Expected Equity Risk Premium: Survey Approach in the Case of a Small Emerging Market

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Abstract

Estimating the equity risk premium is difficult in the case of developed economies with mature stock markets, and it is even harder in the case of emerging markets with short and volatile history of the stocks exchange. In this paper it will be shown the attempt to estimate the expected ERP as a key parameter for financial theorist and practitioners using the survey approach in the case of the Republic of Macedonia as a small and open emerging market economy. It will be shown that the risk-return trade-off holds. Namely, the estimated ERP for the Republic of Macedonia for 2013 amounts 10.84% and 10.92% on average for the next 10 years. It is higher and similar as in the case of the other emerging and developing markets which are perceived by the investors as a riskier markets comparing to the developed markets where the expected ERP is lower.

Keywords: emerging markets, market returns, risk-free rate, expected equity risk premium

1. Introduction

Equity risk premium (ERP) is one of the most important parameters in corporate finance, capital budgeting and valuation. It is the price of risk that should compensate the risk-averse investors for undertaking risky investments instead of risk-free investment. What is meter is not the individual but the general risk aversion in the market as a whole and this parameter called equity risk premium is hard to estimate in the well developed markets with long history and even harder in a small and open emerging markets. If the risk premium is what investors expect today for investing in risky assets, than the most logical approach to estimate this size it seems is to ask these investors what is their expected return on the stock market portfolio above the risk free rate in the next period. As Campbell (2007) states "What return should investors expect the stock market to deliver, above the interest rate on a safe short-term investment? In other words, what is a reasonable estimate of the equity premium?".

The equity risk premium is a forward looking concept. However, commonly applied approach by researchers for estimating the future ERP is the historical equity risk premium approach. The starting point here is that the average realized risk premium in the past is the basis for its estimation in the future. Thus, as Fernandez (2013) stated many authors assume equality between historical ERP and future ERP i.e. expected ERP, although these two concepts are completely different. More precisely, he founds that for many authors HEP = EEP = REP. Fernandez (2013) differentiates four concepts of equity risk premium: **historical, expected, required** and **implied** equity risk premium (HEP, EEP, REP and IEP).

Estimates of the EEP based on analyzes of historical time series assume that the historical data provide adequate direction for future expected long-term behavior. But the historical equity risk premium varies over time, and consequently, it is unclear why data from a distant past can be useful for predicting the expected returns and the EEP. Fernandez (2013) and many other authors emphasize that the historical ERP is not a good estimator of expected equity risk premium. Futhermore, in the case of a small and open emerging country, with short history and volatile equity market, the historical approach seems does not have any sense to be used. Hence, it appears that the survey approach is most appropriate for the estimation of the ERP in emerging countries. Relevant class of investors, managers and academics know best, on average, to assess the stock market and the real price of risk.

2. Theoretical framework and literature review

Many papers emphasize that there must be a unique EEP for all investors at the market (the representative investor). But it is obvious that investors do not have homogeneous expectations. Brennan (2004) further emphasizes that different categories or classes of investors may have different expectations about the prospective returns on stocks leading to different estimates of equity risk premiums. Also, many investors do not hold market portfolio, but subgroups of stocks and bonds. Here, as it is emphasized by Fernandez (2013) even in the presence of "homogeneous expectations" (where all investors have equal EEP), REP will not be the same for all investors. In this situation, investors with lower REP will clear the market. It is obvious that without the "homogeneous expectations" there is not one expected risk premium (but there are many) nor is one required risk premium (but there are many).

Investors are heterogeneous in terms of information they held, the level of risk aversion, their expectations and incentives for investment. The survey of relevant class of investors, professionals, academic and managers allows to see the current mood in the representative or average investor and to estimate the equity risk premium for the market as a whole. Ilmanen (2003) argues that surveys can lead to optimistic attitudes, investors are biased and as a result the expected returns estimated with the survey can be the returns for which they hope rather than their required or really expected returns. In other words, he believes that surveyed subjects are more willing to express the size that they wish for, rather than the one actually expect and/or required. That is, if they are generally optimistic than the required or really expected ERP should be less than that which would be estimated by the survey. Consequently, the survey will overestimate the equity risk premium and conversely, the ERP will be underestimated if investors are generally pessimistic.

The survey approach as a way to collect the opinion of the investors and their averaging in order to estimate the market risk premium is used by multiple researchers. Here we will look at some important and frequently cited works.

