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Forecasting the equity risk premium: The importance of regime-dependent evaluation

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Abstract

Asset allocation is critically dependent on the ability to forecast the equity risk premium (ERP) out-of-sample. But, is superior econometric predictability across the business cycle synonymous with predictability at all times? We evaluate recently introduced ERP forecasting models, which have been shown to generate econometrically superior ERP forecasts, and find that their forecasting ability is regime-dependent. They give rise to significant relative losses during market downturns, when it matters the most for asset allocators to retain assets and their client base intact. Conversely, any economic benefit occurring during market upswings is diminished for high risk-averse and leverage-constrained investors.

Keywords: equity risk premium, out-of-sample forecasting, economic constraints, predictive regression, asset allocation, business cycles

JEL Classification: C53, C58, G11, G14, G17

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