Consumers Council of Canada and the Vulnerable Energy Consumers Coalition (CCC) and (VECC) INTERROGATORY #16 List 1

Interrogatory

Ref: B1/T3/S1 p. 41

Issue 4.0
Issue: Cost of Capital/Capital Structure

Topic: Market Risk Premium

Request:

a) Given that the Canadian institute of Actuaries data goes back to 1922 explain in detail why Ms. McShane decided to start her estimation period in 1947;

b) Please provide Ms. McShane's estimate of the realised excess return of Canadian equities over bonds for the period 1947-1956.

c) Please explain in detail how the four factors in footnote 35 lead to the choice of 1947 as the start date rather than some other date

Response

a) & c) The estimation of the expected market risk premium from achieved market risk premiums is premised on the notion that investors' expectations are linked to their past experience. Basing calculations of achieved risk premiums on the longest periods available reflects the notion that it is necessary to reflect as broad a range of event types as possible to avoid overweighting periods that represent 'unusual' circumstances. On the other hand, the objective of the analysis is to assess investor expectations in the current economic and capital market environment. Hence, focus should be placed on periods whose economic characteristics, on balance, are more closely aligned with what today's investors are likely to anticipate over the longer-term.

The four factors in footnote 35 list the key structural economic changes that have taken place since the end of World War II. As a result, the economic characteristics of the pre-World War II economy are materially different than today.

b) The differential between stock and bond returns was 17.5% (arithmetic average). For the entire period 1924 to 2005 for which data are available for both stock and

bond returns, the average return on stocks was 11.8%; the average return on bonds was 6.5%, for an achieved risk premium in Canada of 5.3%; the achieved premium will be higher when 2006 are added since the return on equities was 17.4% and the return on bonds will be little different from the 2006 average yield of approximately 4.1%. The average experienced return on bonds, at approximately 6.5%, is considerably higher than the current yield, and thus overstates a reasonable estimate of expected future bond return expectations.