Welch (2000) conducted two surveys of professors of finance in 1997 and 1998, asking them what they think will be the expected equity risk premium for the next 30 years in USA. He received 226 responses, which range from 1% to 15%, the arithmetic average of 7% over the long-term government bonds. The survey was conducted in April 1998 when the risk free rate in U.S. amounted to 6%. At the same time the most used database in the U.S., Ibbotson Associates Yearbook published in 1998 showed arithmetic average of the historical risk premium over the Treasury bills of 8.9%. Moreover, at the same time, results of surveys by other authors who surveyed the broad mass of investors and managers showed quite different results, but all were in the range of 2% to 13%, which compared with a range of 1% - 15% shows, that professors have higher spreads. Welch (2001) presented results from a survey of 510 professors of economics and finance conducted in August 2001 and the consensus for the 30 year expected risk premium was 5.5%, much lower than the three years before. Welch (2008) in his study of 2008 shows that the market risk premium "applied" by professors of finance was on average 5.89%, while 90% of the professors apply premium between 4% and 8.5%.

Graham and Harvey (2005) show that financial executives in the U.S. reduced their average EEP from 4.65% in September 2000 to 2.93% in September 2005. In this period the HEP dropped only 0.4%.

O'Neill, Masih and Wilson (2002) conducted survey of their global customers in July 2002 and the estimated average long-term EEP amounted to 3.9%, with most of the responses were between 3.5% and 4.5%. The magazine Pensions and Investment (on 1.12.1998) conducted a survey among professionals working within institutional investors and estimated average EEP was 3%.

Securities Industry Association (SIA) continuously conducted surveys from 1999 to 2004. In the last survey in 2004 they examined 1500 investors in the U.S. and found that the median return was 12.8%, which gives a risk premium of 8.3% above the rate of return on long-term government bonds. In the previous years, they found that the average expected return by investors was 10% in 2003, 13% in 2002, 19% in 2001, 33% in 2000 and 30% in 1999.

Merrill Lynch in a monthly report of the survey of institutional investors in U.S. from February 2007 showed average expected equity risk premium of 3.5%, which increased to 4.1% in March 2008 after the fall of the market. After calming the markets in 2009, the risk premium again returned to a level of 3.76% in January 2010. Until March 2010 risk premium remained in the range of 3.85% to 3.90%, but the premium increased to 4.08% in January 2012.

Johnson et al. (2007) present the results of a survey of 116 professors in North America from March 2007: 90% of professors believe that EEP in the next 30 years is within the range of 3% to 7%.
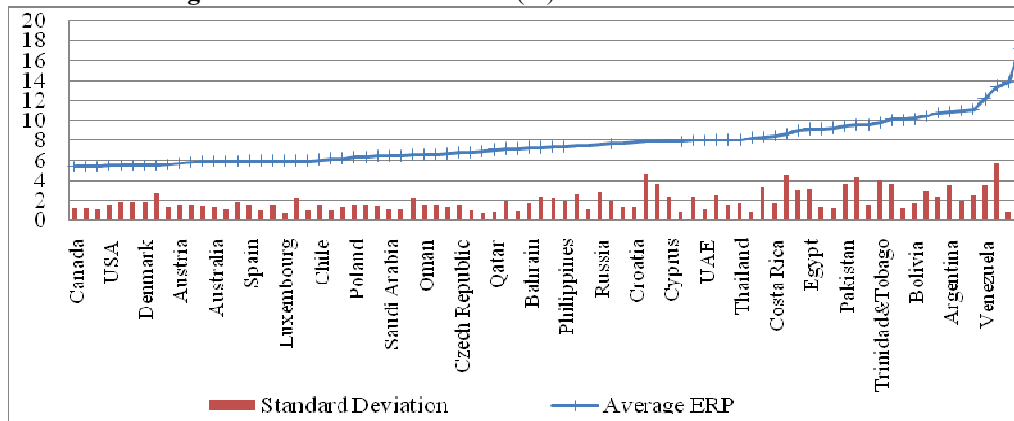
Fernandez, Aguirreamalloa and Corres (2011), in their research provides a comparison of the size and the standard deviation of the estimated risk premium in the three categories of participants: professors, analysts and companies. The results shows that the professors are the most risk averse expecting risk premium of 5.7%, than the companies expecting similar ERP as professors of 5.6%, and the analysts who expect the lowest ERP of 5.0% but with the biggest standard deviation of 2.0%.

Fernandez (2011) has researched the evolution of the market risk premium in the case of the United States based on his studies in the recent years (Fernandez et al, 2009, 2010) and the Surveys of Ivo Welch (2000, 2001, 2007, 2008, 2009). He shows that the results of the surveys are different in different years representing the time varying equity risk premium.

Fernandez, Aguirreamalloa and Corres (2012) conducted one of the most comprehensive world survey ERP. In May and June 2012 they sent 21,500 e-mails to professors of finance and economy, analysts and managers of companies. They provided 7,192 relevant responses from 82 countries for the required market risk premium in 2012. The results are presented in Figure 1. The lowest is the required risk premium in Canada of 5.4%, and the highest in Iran of 17.2%. In fact, the risk premium is low on the left half of the graph where are depicted the developed countries and is becoming higher and more volatile on the right half of the graph where are depicted the underdeveloped countries and emerging countries, which is actually understandable risk – return

trade off since the emerging and undeveloped equity markets are considered to be more risky than the developed ones.

