Does the market risk premium change over time?

Discussion of Prof. Jagannathan’s presentation

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My takeaways from Prof. Jagannathan’s presentation

♦ Methods for estimating the MRP are imprecise
  • new data over time implies estimates will change
  • cannot tell if changes are “real”

♦ Estimates based on past returns may move in the “wrong” direction if the MRP changes

♦ Forward-looking estimates may under-estimate MRP in “bubble” periods
  • if the tech bubble was “irrational exuberance”, MRP did not fall (as much as) forward-looking models suggested
My takeaways (contd.)

♦ Estimating based on past returns is relatively straightforward

♦ If MRP is varying, a forward-looking method is conceptually advantageous
  • but practically difficult

♦ Surveys to be treated with caution

♦ A “rule of thumb” estimate may be OK for long-term investments, although
  • where to get the rule of thumb estimate?
  • is it a point estimate or a range?
Challenges for regulators

♦ Even if long-term MRP is stable over time, MRP estimates are not

♦ What was (is) the impact of the credit crisis?

♦ Different models disagree
  • risk of “model shopping”

♦ Cost of capital decisions seem to be particularly contentious
Example: evidence from bond yields

Spread between 20-year BBB utility bonds and Treasury bonds

Yield spread (%)

96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 11
How to respond

♦ Is the MRP a number or a “method for finding a number”
  • or is it a range
  • or is it several methods

♦ Need to be internally consistent
  • long-term vs short-term interest rate
  • cost of equity (risk-free rate plus MRP) may not be as volatile as the risk-free rate

♦ Nature of the regulatory “task”
  • generic proceeding to set MRP for next N years for all utilities
  • vs specific proceeding to set cost of equity for individual utility
Final thoughts

♦ MRP *estimates* change over time

♦ Hard to avoid the need for judgement
  • impact of the financial crisis

♦ Is there an asymmetry?
  • costs of setting MRP too low vs costs of setting MRP too high
References: “regulatory practice” on MRP

Review of the weighted average cost of capital (WACC) parameters, Australian Energy Regulator (2009) (AER website)

Review of Regulatory Cost of Capital Methodologies, Brattle study for the Canadian Transportation Agency (2010) (on request from info@otc-cta.gc.ca)


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