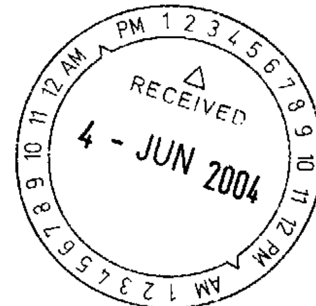
Senate Select Committee on the Free Trade Agreement between Australia and the United States of America

ANSWER TO QUESTIONS ON NOTICE

Tuesday, 18 May 2004



Topic: **Equity Risk Premium**

Hansard Page: **FTA64**

Senator CONROY—Could you refer me to any academic work on the equity risk puzzle, as you describe it?
Dr Kennedy—We could.
...
Senator CONROY—Yes, take that on notice and let us know if there is anybody in the known universe who can help us out.

Answer:

The equity risk premium is the extra return that the stock market provides over the risk free rate to compensate for market risk. The term 'equity risk premium puzzle', first coined by Mehra and Prescott (1985), describes the fact that financial economists cannot explain why this premium is empirically so high without imposing unrealistic assumptions about the risk profile of investors. Since 1985, many academics have attempted to 'solve' this puzzle. However, to date there is still no generally agreed explanation. For literature reviews of the various attempts to resolve this puzzle see Mehra (2003), Grant and Quiggin (2001) and Siegel and Thaler (1997).

While financial economists are yet to find an agreed explanation of the magnitude and components of the equity risk premium, there is no question that it exists. Moreover, within every economy, the equity premium is positively correlated with increased risk. For information on the equity risk premiums of different countries and time periods see Dimson *et al* (2003) and Sterken *et al* (2004).

References

Dimson, E., P. Marsh, and M. Staunton, 2003, Global Evidence on the Equity Risk Premium, *Journal of Applied Corporate Finance*, vol. 15, no. 4, Fall, pp. 27-38.

Grant, S. and Quiggin, J. 2001. "*The risk premium for equity : explanations and implications*," Discussion Paper 89, Tilburg University, Centre for Economic Research.

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Mehra, R, and Prescott, E. 1985, *The Equity Premium: A Puzzle*, Journal of Monetary Economics, vol 15, pp. 145-161.

Mehra, R. 2003, *The Equity Premium: Why Is It a Puzzle?*, Financial Analysts Journal, vol. 59, Jan.

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