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NACVA AND THE IBA'S 2010 ANNUAL CONSULTANTS' CONFERENCE *SESSION SUMMARY*

JUNE 2—5, 2010 THE FONTAINEBLEAU MIAMI BEACH MIAMI BEACH, FL USA

Track: Academic Research Track

Session Date / Time: Friday, June 4, 2010 / 9:15am – 10:05am

Session Title: *The Equity Premium in 150 Textbooks*

Session Summary:

I reviewed 150 textbooks on corporate finance and valuation published between 1979 and 2009 by authors such as Brealey, Myers, Copeland, Damodaran, Merton, Ross… and find that their recommendations regarding the equity premium range from 3% to 10%, and that 51 books use different equity premia in various pages. The 5-year moving average has declined from 8.4% in 1990 to 5.7% in 2008 and 2009. 82 books identify Expected and Historical equity premium.

Some confusion arises from not distinguishing among the four concepts that the phrase *equity premium* designates: the Historical, the Expected, the Required and the Implied equity premium.

There is not a generally accepted equity premium point estimate and that there is not either a common method to estimate it.

The recommendations regarding the equity premium of 150 finance and valuation textbooks range from 3% to 10%. Most books do not distinguish among the four different concepts that the phrase *equity premium* designates: Historical equity premium (HEP), Expected equity premium (EEP), Required equity premium (REP) and Implied equity premium (IEP).

We cannot talk of a "true Equity Risk Premium". Different investors have different REPs and different EEPs. A unique IEP requires assuming homogeneous expectations for the expected growth (g), but there are several pairs (IEP, g) that satisfy current market prices. We could only talk of an EEP = REP = IEP if all investors had the same expectations.

However, different investors have different expectations of equity cash flows and different evaluations of their risk (which translate into different discount rates, different REPs and different EEPs). There are investors that think that a company is undervalued (and buy or hold shares), investors that think that the company is overvalued (and sell or not buy shares), and investors that think that the company is fairly valued (and sell or hold shares). The investors that did the last trade, or the rest of the investors that held or did not have shares do not have a common REP nor common expectations of the equity cash flows.

A reasonable REP may be constant for all maturities, while reasonable EEPs may be different for different maturities. EEPs may be negative for some maturities (for example, in 2000, in 2007 and in 2008 many were negative) while REPs should be always positive.

CPE Hours / Fields of Study: One (1) hour / Finance (FN)

Presenter Bio:

Pablo Fernandez holds a Ph.D. in Business Economics from Harvard University. He is the PricewaterhouseCoopers Professor of Corporate Finance at IESE Business School (Spain). His areas of specialization include company valuations, investment banking, and mergers and acquisitions. He consults and has written extensively on company valuation. He is the author of a paper in the Journal of Financial Economics (2004): "The Value of Tax Shields is NOT Equal to the Present Value of Tax Shields", and of the book "Valuation Methods and Shareholder Value Creation", published by Academic Press in 2002.