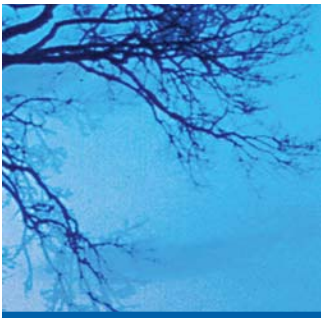


StockVal's

Prospective Equity Risk Premium

The equity risk premium is a critical component of asset allocation decisions. Much debate has been centered on its measurement, level and whether the risk premium changes over time. This paper will illustrate StockVal's market implied risk premium which is derived utilizing an approximate earnings certain composite basket called The ACE Portfolio and the StockVal G-Model present value modeling system. Historical levels of the equity risk premium and total discount rate will be discussed along with their corresponding impact on market valuation levels.



ABOUT STOCKVAL

Since 1985, StockVal has offered comprehensive equity analysis and portfolio management tools to the investment management community through distinctive software and database products.

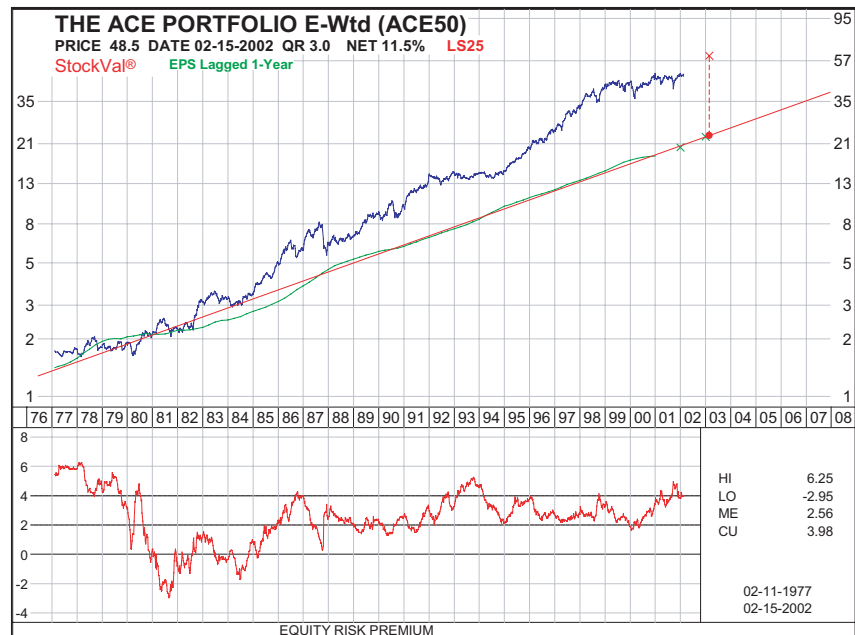


Chart 1

Using the ACE Portfolio to Derive a Prospective Risk Premium

Jerry Gould, founder of StockVal, introduced the concept of The ACE Portfolio as a tool to derive an "earnings-certain" equity risk premium in 1987.

Gould discovered that standard equity risk premia proxies were flawed for two primary reasons: a) proxies normally were averages of historical values, and thus not current or "forward looking"; b) earnings variability in standard market proxies skewed risk premia calculations because price is "forward looking", anticipating future earnings. Thus, it is impossible to determine what portion of equity risk premia change is due to anticipating earnings change as opposed to other macro factors. The creation of The ACE Portfolio eliminated most of the uncertainty related to earnings allowing a more pure prospective equity risk premium to be derived. In essence, The ACE Portfolio has approximate earnings certainty.

STOCKVAL'S PROSPECTIVE EQUITY RISK PREMIUM

The "ACE" acronym is a finance/economics term that stands for "approximate certainty equivalent".

Chart 1 displays a long term history of the price and earnings of The ACE Portfolio. A twenty-five year least-square fit of earnings is shown to illustrate the stability of earnings. The table below contrasts the earnings stability statistics of the ACE Portfolio versus the S&P 500 Index.

Table 1 shows that The ACE Portfolio companies' earnings are significantly more stable than the S&P 500 companies. The statistics can be interpreted as follows: the lower the mean estimate error value, the better the fit between historical trailing earnings and the least square line. The earnings stability measure allows for the convenient creation of earnings certain composite baskets.

Measuring "Approximate Earnings Certainty"		
EPS Stability Measure (Mean Estimate Error)		
	5 Year	10 Year
S&P 500 Companies	55.06%	60.03%
The ACE Portfolio	3.02%	4.74%

The mean estimate error is the absolute percentage from a least squares fit to adjusted earnings.

Table 1

StockVal constructed The ACE Portfolio for the main purpose of generating an earnings certain equity risk premium. By creating an earnings certain portfolio, the market pricing associated with earnings uncertainty can be eliminated. StockVal's composite engine is used to create the equally-weighted ACE proxy. In addition to the "approximately certain" earnings provided by ACE, the known market variables of price and current interest rate also serve as model inputs. Using all of the above known factors, the proprietary G-Model present value model can then be used to solve for the market implied equity risk premium.

