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The Disappearance of the Equity Risk Premium

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A basic tenet of financial theory is that equities will outperform fixed-income investments — they must to compensate investors for additional risk. The difference between equity returns and risk-free rates — known as the equity risk premium — was almost 9% for most of the 20th century, as detailed by William Goetzmann and Roger Ibbotson's 2005 study, *History and the Equity Risk Premium*.

Today that premium has disappeared. Bonds now offer equity-like returns.

Virtually all fixed-income spreads are at record levels. High-yield corporate bonds are trading at approximately 1,400 basis points above equivalent Treasury bonds. As we noted in an article several weeks ago, investment-grade corporate bonds are trading at spreads of approximately 500 basis points, more than five times their traditional level.

Mortgage-backed spreads are at record levels. A mortgage pass-through security with little exposure to bubble housing markets yields in the mid-teens.

Municipal bonds are perhaps the most extreme example of a market turned upside down. Their yields exceed those of equivalent-maturity taxable bonds by 100 or more basis points. On an after-tax basis, these spreads are even greater. Such numbers are unprecedented in the last 40 years.

Private equity companies use leveraged loans to finance the purchase of companies in which they invest. These loans are the most senior in the capital structure and, in "normal" times, trade at par. Today, many of these loans trade at 70 cents on the dollar, often with yields exceeding 20%.

Yields on Treasury securities have contracted amid a global flight to quality, with the US government markets being the safe haven of choice. But everywhere else you turn, investors are being compensated at record levels.

Moreover, this is not a fleeting opportunity. Most of these spreads have been at record levels for over a month, without any sign of receding.

Some of this dislocation has a logical explanation. The risk of default is rising for high-yield corporate and municipal bonds. The recession is straining corporate profits, threatening the companies' ability to service debt. Similarly, many municipalities are facing budget crises as property tax revenues shrink and unemployment rises. It was feared that California, in particular, would need a Federal bailout.

Yet, there have been very few corporate bankruptcies and no municipal defaults since the onset of the credit crisis.

Liquidity is at least partially responsible for this phenomenon. Frozen credit markets have eliminated virtually all new issuance of securities, and activity in the secondary market has slowed dramatically. There are very few sellers and, more importantly, very few buyers.

In short, there is no money flowing into the fixed-income markets, either from institutions or individuals, creating surely once-in-a-lifetime opportunities.

Goetzmann and Ibbotson's research suggests a fundamental shift could be the reason for the evaporating premium. They found that the equity risk premium was about 400 basis points lower from 1792-1925 than it was from 1926-2004. One explanation for this difference is that America enjoyed a privileged position during the 20th century, in contrast with European dominance in the 19th century. Compared to the rest of the world, America enjoyed political stability and economic success in the last century, and, according to the authors, it did not experience the catastrophic loss of savings or widespread redistribution of wealth seen elsewhere in the global system.

It could be that American dominance in the 20th-century global marketplace contributed to generous equity risk premiums. If so, today's markets may be pricing in a more modest role for US commerce vis-à-vis the rest of the world. For now, at least, the disappearance of the equity risk premium has been a global phenomenon, so this theory remains untested.

Nobody wants to believe that we are headed for another Great Depression, but that appears to be exactly the scenario priced into the fixed-income markets.

Eventually — probably fairly quickly — opportunities in the fixed-income markets with such high spreads will disappear. Cash balances in money market funds are at record levels, and investors' patience will soon waver with the temptation of equity-like returns for securities that are undeniably less risky.

Investment-grade and municipal bonds should be the first to attract capital flows. There is no logical explanation for the yields they offer today.

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