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The Great Divergence: French Equity Premium is Lower and Riskier than the US since WWI

David LE BRIS, BEM Bordeaux Management School
Sandrine Tobelem Foldvari, AHL Research and Trading

In this paper, we compare the US and French risk premium computed on high quality data. We confirm that the US risk premium has been constantly higher. We also show that the US equity outperformance is even higher when we compute the price of risk. Indeed, the US equity risk has been lower than the French one since 1997. The two world wars do not seem to explain the risk premium difference, as the US continues to outperform the French equity market after 1950. We conclude that the particular case of the outperformance of the US equity cannot be directly extrapolated to other equity markets.

Is the KIID Sufficient to Associate Portfolios to Investor Profiles?

Georges Hübner, HEC University of Liège, Maastricht University, Gambit Financial Solutions, EDHEC

With the Key Investor Information Document (KID), the new UCITS IV framework brings a useful standardized and simplified scheme to explain the risk of mutual funds to non-professional investors. The Synthetic Risk and Reward Indicator (SRRI) methodology defines how to assess a volatility equivalent for each type of funds, and recognizes the specificities of various types of investment vehicles in the process. The SRRI rests upon two key principles: (i) risk-volatility mapping: the level of risk can be accurately translated by the volatility of returns; and (ii) reward to volatility: there must be a positive connection between the level of risk borne by the individual investor and the associated reward in terms of returns. We show that the SRRI methodology does not guarantee that these two principles are respected in practice. By forcing any type of risk to be translated into a volatility estimate, the approach overlooks investor's heterogeneity in the definition of risk. The SRRI synthetic approach is powerless to adequately reflect the trade-off between normal and extreme risks the way it is perceived by individual investors. It also ignores that fund returns are not necessarily only related to volatility. We show that the KID does not replace a proper investment profiling system. The analysis of investor profiles is a necessary complement to the KID in order to provide adequate advice to investors. We provide an approach, based on the linear-exponential utility function, that enables the financial advisor to address the heterogeneity of investors when defining the risk of an investment portfolio.

Momentum Investing Over the Last Twenty Years in France, its Persistence and The Effects of the Financial Crisis

Emilios C. Galariotis, Audencia PRES LUNAM, Centre for Financial and Risk Management

The paper investigates momentum investment strategies for the French Security Market during the most recent twenty years. The aims are to test whether such strategies perform persistently, i.e. they remain profitable today consistent with earlier literature, and if so, whether they are abnormal and if there has been an effect from the recent global financial crisis that has different characteristics compared to other crises in the sample. Sixteen trading strategies are investigated ranging from three to twelve months, and results show that momentum returns appear to be significant on a risk adjusted basis (both univariate and multivariate), and that momentum portfolios on average provide a good hedge for market risk. Nonetheless, considering the financial crisis, momentum profitability disappears or is even reversed (at which time it pays off to be a contrarian investor), showing a risk not captured by traditional asset pricing models.
THE GREAT DIVERGENCE: FRENCH EQUITY PREMIUM IS LOWER AND RISKIER THAN THE US SINCE WWI

For the study of long term stock price behaviour, most authors focus on the biggest stock market in the world: the US market. Cowles (1939) conducts a thorough study of the long term US capital market behaviour and recreates reliable return time series from 1871. This landmark study is followed by the work of Schwert (1990) and especially the work of Siegel (1994) who evaluates the evolution of US stock prices since 1802. One of Siegel major results is to prove that the equity premium remains remarkably stable over the long run (and equal to a “Siegel’s constant” of about 5% in geometric mean).

Table 1 below gives a snapshot of the different US equity risk premium computed in the main studies found in the literature (to which we have added our own measurements for the French and US equity risk premium). All those studies on the US equity premium converge towards to the Siegel’s constant.

However, the US studies suffer from a potential bias as identified by Brown et al. (1995). Indeed, the US economy is one of the most successful over the long run, and extrapolating results obtained for the US market on other markets may prove fallacious.

Accordingly, several studies investigate other markets. Dimson and Marsh (2001) reconstitute a monthly UK index over the period (1950-2000). In their book, Dimson et al. (2002) collect total stock returns for 17 countries since 1900 (yearly revised, see Dimson et al., 2010). According to these authors, huge differences exist among total real returns across countries (between 2.90% for Belgium and 7.10% for Australia). A major shortfall in those studies however, is the quality of the data used. Indeed, the equity return is computed as a compilation of indices built ad hoc which do not effectively represent the return of an investment in stocks (see Le Bris and Hautcoeur, 2010).

In this paper, we consider high quality data for the French equity returns that have been recently made available on a monthly basis since 1854 (Le Bris and Hautcoeur, 2010). We can therefore reliably compare the US equity return (as computed by Cowles-S&P data, see Appendix A) and the French equity return performances.

It is indeed interesting to be able to compare reliably the performances of the US market and another developed market that experienced a radically different situation during the 20th century. Compare to the Russian or German markets, the French market has survived better the two world wars. However, France has still suffered dire economic consequences of the conflicts and implemented interventionist and socialist policies, whereas the US has been left relatively unscathed. The respective share of the US and French markets in the world equity market has followed an inverse path. The US market share (which remained the first market capitalization during the whole 20th century) has doubled from 1900 to 2000 (from 22% to 46%), whereas the French market share has been divided by two (8% in 1900 against 4% in 2000), sliding from the third to the fourth position (Dimson et al., 2002). Thus, the French case is a good candidate to help balancing the results found for the US equity market.

Using several performance measures, we investigate the differences of the long term equity premium in the US and French markets. Our paper provides three findings to the existing literature. We first bring reliable evidence to confirm the US survival bias: the US equity premium is consistently higher than the French one. Secondly, we measure that the French premium is also more unstable over time (i.e. riskier). As a result the higher US performance increases if we take account for the level of risk associated with the equity premium. Thirdly, this better remuneration of risk in the US was not observed before 1917 when the two countries were economically more similar, but remains strong after 1950. The paper is organized as follows: we first present the US and French monthly time series used for our study. Then, we describe the distinct four periods we consider to analyse US and French equity performances from 1870 to 2007. Thirdly, we present our results. A last section concludes.
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