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Equity premia in emerging markets: National characteristics as determinants

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ABSTRACT

There is little research on international equity premia estimates. Using improved and consistent methodologies covering a recent 8-year period, this paper estimates annual equity premia for sixteen emerging markets and finds that they are generally low even compared to risk-free rates. In addition, based on a panel-data regression analysis, this paper finds that, for emerging markets, equity premia narrow with higher market synchronicity, higher economic inequality and better civil liberties, while equity premia widen with better regulatory quality and investor protection and greater international corporate bond spreads. Our results suggest the possibility that in many emerging markets there are non-pecuniary benefits to holding equity or that controlling ownerships have preferential access to capital. These results pose important questions regarding the role of equity in emerging markets. Given the importance of the equity premium, these results should be of great interest to practitioners and researchers.

1. Introduction

There is much interest in the expected equity premium—the difference between expected returns on equity (a diversified portfolio of stocks) and the risk-free rate. It is an important estimate used by investors (e.g., in estimating required returns on stocks), corporate managers (e.g., in estimating funding needed to meet long-term obligations such as pension and health-care obligations), and money

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managers (e.g., determining the draw-off rate for foundation/retirement assets). However, empirical estimates of this critically important number, the ex-ante equity premium, are quite uncertain. Further, most research on the equity premium has focused on the US equity market with relatively little attention paid to estimates of the equity premium even in other major equity markets such as European equity markets let alone equity premia estimates for emerging markets. However, capital markets in many emerging markets have grown in recent years to become large and important. Such markets are drawing increasing investments from the US and other developed countries. While some recent research, including Hail and Leuz (2006), Guedhami and Mishra (2007), and Mishra and O'Brien (2005), look at determinants of the cost of equity capital, there is little research examining the cultural, legal and other determinants of national ex-ante equity premiums. A closely related paper is Shackman (2006) who examines the determinants of ex-post equity premia (excess returns).

We focus on ex-ante equity premia defined as an estimation of the ex-ante cost of equity capital less local treasury or money-market rates. This paper focuses on such "local" equity premiums in sixteen important emerging markets: Brazil, Chile, Greece, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Portugal, South Africa, Thailand, and Turkey, and, for the recent 8-year period, 1996–2003. This sample of countries satisfy two criteria: have a GDP per capita of $20,000 or less as reported for 2005 by the *CIA World Factbook*, and have firms with earnings forecasts reported on I/B/E/S (necessary as the equity premia are estimated using an earnings-based procedures). We restrict ourselves to country/years with at least four firms and so for reasons of data availability start our period of study at 1996.

This paper uses improved and consistent methodologies to estimate ex-ante equity premia based on earnings forecasts for sixteen of the more important emerging markets. The findings indicate that, with a mean (median) of 3.13 (1.27)%, emerging market equity premia are quite low, especially as compared to the risk-free rates that have a mean (median) of 11.08 (8.30)%. Thus, this paper documents that, in spite of the generally higher risk and uncertainty in emerging markets, ex-ante equity premia in many emerging markets are surprisingly low. In contrast to recent research on determinants of the cost of equity capital, this paper documents equity premia in emerging markets widening with improved governance. Controlling for governance and investor protection and other relevant country variables, we find evidence that regulatory quality is a significant determinant of nations' equity premiums. As regulatory quality improves investors demand higher returns over money-market rates as compensation for assuming equity risk.

Based on a panel-data regression analysis, this paper finds that, for emerging markets, equity premia narrow with higher market synchronicity, higher economic inequality and better civil liberties, while equity premia widen with better regulatory quality and investor protection and greater international corporate bond spreads. Our results suggest the possibility that in many emerging markets there are non-pecuniary benefits to holding equity or that controlling ownerships have preferential access to capital. These results pose important questions regarding the role of equity in emerging markets.

2. Emerging market equity premia and their determinants

2.1. Aspects of emerging markets

In this paper we define markets as "emerging" markets if their respective country has a GDP per capita of $20,000 or less as reported for 2005 by the *CIA World Factbook*. However, emerging markets differ from developed markets in many other ways. A qualitative comparison of emerging markets with developed markets for our period of study indicates that generally emerging market countries have – in addition to lower capital market development – lower quality of governance and higher country credit risk. [2] Emerging markets also have more synchronous market movement, as reported by Morck et al. (2000), and a smaller influence of individual stock characteristics. Further, they also have higher market concentration with small samples of firms accounting for large proportions of aggregate

[2] Based on summary means of factors used in this paper for our sample of countries and sample period. Detailed results not reported here for brevity.