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The equity risk premium: emerging vs. developed markets

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Abstract

This article gives an empirical view of the ex post equity risk premium in a number of international markets with special attention to emerging ones. Our study yields interesting implications for finance. Conform expectations we find that the equity risk premium in emerging markets is significantly higher than in developed markets. However, the extent to which emerging stock markets reward investors varies through time. We observe that the time varying nature of the equity risk premium relates more to economic cycles than to the presence of some sort of structural break based on stock market liberalisations. The distribution of equity risk premium in emerging market is neither normally nor symmetrically distributed, which suggests that investors should focus more on downside risk instead of standard deviations.

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1. Introduction

In the long run investing in equities provides investors a return that hopefully exceeds the risk free rate of return. The difference between the two is also known as the equity risk premium, or ERP. The average long-term ERP exceeds the level

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that classical equilibrium theory predicts. Mehra and Prescott (1985) showed that for the US in the period 1889–1978 the ERP has been in excess of 6% per annum. In a consumer CAPM framework this corresponds with a level of relative risk aversion of 26, far beyond the normal range between 1 and 10 that experimental theory predicts. Being incapable of associating the measured risk with the observed return, Mehra and Prescott dubbed the phenomenon, the equity premium puzzle. Ever since, the issue caught the attention of academics as well as practitioners and spawned a whole new literature based on two classes of explanations for the existence of the ERP puzzle: theoretical and empirical. This article is a contribution to the empirical side of research.¹

Within this empirical side of research two different approaches can be found: *ex ante* and *ex post*. Many attempts have been made to estimate the *ex ante* ERP using forward-looking information, with most research based on US data, like Arnott and Bernstein (2002) or Fama and French (2002). Within the area of *ex post* estimates of ERP Siegel (1992) extended the Mehra–Prescott sample. He found an average annualised ERP of 5.3% over the period 1802–1990. With most of the low ERP, interestingly enough, at the start of this time frame and the large ERP at the end. Brown et al. (1995) and Goetzmann and Jorion (1999) suggest the high equity premium in US equities to be an exception. They both hint at the issue of survivorship bias. Only by using US data, one surely picks the economic winner of the last century. Blanchard (1993), Fase (1997) and Dimson et al. (2001) show the robustness of the puzzle by studying a number of developed countries. Fase finds the theory to be even more at odds with reality for Belgium, France, Germany, The Netherlands and the UK in the post-war period compared to those in the US. This, however, still does not completely resolve the issue of survivorship bias.

The above mentioned *ex post* approach is the main focus of our study. We find, however, that empirical finance mostly focuses on developed equity markets. We aim to extend the analysis to include emerging markets. Among others, Bernartzi and Thaler (1995) and Campbell and Cochrane (1999) claim that the high equity risk premium in the US were necessary to entice people into the market. Where does this leave emerging equity markets? As emerging markets are perceived to be more risky, one would expect a higher incentive. Barry et al. (1997) and Claessens et al. (1995) have shown that investing in emerging markets is beneficial in a risk/return framework. These articles claim that investors are compensated for bearing the extra risk by receiving a higher average return and a low correlation with other markets. We want to leave the issue of diversification aside and would like to focus entirely on returns. We want to test whether the perceived risk is reflected in larger ERP for emerging markets. In this article we provide differences and similarities of the *ex post* ERP for emerging markets compared to developed markets and show that the ERP is significantly higher in emerging markets. This is of great importance as the ERP is a crucial input for both asset allocation and corporate finance.

¹ For an excellent discussion of the theoretical literature we refer to Kocherlakota (1996) and Mehra and Prescott (2002).

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