Figure 1. Market Risk Premium (%) used for 82 ciuntries in 2012

Source: Author's calculations according to data published in Fernandez, Aguirreamalloa & Corres (2012)

Professors John R. Graham and Campbell R. Harvey from Duke University in the United States, starting from the third quarter of 1996 to the present, continuously conduct surveys of U.S. Chief Financial Officers (CFOs). Graham and Harvey (2013) have summarized the data showing the expected risk premium for the period from June 2000 the December 2012. Figure 2 shows the movement of the expected risk premium for the next quarter in the specified period.

Figure 2. The movement of the Expected Equity Risk Premium in USA
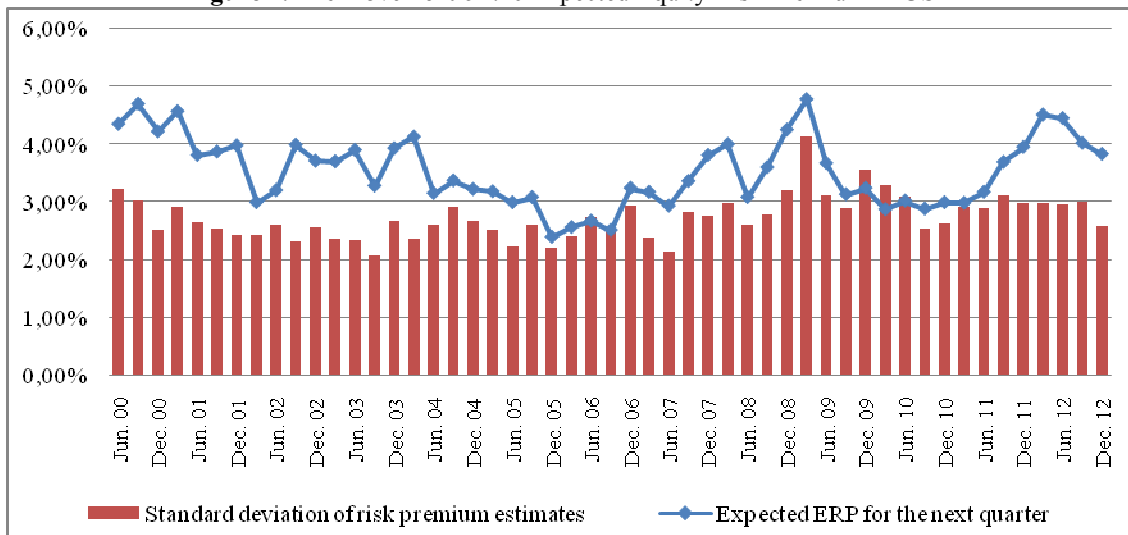
Source: Author's calculations according to data published in Graham u Harvey (2013)

Figure 3. Comparison of Expected ERP with the Realized ERP
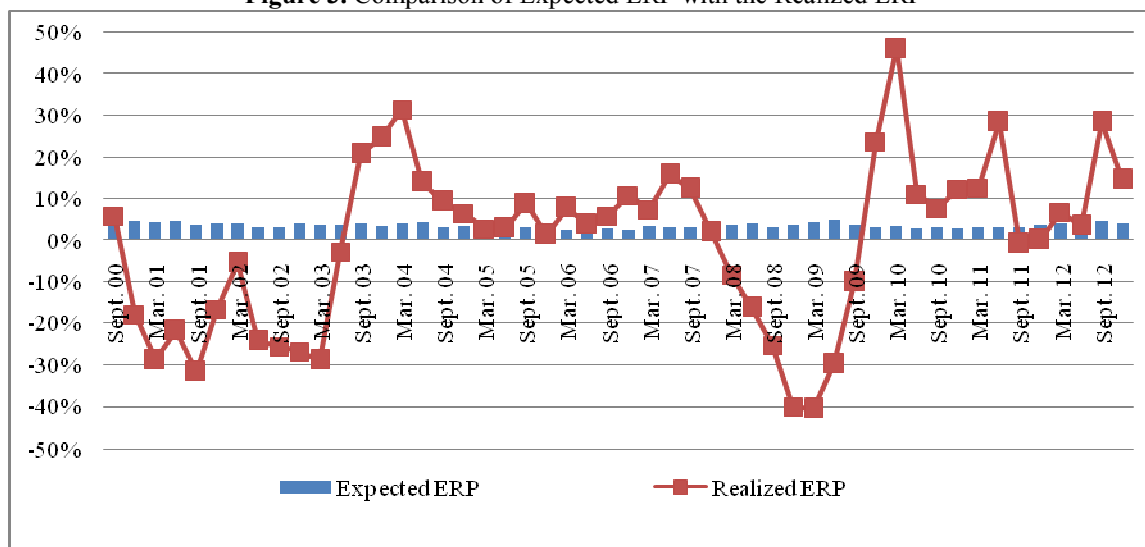
Souce: Author's calculations according to the data published in Graham u Harvey (2013) and authors' own calculation for the realized ERP using the MSCI data series

