# Riskier rewards for premium advice

**The equity risk premium still exists, according to Anthony Edmonds, but helping others find it is a challenging business**

By Anthony Edmonds

Recently I have heard a lot of people question the merits of investing in shares. They point at the poor returns produced by shares over the last decade and ask: Why bother taking the risk?

This raises the question just how big is the premium that investors should expect from investing in shares?

Unfortunately, the answer to this question provides us with two inconvenient truths.

Firstly, the long-term reward for investing in shares is not that massive compared to simply putting your money in the bank. However, it is big enough to pursue. Secondly, and more challenging, is what this tells us about fees and how they might have to change in the future.

It appears that the reward for educating people about the merits of investing, and then holding their hands while they ride through the inevitable periods of volatility, isn't going to get any bigger over time. In fact, it is likely we will see real pressure on fees to fall in the future. As with any environmental change, those that struggle to adapt might also struggle to survive.

## The equity risk premium

Despite what recent history would suggest, investing in shares over the long term will outperform putting your money in the bank. The risk you take in achieving this superior return is called the 'equity risk premium'.

Most in the industry understand the equity risk premium and how it works. At a practical level, if you invest in a business (or a portfolio of businesses) you would expect to earn a premium as opposed to just leaving your money in the bank.

The concept that investors in businesses should get a premium for taking risk is at the heart of the investment management industry. Whenever we go through periods where shares have performed negatively, we inevitably hear people questioning the merits of investing in them.

At times like these, we all have to draw a deep breath and remind investors of a couple of things. The first is that, over time, business owners will earn higher monetary rewards than most other groups that make up an economy. A simple way to demonstrate this is to ask – who, in a small town, will get wealthiest over time? Most work out that it will be the business owners.

Importantly, they also get that these business owners are taking risks with their money, and will naturally experience both good and bad times (volatility).

Secondly, the best time to buy these companies is often when investor sentiment is negative – or, put more bluntly, after the market has fallen sharply. If your objective really is to make money, then the less you pay for a business the better.

## Just how big is the equity risk premium?

There are lots of theories and views about how big the equity risk premium is. By employing old-fashioned guess work and intuition, I am going to suggest that in the long term it's around 3% to 4% per annum.

So investors in shares should expect approximately 3% to 4% per annum over and above the return they would get from putting their money in a less risky investment like an on-call bank deposit or government bonds.

On the face of it, this reward isn't massive when you think through how much additional risk investors are taking investing in shares.

But the premium will vary depending on the valuation of shares, especially relative to other assets. Generally the more you pay for every dollar of earnings that a company produces, the lower the expected return becomes.

Another way to cut this is to compare the price/earnings ratio of, say, global shares with the 10-year average annual return produced by the market. To do this, take a point in time and look at the price/earning ratio for global shares (for example, say this multiple is 14-times). Invert this to give a percentage figure (inverting 14 gives us 7.1%).

Now jump forward 10 years and check what the actual average annual 10-year return was. I am picking it will be close to the inverted price/earning ratio number – which in this example was 7.1%.

In simple terms, if the price/earnings ratio for any market is high today, expect the returns for the next 10 years from that market to be low and vice versa.

This is a really simple way to highlight that the equity risk premium does change over time and that, over the longer term, the return share investors receive is an output of the current valuation of those shares.

There are many investors looking back at the 10-year return for global shares and saying that investing in shares just hasn't worked. The irony here is that the problem that drove this outcome occurred 10 years ago in 1999/2000 when shares were priced to perform poorly. All they have done is deliver on what their valuations promised all those years ago.

Today, global price/earnings ratios are moving to levels that suggest double-digit returns ahead. This is especially attractive when compared to the return from cash in the bank (being the risk-free rate of return).

Accordingly, the equity risk premium appears to be relatively high at this point in the market cycle, suggesting that investors will receive higher returns for taking the same amount of risk.

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## The equity risk premium helps set investors' expectations – both risk and reward

Understanding the equity risk premium is important, because we can use it to set investor expectations. When you invest in shares you should receive a higher return than simply putting your money in the bank.

However, the reward you are going to receive in the long term is not massive. In fact, if you believe my earlier estimate, over the long term investing in shares is only going to bolster your returns by an additional 3% to 4% per annum.

In order to get this additional return, investors need to be able to tolerate a reasonable amount of volatility (or risk), as in any given year the actual return will vary a lot. Generally we expect the standard volatility of shares to be approximately 15% per annum, meaning that we have about a 95% chance that the actual return will be within ±30% (being two standard deviations) of the expected market return in any given year. For example, if the expected market return is 10%, there is roughly a 95% chance that the actual return for the next year will be between -20% and +40%.

As investment managers and advisers, this is something we have to make sure clients understand at the outset. Educating people about expected returns and risk is an extremely worthwhile endeavour, as it helps stop a lot of panic and heartache in the future.

## Impact on fees and the future of the industry

A by-product of thinking about the equity risk premium is that it helps with exploring issues like the importance of fees and costs. Clearly fees and costs act as a drag on investment performance, a key question is how much drag is too much drag?

If we are going to encourage people to invest, then we have to ensure that the associated fees and costs don't eat up all the additional expected returns. In future, I believe the industry needs to be able to deliver diversified portfolios to investors for around 1% to 1.3% per annum (all inclusive). If fees are above this level then too much of the 'risk premium' is eaten up to justify the risk that the investor is taking. If you are reading this and now choking on your cornflakes, then you need to think about a bunch of factors – including the scale of your book of clients and the costs that you incur in managing them. Some quick maths suggests that significant scale is needed to survive and thrive in this type of environment. Contemplating the equity risk premium will help people in the industry understand how advice and investment businesses will have to change over time to achieve lower costs and greater economies of scale.

## So what's the catch?

I think that many investors come to the market with unrealistic expectations about how well rewarded they will be for investing in shares. Many hope to make hefty returns while somehow managing to avoid the pain of ever losing money. The reality of the market is far more savage than this and a major challenge is getting people to have realistic expectations. Given that investors don't like losing money, it takes lots of effort to educate them to the point where they will hold their shares (relatively) calmly through various market cycles – especially periods like we are currently experiencing.

The catch 22 is that in educating and setting our investors' expectations about this, we inadvertently highlight the importance of minimising fees and expenses. And this is where the world becomes somewhat circular. You can't avoid educating your clients about a concept like the equity risk premium, or they will never be able to withstand the challenges associated with holding an asset class like shares. This then puts the spotlight on fees, which in turn might result in a need to reassess the viability of business models. This is a bit like global warming in that it's hard to see exactly how this will all play out. But one thing is a given. If you are only producing or selling inefficient gas-guzzlers, then you should be worried. Perhaps the best advice is to embrace the environmental change and move to adapt to survive, and thrive, in this new world. A

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