MAKENA INSIGHTS

REBALANCING AND THE EQUITY RISK PREMIUM

November 2020

Market drawdowns are scary events for investors. They throw carefully diversified portfolios out of balance and force investors to make difficult investment decisions around rebalancing. Rebalancing too soon may feel like attempting to "catch a falling knife," while failing to rebalance could lead to a long-term impairment of capital. In that context, rebalancing seems to be a question of timing, which is impossible to perfect even for the most experienced investors. How, then, can investors make rebalancing a timing-agnostic decision?

The answer is valuation. Investors must be comfortable rebalancing portfolios when valuations indicate they will be compensated for taking risk (i.e., rebalancing into equities). One important "bottom-up" valuation metric is the opportunity set from underlying managers and portfolio companies; if quality businesses are "on sale" relative to their fundamentals, investors should rebalance into those equities with the confidence that they will perform well over the long-term. Another useful valuation metric is the equity risk premium ("ERP"). The ERP attempts to measure how well investors are being compensated for taking equity risk relative to risk-free assets.

$$\textit{Equity Risk Premium} = \textit{Expected Equity Market Return} - \textit{Risk Free Rate}$$

The ERP is not directly observed but must be estimated from market data. We developed a valuation-based approach to estimate the projected ERP. To test the accuracy of the projected ERP for U.S. stocks using our approach, we compared projections to the actual realized ERP over rolling 10-year periods for 100 years of monthly data.[1] We found a positive statistically significant relationship between the projected ERP and the subsequent realized 10-year ERP.[2]

The sharp market drawdown resulting from the global COVID-19 pandemic threw portfolios out of balance, and, like all drawdowns before it, forced investors to contemplate when to rebalance. As we noted in March, "although every 'black swan' event is different, the market reactions are often similar."[3] The market panic in March felt like the Volcker Recession in the early 1980s and the height of the Global Financial Crisis ("GFC") in 2008. Below, we assess how the ERP helped to assure investors to rebalance in both instances and discuss how the ERP similarly assured investors in 2020.

"Volcker Recession"

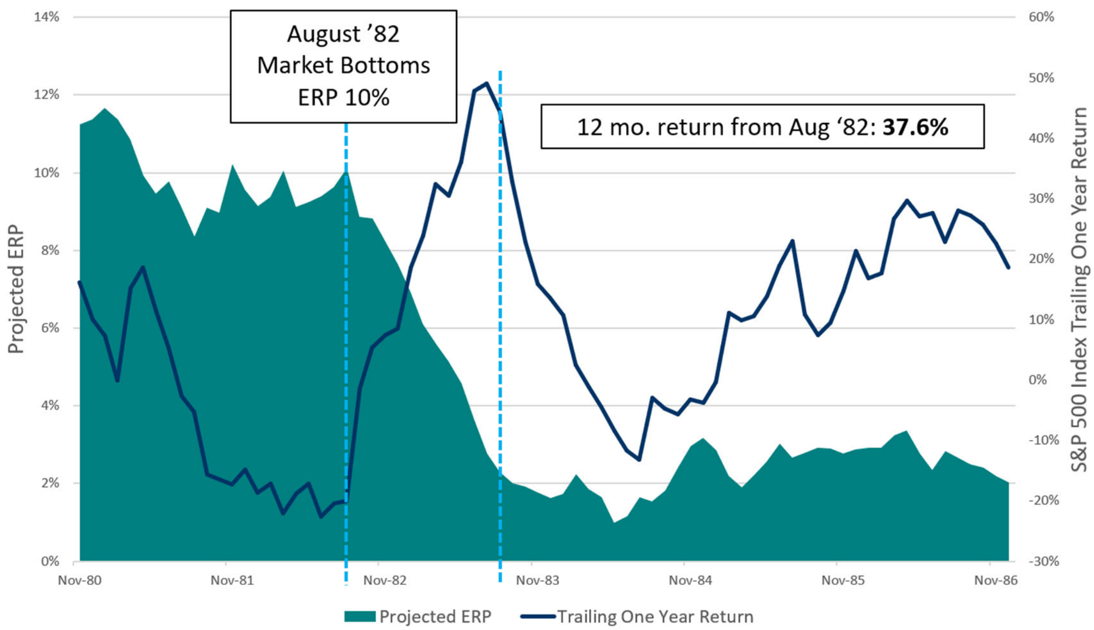
The Federal Funds rate increased to over 20% by the end of 1980, leading to the deepest recession since the 1930s; the S&P lost 28% from November 1980 to August 1982. Although equities looked poised to continue to fall, the projected ERP was +10% in August 1982. Should investors have rebalanced based on the forecast premium? Yes. The S&P rose more than 37% in the 12 months following August 1982, and the realized ERP over the following 10 years was +5% per annum, during a period when bond returns were quite strong. The following graph illustrates that in the turmoil of the Volcker Recession, investors would have benefitted substantially by trusting the projected ERP.

