MARKET INSIGHTS

from Ziegler Capital Management

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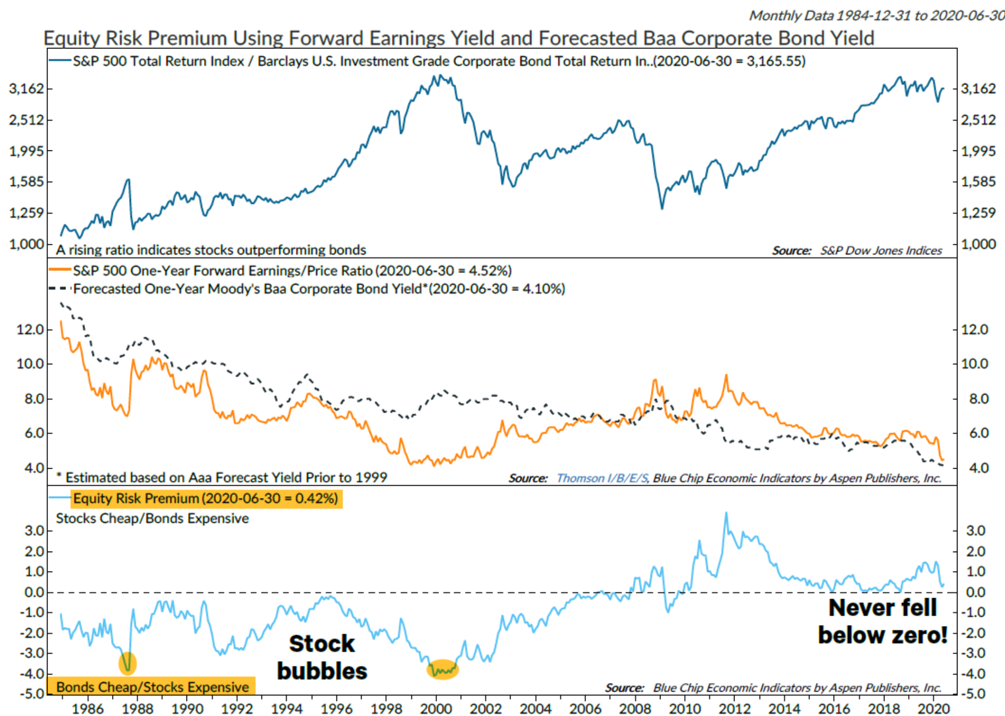
More Room for Stocks to Run?

One of the timeless questions investors ask is one of asset allocation. It is often the simple question, “Does one have too much or too little exposure to the equity market in relation to fixed income and other risk mitigating assets?”. While some advocate hard and fast rules (such as a 60/40 portfolio), or one based on age and time horizon, there are multiple schools of thought to consider.

We would like to address a concept known as the “equity risk premium” (ERP). Simply put, it is the difference between returns on equities/individual stocks and the risk-free rate of return, or simply the extra compensation equity investors demand for the risk of being in stocks. As a part of this idea, there is also a school of thought that a more “apples to apples” comparison is the premium that investors demand to be in stocks verus the bonds of the same corporations, instead of the risk-free rate (often defined as U.S. Treasury yields). The below chart serves as a nice illustration of this similar dynamic.

Stocks Fairly Valued, Far From Bubble Territory

Chart Credit: Ned Davis Research – https://www.ndr.com



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A series that provides a glimpse of our internal thought process through current topics affecting our clients and colleagues.

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It has historically been profitable to be in stocks when the observed equity risk premium is high, as investors demand greater returns from stocks. Conversely, it has also been prudent to lighten up on equities when investors get too "comfortable," and the premium is in negative territory.

We can see that during the last decade that the positive equity risk premium signaled to be in stocks consistently outperformed corporate bonds, as shown in the top panel. Additionally, the ERP was flashing a warning signal during the late 90's/early 2000's tech bubble. This may help us look at current P/E ratios in a different light. While the current 22.1x one-year forward P/E ratio may seem high, it needs to be put it in context of record low interest rates. The equity risk premium lets us do that.

By inverting that 22.1x P/E ratio, we get a current projected earnings yield for the S&P 500 of 4.52% (1/22.1). The equity risk premium here is defined as a projected earnings yield of 4.52%, minus the forecasted one-year Baa corporate bond yield, which is hitting historic lows at 4.1%. That gives us a positive difference of 0.41%. As we can see in the middle panel, while stocks may not be as attractive as they were a few months ago when the ERP was 0.65%, it remains firmly in positive territory, and may serve as a signal that stocks still are comparatively attractive to bonds and other risk mitigating assets.

While time will tell, we think that this information may show that there is more room for stocks to run.

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