

EQUITY RISK PREMIUM PUZZLE: EVIDENCE FROM INDONESIA AND SRI LANKA

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This paper investigates the equity risk premium puzzle in the Indonesian and Sri Lankan stock markets in order to identify the relationship between the volatility of excess returns and the equity risk premium. The asymmetric impact of negative shocks on the equity risk premium is also examined using threshold and exponential GARCH-M models. We analyse data on the excess returns of the Indonesian and Sri Lankan stock markets from 2004 to 2013, and we find that the impact of the conditional volatility of excess returns on the equity risk premium is not significant in either country. Instead, we find an impact from negative return shocks on the equity risk premium only in Sri Lanka. Therefore, we conclude that investors are not compensated for the conditional volatility of the excess returns in these two markets, while Sri Lankan investors are compensated for the risk of negative shocks.

Keywords: *emerging markets, equity risk premium, GARCH-M, negative shocks*

JEL classification: G1, C5, F0

INTRODUCTION

Stock market volatility has become a focus of many studies, because volatility itself is a puzzle, as Wang and Ma (2014) note. Estimating volatility and analysing its relationship with the equity risk premium (ERP) have become important research areas in finance. The capital asset pricing models (CAPM) in Sharpe (1964), Lintner (1965), and Black (1976) suggest a positive, linear relationship between risk, or volatility, and the expected returns on securities.

The ERP has attracted attention in asset-pricing literature long since it was found to be significant in determining the expected returns on investments. Mehra and Prescott (1985) introduce the equity premium puzzle (EPP) and find that the historical ERP is an order of magnitude too great to rationalise using US data from 1889–1978. However, studies using relatively recent data on the US market find results that contradict Mehra and Prescott's findings (Turner, Startz, and Nelson 1989; Glosten, Jagannathan, and Runkle 1993; Nelson 1991; Kim, Morley, and Nelson 2004; Bekaert and Wu 2000). In contrast, a negative relationship, or an insignificant relationship, between volatility and expected returns has been evident.