Q. Referring to page 27, lines 14-17: Please explain why analysis of historic risk premiums should consider the U.S. equity market rather than other world equity markets. Would the result be different if other world equity markets were considered? Please explain and document your answer.

A. The consideration of the U.S. market results arises from the following:

(1) The S&P 500 is regarded globally as an equity market benchmark;

(2) The U.S. equity market comprises over half of the world equity capitalization;

(3) The U.S. equity market is the most integrated of world markets with the Canadian market;

(4) The U.S. market represents the highest proportion of foreign equity investment on the part of Canadian investors.

The "world market" historic risk premiums were presented by Elroy Dimson, Paul Marsh and Mike Staunton in <u>Triumph of the Optimists: 101 Years of Global Investment Returns</u>, Princeton, N.J.: Princeton University Press, 2002, from the point of view of a U.S. investor (i.e., returns translated into U.S. dollars). For the period 1900-2000, the risk premium vs. bonds was reported as 4.6% on a geometric basis and 5.6% on an arithmetic basis. For the second half of the century, the geometric risk premium was 5.3%; the arithmetic risk premium was not provided, but, given the relationship between arithmetic and geometric returns, it would be in excess of 5.3%.

Focusing on the second largest destination of Canadian foreign equity investment, the U.K., the historic risk premiums (1947-2002) were 5.9% on an arithmetic average basis and 5.5% on a geometric basis (*Equity Gilt Study*, Barclays Capital).