[1] Online Data Robert Shiller: http://www.econ.yale.edu/~shiller/data.htm

[2] Actual ERP = 2.1% +0.5*Projected ERP with a T-stat of 25.9, which is 2.4 after an adjustment for the overlapping data

[3] *Coronavirus Response – Update*, Makena Capital, March 2020: https://www.makenacap.com/wp-content/uploads/2020/03/makena-coronavirus-response-update_march-2020-public.pdf

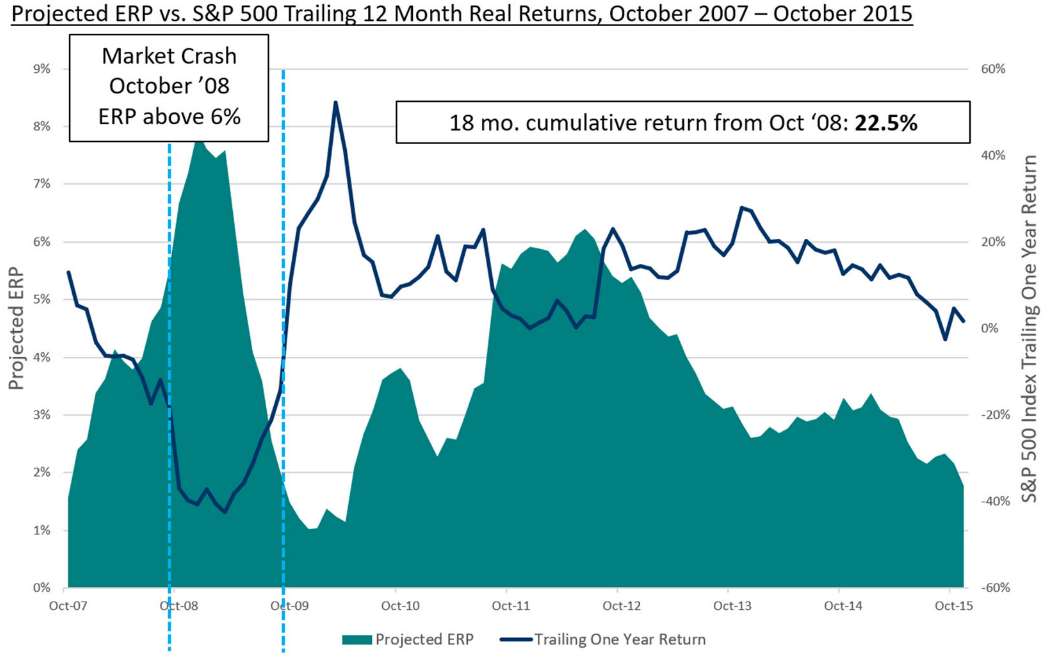
Projected ERP vs. S&P 500 Trailing 12 Month Real Returns, November 1980 – November 1986



The Global Financial Crisis

Amid a tumbling market at the outset of the GFC, the projected ERP in October 2008 ballooned to over 6%. Would investors employing the ERP as a guide have benefitted? Yes. Although the market continued to decline from October to March 2009, an equity buyer in October was positioned handsomely for the next year and beyond. The S&P returned 22.5% in the 18 months following October, and the realized ERP over the following 10 years was over 9%. In this case, as well, the projected ERP would have correctly pointed investors to undervalued equities.

Projected ERP vs. S&P 500 Trailing 12 Month Real Returns, October 2007 – October 2015



Today

The projected ERP at the beginning of April was +5%, increasing from a year-end 2019 level of 3%, partly due to lower stock prices and a dramatic decrease in real bond yields. Our study analyzed the rolling realized 10-year ERP onward from 1910, which ranged from a low of -8.6% to a high of +18.5% per annum, with a median of +4.4% per annum. The median projected ERP over this 100-year period was 3.5%. Should investors have rebalanced? An above-median ERP provides a starting point for investors seeking discount equity valuations, but no single metric can guarantee success in rebalancing. Rather, top-down analysis must be combined with bottom-up observations to establish a decision-making framework. Makena's manager network provides a "boots on the ground" perspective, bolstering our ability to make long-term decisions with speed and efficiency, when necessary. In times like these, the advantage of investment relationships based in collaboration and partnership represent a greater asset than any statistical indicator.

Through some of the most distressed markets of the past century, the projected ERP would have been a useful tool for investors to find comfort in rebalancing into equities. Will April's above-median ERP provide a useful guide for investors rebalancing into equities? Time will tell.