Expectations of U.S. CFOs in December 2012 are that the return of the stock market in the U.S. in the first quarter of 2013 will be 5.46%, which compared to the yield of the 10 year govrnemnt bond rate taken as a risk free of 1.63% gives an expected risk premium of 3.83% which in turn is slightly higher than the overall twelve year average expected risk premium of 3.53%. The highest expected risk premium is in February 2009 of 4.78%. The analyzed period covers two crises: March 2001 - September 2001 and the recent global financial crisis - December 2007 - June 2009. Overall, the risk premium is not constant over time as it is assumed by the classical financial paradigm, but varies over time, and financial theory links that with the influence of the business cycles. In fact, the simple economic logic suggests that the risk premiums should be highest during the recession when risk of investment in shares increases, and decline during economic prosperity when investors optimism increase. The concept of the historical risk premium has proved the opposite, but the concept of the expected risk premium should reflect the simple economic logic.

According to Graham and Harvey (2013) during the recession the expected market risk premium was 3.98%, and during stable economic activity was 3.42%. In fact, for the entire analyzed period the expected average premium is 3.53%, indicating that the expected risk premium is high also in the non-recessive period. In fact it is still a result of expectations for market growth and as Damodaran (2013) states, in forming their expectations the subjects are biased and also their expectations are under influence of the happenings in the most recent past. Figure 3 shows large deviations between the ERP that was expected and the ERP that was realized, which means that the expectations of CFOs have almost never realized, even in one of the most developed equity markets. Also, in the recessive period it is evident the increase of the standard deviation of the risk premium, suggesting that people have less confidence in their predictions. But while in the post recessive period the EEP decreases, however the standard deviation remains high.

Fernandez (2010) gives a unique exploration of the risk premium that professors recommend in the their books. He had performed observation of 150 books on corporate finance and valuation published between 1979 and 2009 from the most famous, as well as less known authors (Brealey, Myers, Copeland, Damodaran, Merton, Ross, Bruner, Bodie, Penman, Arzac etc.) and found that their recommendations as to what risk premium is to be used ranged between 3% to 10%. In 51 books he found that the authors recommend different risk premium on a different page in the book. The five-year moving average decreased between 8.4% in 1990 to 5.7% in 2008 and 2009. He concluded that there is confusion between the authors that they do not make a difference in terms of the different concepts of risk premium: historical, expected, implicit and required. In 129 books a distinction is made between expected and required, and in 82 books authors clearly distinguish between historical and expected risk premium. Fernandez (2010) in the appendix of the paper gives a comprehensive overview in the form of a list of all 150 books, by author, year of publication, the concept of risk premium used and the page in the book on which is stated the recommendation.

3. Estimating the expected equity risk premium using the survey approach in the case of the Republic of Macedonia

In this section we analyze the results of the survey of the expectations for the stock market in the Republic of Macedonia, a small and open European emerging economy with short and very volatile history of the stcok

market. The estimation is provided for the end of this year 2013 and for the next 10 years. We survey professors, analysts and managers for their expectations of the value of the Macedonian Stock Exchange Index - MBI10 - in the future. We derived the ERP indirectly. Namely, based on these expectations we calculate the market return, and given the current size of the ten-year yields of German government bonds as a benchmark for the risk-free asset we estimate the expected risk premium. Also we present the measures of descriptive statistics.

3.1 Method
3.1.1 Design
On March 4, 2013 we sent a survey to a very carefully selected class of professors, analysts, investors, managers, professionals in the field of capital market in the Republic of Macedonia. The survey was conducted electronically, and the subjects interviewed by e-mail were sent a link to an anonymous survey. Appendix A provides an overview of the survey.

The survey contained two key question. The first asked respondent subjects to provide short-term forecast and was stated: "At the end of 2013 I expect that the value of MBI10 will be: ". The second question asked respondent subjects to provide long-term forecast and stated: "After 10 years, I expect that the value of MBI10 will be: ". Moreover, in both cases the respondents were asked to express their expectations about the value of MBI10 in three scenarios: lowest value, most likely value and the highest expected value. The third question asked them to indicate in which area belongs the company in which they work.

