Directors and professors treat market risk differently

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More than half of companies surveyed in 2008 say they use a risk premium higher than in 2007, as opposed to 15 percent of professors surveyed.

In "Market Risk Premium Used: Survey 2008," IESE Prof. Pablo Fernández put three simple questions to 424 business executives and professors, mostly Spaniards. What market risk premium does your company use? How is it justified? Did you use different premiums in previous years? The findings of the survey can be grouped into eight sections.

First, there is a great spread between the companies and professors surveyed. The professors use premiums between 3.5 and 10 percent, and the businesses between 2 and 30 percent. Banks and financial firms, however, show a much smaller dispersion: between 2 percent and 8.2 percent. In addition, the average premium used by companies (6.3 percent) is higher than that used by professors (5.5 percent).

A large number of companies do not use the market risk premium. Many of them use a minimum WACC, a minimum IRR or the minimum return required on the shares calculated without taking into account the market risk premium. Others use other criteria such as ebitda-to-sales, margin-to-sales and price-to-earnings ratios.

Many companies and many professors use published books and articles to justify the premium they use. The variance is also high: between 2 percent and 12 percent for businesses, and between 3.5 percent and 8 percent for professors.

Same source, different premiums

Curiously, professors and businesses that establish their premiums using the same source use very different market premiums. This is due to three factors:

- some sources use different premiums in different editions;
- some sources use different premiums in different pages of one edition;
- some companies and professors use premiums that do not coincide with the sources mentioned.

In 2008, 54 percent of companies used a risk premium higher than that used in 2007 (1.3 percent on average), 38 percent used the same one and 8 percent used a lower one (1.1 percent on average). The average premium in 2000 was nearly 8 percent, falling to 5.5 percent in 2005 and rose in subsequent years until it reached 6.3 percent in 2008.

In 2008, 15 percent of professors used a risk premium higher than that used in 2007 (0.8 percent on average), 46 percent used the same one and 39 percent used a lower one (1.4 percent on average). The average premium in 2000 was 6.5 percent, and fell in subsequent years until it reached 5.5 percent in 2008.

Finally, in 60 companies, the risk premium was fixed by the owner or by headquarters, which the author finds logical and sensible.

The report contains a final appendix that summarizes the requirements on market risk premium carried out by two Spanish national commissions: the telecommunications market (WCL) and that of energy (CNE).