Author's Accepted Manuscript

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Jiahan Li, Ilias Tsiakas

PII: S1386-4181(16)30112-4
DOI: http://dx.doi.org/10.1016/j.finmar.2016.09.001
Reference: FINMAR411

To appear in: *Journal of Financial Markets*

Received date: 12 May 2016
Revised date: 29 August 2016
Accepted date: 2 September 2016

Cite this article as: Jiahan Li and Ilias Tsiakas, Equity premium prediction: The role of economic and statistical constraints, *Journal of Financial Markets*, http://dx.doi.org/10.1016/j.finmar.2016.09.001

Equity premium prediction:

The role of economic and statistical constraints*

Jiahan Li
University of Notre Dame
jiahan.li0@gmail.com

Ilias Tsiakas
University of Guelph
itsiakas@uoguelph.ca

Abstract

In this paper, we show that the equity premium is predictable out-of-sample when we use a predictive regression that conditions on a large set of economic fundamentals, subject to: (1) economic constraints on the sign of coefficients and return forecasts, and (2) statistical constraints imposed by shrinkage estimation. Equity premium predictability delivers a certainty equivalent return of about 2.7% per year over the benchmark for a mean-variance investor. Our predictive framework outperforms a large group of competing models that also condition on economic fundamentals, as well as models that condition on technical indicators.

Keywords: Equity Premium; Out-of-Sample Prediction; Economic Fundamentals; Technical Indicators; Shrinkage Estimation.

JEL Classification: G11; G14; G17.

*The authors are grateful for useful comments to Amit Goyal (editor), an anonymous referee, Zhi Da, Nikola Gradojevic, Davide Pettenuzzo, Jun Tu, Guofu Zhou, and seminar participants at McMaster University, Brock University, the 2014 RCEF Conference in Rimini, the 2015 CEA Conference in Toronto, and the 2016 Financial Econometrics and Empirical Asset Pricing Conference in Lancaster. *Corresponding author*: Ilias Tsiakas, Department of Economics and Finance, University of Guelph, Guelph, Ontario N1G 2W1, Canada. Tel: 519-824-4120 ext. 53054. Fax: 519-763-8497. Email: itsiakas@uoguelph.ca.