Our target group were University Professors in Finance and Economics, CFOs, Chief Accounting Officers, Treasurers, Portfolio managers, Analysts, Fund Managers, Stockbrokers, Bankers in the area of corporate lending, Risk managers in banks, insurance companies and others, Managers in insurance companies, Journalists in sections for economy and business in various media and Individual investors.

The survey was sent to 145 subjects, of whom 77 responded, which represent 53.1%, which essentially can be considered a very high response. It has been given four working days to be responded to the survey. The majority of responses were received on the first day.

3.1.2 Data integrity
In order not to give any suggestions in terms of the answer there haven't been given any additional information and additional data in order to challenge to respond only those who know the stock market very well and the overall current and expected macroeconomic, political and other environment in the Republic of Macedonia and the events and movements in the world economy. It was given only the following introduction to explain specifically what is required from the surveyed subjects: "As at 28.12.2012 - last trading day of the year - the value MBI10 Index was 1,731.2. Please give your short-term and long-term forecasts for the future value of MBI10 Index." Despite, we received extremes in the responses.

Thus, some showed that the value of the index will be 1,000, which actually is the value of its initial level of the MBI10 Index on its introduction on January 1, 2005. Others expressed overoptimistic amounts, where there are some who expect that the value of the index will reach 20,000 or even 30,000. MBI10 Index reached its historic maximum before the beginning of the global financial crisis on August 31, 2007 of 10,057.77. Both responses are considered to be unrealistically optimistic and pessimistic expectations, especially since the same subjects at the same time have given very low lowest-value and extremely high highest-value, where the most likely value is somewhere in the middle between the lowest and the highest expected value (e.g., the same subject expect that the value of MBI10 Index will range from 1,500 lowest value, 15,000 most likely to 30,000 the highest value). Such responses will only contribute for excessive standard deviation and thus to a less confidence in the estimated size. Therefore, according to the approach used in Graham and Harvey (2013), there was elimination of answers that were considered unrealistic: over optimistic and over pessimistic expectations, responses with excessive range values (e.g., 1,500 to 30,000), and the so-called lazy answers where three values have been given the same amounts in the three scenarios. Finally, this led to be deleted 4 responses in both questions and assessment is carried out with the remaining 73 observations.

3.1.3 Methodology
The estimation of expected equity risk premium is derived indirectly. We were convinced that in a very yang stock market the concept of the equity risk premium is not known very well. Therefore, the surveyed subjects were asked to express their expectations about the value of the MBI10 Index after one year and after ten years. For each value they were asked to express their forecasts in three scenarios: scenario 1- the lowest value; scenario 2 - most probable value; and scenario 3 - the highest expected value. Accordingly, the series is comprised of the expected values of the Index in future time t (t = 1 and 10) for each scenario s (s = 1,2,3), i.e. it is MBI10$_{t,s}$. Thus, the expected value of the Index after one year for the scenario s is MBI10$_{1,s}$, and the expected value of the Index in the scenario s after ten years is MBI10$_{10,s}$. Based on the expected values we initially calculated the annual return in each scenario s (1,2,3).

The expected annual return E($R_{1,s}$) in the short-term forecast, in each scenario s is:

$$E(R_{1,s}) = \frac{E(MBI10_{1,s}) - MBI10}{MBI10} \cdot 100 \qquad (1)$$

Here, $E(MBI10_{1,s})$ is the expected value of the Index MBI10 after one year in the scenario s, and MBI10 is the value of the Index of 1,731.2 on the last trading day of the last year (as at December 28, 2012).

The expected annual return for the long-term forecast, for each scenario is defined as the average annual growth rate of the Index value, using geometric growth rate:

$$E(R_{10,s}) = \left(\sqrt[n-1]{\frac{E(MBI10_{10,s})}{MBI10}} - 1 \right) \cdot 100 \qquad (2)$$

Here, $E(R_{10,s})$ is the expected annual stock-market return for scenario s in long-term prognosis (average annual growth rate of the Index value), $E(MBI10_{10,s})$ is the expected value of the Index after 10 years in the scenario s, and MBI10 is the value of the Index on last trading day of the preceding year (as at 28.12.2012).

