500 forward expected earnings to price ratio minus 10-year treasury bond yield minus average expected median CPI inflation rate for next 5 years. (Consumer Sentiment Survey)

### Conclusion

In conclusion, investing is not about avoiding risk, but about managing. To do this investors need to ensure that the price they pay for riskier assets, such as equities, adequately compensates them for the full range of unavoidable risks. The equity risk premium calculation assists in this process.

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