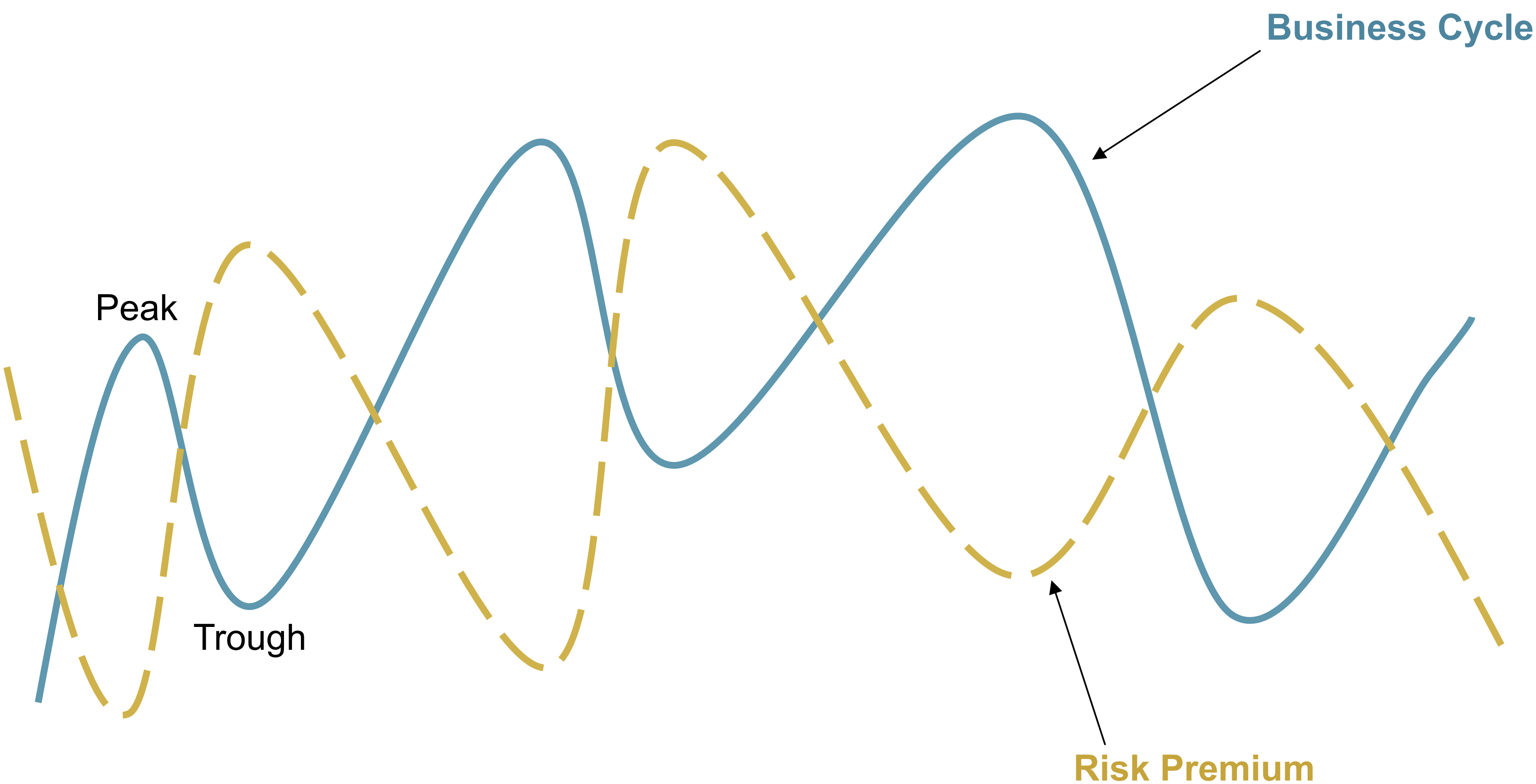
Market Risk Premium Is Countercyclical



The risk premium is the additional return an investor requires to compensate for the risk borne. Business cycle is a repetitive cycles of economic expansion and contractions. Peak is the high point at the end of an economic expansion until the start of a contraction. Trough is the transition point between economic recession and recovery.

Many investors assume that stock returns follow the business cycle. According to this view, the stock market offers a higher expected return premium in a strong economy and a lower premium in a weak economy. (The market premium refers to the return of stocks over T-bills.)

In reality, the market premium tends to run counter to the business cycle, as illustrated in this conceptual graph. The premium is a function of how investors perceive their risk exposure in equities relative to cash, or T-bills. During recessions, as company earnings fall and investors become more risk averse, stock prices adjust downward, which raises expected returns. The possibility of earning higher returns compensates investors for choosing stocks over cash. Conversely, investors will accept a lower expected return when they regard stocks as less risky relative to cash (i.e., a lower market risk premium). This typically occurs when the economy is expanding and the outlook for company earnings is strong. As more investors choose to hold stocks, market competition drives up stock prices relative to company performance, which reduces expected returns.

Investors should not attempt to time the business cycle. Economic performance is only known after the fact, while stock prices reflect the market's view of future business performance. As new information becomes public, stock prices adjust to provide equity investors an expected return that matches perceived risk.

Investors are best served by diversifying across many stocks, maintaining a long-term perspective, and applying discipline throughout the business cycle.