Given that there are three scenarios and three expected values of the MBI10 Index - lowest, most probable and highest expected value - the expected return $E(R_i)$ for observation i is defined as a sum of the products of the expected returns $E(R_s)$ and the corresponding probability $P_{(s)i}$ in each scenario s. Thus, the expected market return $E(R_i)$ is a weighted average return of the expected returns $E(R_s)$ in the three scenarios $s = 1,2,3$, where, the weight is the probability for that scenario. The likelihood of achieving the lowest and highest value of the index is assumed to be 15%, as it is in the most finance books, i.e. $P_{(1)} = P_{(3)} = 0.15$, and the probability of the most probable value is 70%, i.e. $P_{(2)} = 0.70$.
Expected returns for observation i is calculated as:

$$E(R_i) = \sum_{s=1}^{3} E(R_{s,i}) \cdot P_{(s)i} \qquad (3)$$

Here, $E(R_i)$ is the expected weighted annual return for observation i; $E(R_{s,i})$ is the expected return for the scenario s for observation i; $P_{(s)i}$ is the probability for scenario s for the observed response i.
Finally, the expected equity risk premium for the observed response i is the expected incremental return over the risk-free rate of return:

$$E(ERP_i) = E(R_i) - R_f \qquad (4)$$

Here, $E(ERP_i)$ is the expected equity risk premium for the observed response i; and R_f is the current risk free rate.
The main problem here, as it is in many emerging and developing market is what risk free rate to be used. There is agreement among the financial theorist and practitioners that the yield on the government bond provides that measure, besides there is not agreement whether this should be the short term or long term security. Bonds issued by the government of the Republic of Macedonia do not fulfill the definition for the risk-free assets according to Damodaran (2008); therefore, we use the German government bond yields as a risk-free rate. According to this author, and considering the recent European public debt crisis with defaults on government bonds, the only risk-free rate can be the yield on government bonds of a country with AAA credit rating. Macedonia has a fixed exchange rate toward the EURO, it is an aspirant for membership in EU, and has the grates trade exchange of goods and services with Germany. Thus, the yield on German bond is the best benchmark for the risk-free rate.

4. Results – expected market return and expected equity risk premim
Table 1 shows the results of the analysis. Academics and practitioners expected return on the MBI10 Index for 2013 is 12.14%. The current yield on the German 10-year government bond is 1.3%, which generates the expected risk premium for 2013 of 10.84%. Expectations for the next ten years are that the average annual return of the MBI10 Index will be 12.22%, which generates a risk premium of 10.92%. Short-term forecasts are nearly equal to long-term with minimally greater optimism in the long-term prognosis.

Although returns and risk premiums are approximately the same on the short and on long term, however the deviations are significantly different. We calculate the standard deviation as a measure of risk,

which is also taken as a measure of disagreement of the subjects regarding the forecasted size. The standard deviation of the short-term forecast is twice as high than the short-term. We calculate the semideviation as a measure of the likelihood of achieving returns lower than expected, and it has a similar size as the standard deviation.

Table 1. Summary statistics of expected market risk premium in the Republic of Macedonia based on the survey approach

	Short-tem forecst		Long- term forecats	
	Expected Return on MBI10 in 2013	Expected Equity Risk Premium for 2013	Expected Average Annual Return on MBI10 for the next 10 years	Expected Average Annual ERP for the next 10 years
Mean	12.14%	10.84%	12.22%	10.92%
Median	12.35%	11.05%	12.44%	11.14%
Maximum	45.71%	44.41%	25.49%	24.19%
Minimum	-14.22%	-15.52%	1.09%	-0.21%
Std. Dev.	11.48%	11.48%	5.68%	5.68%
Semideviation	11.32%	11.32%	5.63%	5.63%
Skewness	0.126	0.126	0.066	0.066
Kurtosis	3.404	3.404	2.409	2.409
Jarque-Bera	0.690	0.690	1.116	1.116
Observations	73	73	73	73

Source: Author's calculations

The stock market returns and the ERP has positive skewness in the short-term as well in the long-term, which is normal for investors who want to earn returns that are higher than the expected retirns. The kurtosis of the premium and the returns in short-term forecast is lower than normal, but is higher than the normal in long-term prognosis.

The distribution is not normal nor in returns nor in the risk premium. Figure 4 show the distributions.

Figure 4. Distribution of returns and equity risk premium
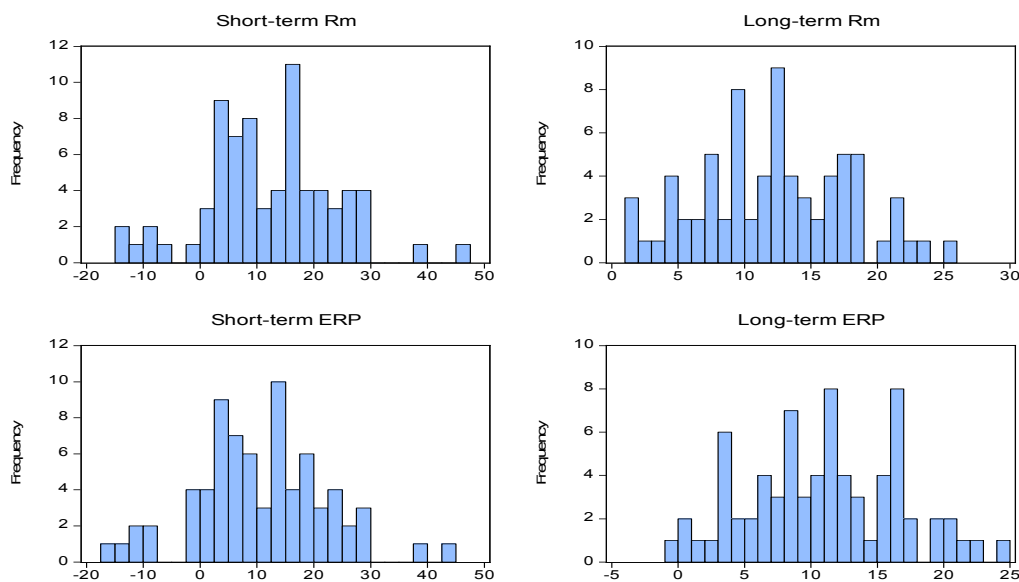
Source: Author's calculations

