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## “Maybe things aren’t so gloomy” – the Prospective Equity Risk Premium

Brian Pizzala (Letters, August 21), claims managers are becoming overly bullish again about equities, but makes a fundamental error in comparing the current earnings yield with the yield on government fixed-interest bonds, instead of on index-linked ones - the index-linked yield is needed because earnings are expected to have some reasonably strong correlation with inflation, rather than to be static.

Whilst this analysis is still not a perfect comparison, it provides a prospective equity risk premium (ERP) closer to 3.2%pa at present, not the 1%pa he quotes. Our analysis of past trends for the ERP in the UK and the US has suggested institutional investors are happy to hold equities when the ERP is 2.5%pa (or in some cases much less!), so maybe the current situation is not so gloomy for these managers and their clients after all?

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**Note** The analysis was set out in the January and February 2003 issues of our monthly *Investment Update* publication (see the separate page on this website for pdf downloads). The chart of prospective ERP, updated to the end of July 2003 is shown below, for those who are interested – as noted in our original analysis, the trigger level shown is illustrative and subjective.

**Figure: Prospective Equity Risk Premia**

