

The Equity Risk Premium

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The Equity Risk Premium

THE LONG-RUN FUTURE
OF THE STOCK MARKET

Bradford Cornell



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Preface

Books and articles on the stock market span a wide spectrum between two poles. At one end is the academic literature as published in major scholarly journals, including *The Journal of Finance*, *The Journal of Financial Economics*, and *The Review of Financial Studies*. This literature is highly complex and sophisticated, yet it is remarkably humble. Despite all the high-powered tools financial economists bring to analysis, they recognize that most of the variation in stock prices is unpredictable, particularly over the short term.

At the other pole are books designed to sell investment strategies to beat the market. These are written in clear, forceful language. They are often aggressively marketed and occasionally become best-sellers. Unfortunately, the messages they convey usually have no scientific validity.

Between these two poles are thousands of books and articles on the stock market and investing. This book lies at a point about three quarters of the way toward the academic-literature pole. The goal here is to summarize the scientific work in a digestible manner for people who are not professional economists. There is a risk in this, of course. If the scientific articles could be fully explained without the technical complexity, the technical complexity would never have evolved in the first place. Any simplification is just that—a simplification. Because some readers, particularly finance students, may not be satisfied with my explanations, this book

contains numerous citations of the literature on which it is based. Nonetheless, this book is not a finance textbook. Too many people are interested in scientific work on investing to limit the book's audience to business-school graduates.

The goal of this book is to help the reader understand what can be expected from the stock market in the future over the long run. The path to this goal is through the equity risk premium—the difference between the returns on common stock and the returns on government securities. Be forewarned: There no dramatic tips or secrets revealed here. In fact, if I had such information, I would be exploiting it, not writing about it. In this respect, the scientific literature on investing indicates that I am not alone. When it comes to investing, no one has any dramatic secrets. This does not mean, however, that a thoughtful analysis of the behavior of stock prices cannot help one become not only a better investor but a more relaxed one. Recognizing one's limitations can be as liberating as learning new skills.

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