Based on the estimated returns on MBI10, Table 2 gives the expected values of MBI10 Index at the end of 2013 and after 10 years. Clearly, by the end of the year the index is unlikely to exceed 2,000. After ten years MBI10 Index most likely will reach nearly 6,000, which is far less than the highest historical value.

Table 2. Expected value on MBI10 Index

	Realized value on MBI10 Index in 2012	Expected value on MBI10 at the end of 2013 *	Expected value on MBI10 Index in 2022 **	Expected value on MBI10 Index in 2022 ***
Mean	1,890.38	1,941.35	5,483.94	5,988.24
Median	1,864.94	1,945.00	5,591.50	6,105.69
Maximum	2,167.67	2,522.50	16,770.31	18,312.48
Minimum	1,704.75	1,485.00	1,929.61	2,107.06

Source: Author's calculations

* **The value on MBI10 on the last day of trading, at** 28.12.2012, amounted 1.731,18
** **Based on the** last **value** of **MBI10 Index in 2012 which** amounted 1.731,18
*** **Based on the average value of MBI10 Index in 2012 which amounted** 1.890,38

The analysis below shows the differences in expectations between the two classes of participants: professors and practitioners. Figures 5 and 6 depicts the results.

On a short term, it is obvious that the academics are more optimistic than practitioners. Professors expect that the return on MBI10 Index will be 13.3%, which is above the average of the whole number of respondents (of 12.14%), and practitioners have lower expectations, and believe MBI10 Index will grow by 11.7% which is less than the entire average. However, the degree of disagreement with forecasted growth measured by the standard deviation is also higher among the professors. The same conclusions are in terms of the expected risk premium. Namely, professors are more risk-averse and expect higher compensation for the risk undertaken on short term of 12% compared to 10.4% for practitioners.

Long-term forecasts are reversed. Practitioners are more optimistic and expect average annual growth of 12.8% of MBI10 Index compared with 10.7% of the professors. The average of entire number of respondents is 12.22%. Also, practitioners expect greater compensation for the risk undertaken of 11.5%, compared to 9.4% for professors. The standard deviation is similar in both classes of respondents which is twice lower than the short-term forecasts.

Figure 5. Short-term forecasts of professors and practitioners
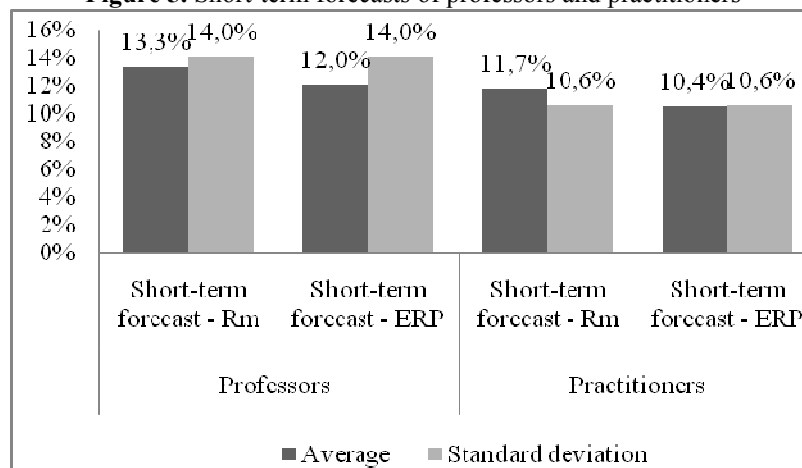
Source: Author's calculations