The StockVal Prospective Equity Risk Premium History

Over the last thirty years, the median equity risk premium generated by the process described above was 2.60%. It is important to note that this figure is not a defacto excess return, but the market implied risk premium that investors demand in excess of the risk free rate.

Historical Risk Premium Levels	
Median Risk Premium	
1975-80	4.65%
1980-85	0.15%
1985-90	2.40%
1990-95	2.95%
1995-Today	2.72%

Table 2



Chart 2

Observing historical time segments, the highest average prospective equity risk premium occurred in the mid- to late-1970's when inflation was the major issue affecting the equity market. The equity risk premium actually went negative in the early eighties when investors bet on a big interest rate decline. In essence, equity investors demanded less than the risk-free rate because they made a bet that equities would turn around through the equity duration effect. The risk premium over the last fifteen years has been relatively stable in the normal benchmark band of 2% to 4%. However, recent events associated with terrorism and accounting irregularities has resulted in a current value of 3.92%.

STOCKVAL'S PROSPECTIVE EQUITY RISK PREMIUM

Some general observations and assumptions can be made about the level of the equity risk premium over time. A high or low (K) prospective equity risk premium generally is associated with the following:

<u>K is high (over 3%)</u>	<u>K is low (under 2%)</u>
1. Equities are undervalued	Equities are overvalued
2. Earnings are overstated	Earnings are understated
3. Investors are betting on rising market instability	Greater market stability
4. Higher inflation expectations	Lower inflation expectations
5. Socio-Economic instability	Socio-Economic stability

Table 3

Highlighted historical events below can be associated with the above conditions.

- The 1970's stock market experienced socio-economic instability, high inflation expectations, and market instability due to oil supply shocks.
- In early 1987 equity investors demanded less than a 1% equity risk premium in anticipation of an interest rate decline which did not transpire until after the crash. Accepting a low risk premium in this case resulted in making the wrong bet.
- For asset allocation decisions, a high equity risk premium usually implies that equities could be undervalued whereas a low premium indicates the possibility of overvaluation.
- Each of the above serves as an independent reason for the associated level of the equity risk premium. At the same time, the level at any given time can be explained by more than one cause.

The Total Discount Rate History

It is important to recognize that the equity risk premium is just part of the overall discount rate. In general, investors must understand that it is subject to measurement error and, more importantly, assumption error. For example, a significant number of models assume a fixed long-term equity risk premium. Making this assumption to the inherently variable risk premium can distort the overall discount rate.

The total discount rate is simply the summation of the prospective equity premium and the risk free rate. In most cases, the equity risk premium and risk-free rate move in opposite, but usually not equal, directions.

Chart 3 shows that the overall equity discount rate over time is variable and is dependent on movements of the risk free rate and the equity risk premium.

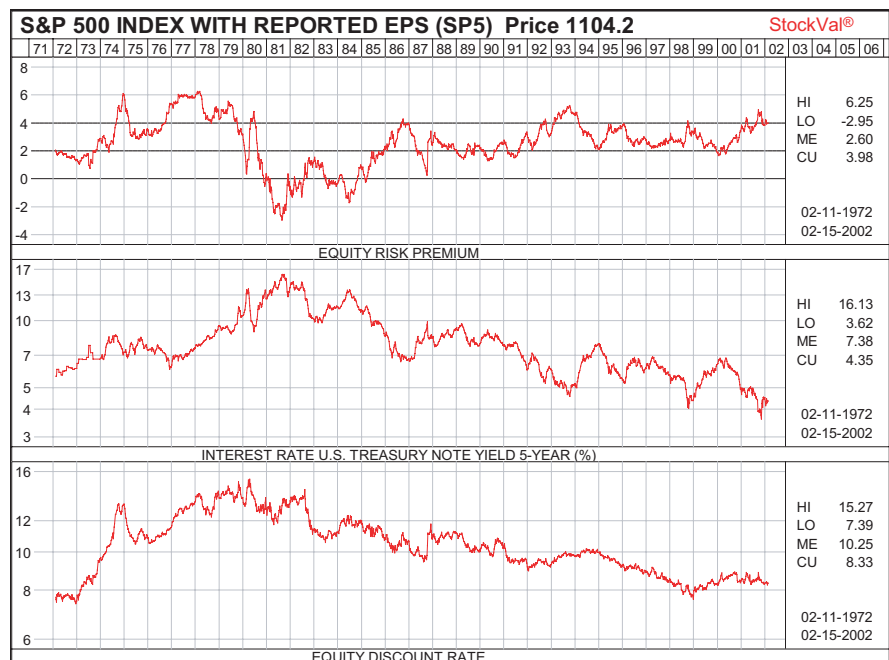


Chart 3

STOCKVAL'S PROSPECTIVE EQUITY RISK PREMIUM

Summary

The market implied equity risk premium is a key metric in determining what investors should demand to own equities versus risk-free securities. Measuring the equity risk premium always presents a problem for equity investors. The ACE Portfolio and the G-Model in StockVal allow for the creation of current and historical market implied prospective equity risk premium.

Studying the history of the market implied equity risk premium is valuable to determine the normal benchmark level. Several assumptions can be made when the level is high, normal, or low.

The total discount rate is essential to understanding the context of reasonable market valuation levels.

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StockVal

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