Figure 6. Long-term forecasts of professors and practitioners
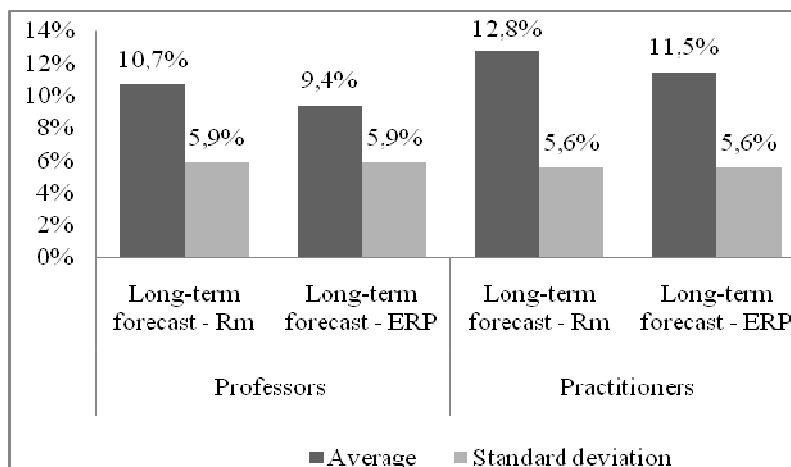
Source: Author's calculations

5. Results – realized market return and realized equiry risk premium

In circumstances where a bank deposits had large growth of 6%, the high risk aversion which is inherited from 2008 contributed to the lack of interest of investors to invest in equity shares in 2013, the weak trading volume and status quo at the Macedonian Stock Exchange. The realized value of MBI 10 on the last trading day, December 30, 2013, was 1,738.86 and was much smaller than the size that was expected by market participants and analysts on average of 1,941.35 . Thus , the realized annual return in 2013 was 0.44 % . The risk free rate measured by the size of the German bond yield at the end of December stood at 1.8 % . As a result , the expected risk premium of 10.84 % was not achieved. The realized annual equity risk premium was negative and amounted to -1.36 %. It is obvious that this yang and volatile market does not provide the proper priceing of the equity shares and gives the wrong signals for the analysts. It is clear that the historical data in this emerging market are not relevant. Rational expectations of investors gives better picture of reality.

6. Conclusion

The equity risk premium is one of the curtail parameter in corporate finance and assets pricing. It is a calculative parameter in every risk-return model as the CAPM, its derivations, the APT etc. Besides it is not a perfect model, CAPM is the mostly accepted and applied especially in the case of the developed market. The estimation of the ERP is a difficult in the most developed and mature equity markets with long history, and is even harder in the yang markets of the small and open emerging markets economies as are the post communistic countries in Southeast Europe. The economy of the Republic of Macedonian belongs to the group of emerging markets, and accordingly the capital market is underdeveloped, both in terms of representation of various financial instruments and the volume of trading in the existing. Thus, the capital market in Macedonia shares the same characteristics of emerging markets. The time series of data is too short and volatile, and furthermore there is no relevant financial instrument as a benchmark for risk-free asset.

Besides in the last five years the market returns on the Macedonian Stock exchange is negative, the historical realized annual **average ERP** is positive and amounts to 11.66% (Naumoski, A., 2013). It is obvious that in the yang market, with short and volatile history, the historical realized returns are not enough for predicting the future. In our paper we estimated the ERP using survey of academics and practitioners. We derived the expected ERP indirectly by asking the surveyed subject for their expectations about the value of the stock market Index MBI10. This is because we thought that most of the subjects do not understand the concept of ERP. Their answers allowed us to calculate the expected market return for 2013 of 12.14% and the average return for the next 10 years to 2023 of 12.22%. Accordingly the expected equity risk premium amounts to 10.84% and 10.92%. Compared with the other studies for different countries this amounts are similar with the other emerging markets in the world and pretty much higher than the developed markets. This typically depict the risk-return relationship which exist in the investors' perceptions for emerging markets as more risky markets, which requires higher compensation for the risk undertaken.

The realized annual risk premium in 2013 was negative and amounted to -1.36%, versus expectations of +10.84%. In fact, the realized returns on the Macedonian Stock Exchange in the last five years continuously are lower than the risk-free rate of return. The key question is whether in the analysis in corporate finance and valuation in this young market should be used a negative risk premium? If the equity risk premium is assessed in the light of historical data then one should take a negative equity risk premium. In fact, this young and underdeveloped market, where the behavior of the domestic investors is irrational and the foreign investors are absent, prevents a proper pracing of the shares. In a situation where in the last few years domestic companies

show continuous growth of earnings and most of them regularly paid dividends, inherited risk aversion from the huge drop in the stock market after 2008 makes investors high risk averse and not interested for investing in stocks. Thus the stock market is inefficient and does not allow shares to have their true value. Hence, the negative risk premium should not be taken in the analysis. The surveys of rational expectations of market participants and analysts on average provide more relevant data for analysis than actual historical data.

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