Malaysia's Equity Risk Premium Gets a Boost: December 2022 Update

Understanding the Latest Developments and Implications for Investors and Professionals

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Introduction

The equity risk premium (ERP) reflects the investors' expectation about the risk in a market and how much to price the risk associated with the general market.

Under the Capital Asset Pricing Model (CAPM), ERP plays an influential role in estimating the cost of equity. It measures how much return an investor can expect from shares compared to a risk-free investment.

Investors can make better and more informed investment decisions if they understand how ERP prices their investments through the cost of capital and discount rates.

Recent Economic Outlook

Malaysia's economy looks optimistic. In 2022, the country was projected to see a solid growth recovery following a contraction in 2020. The economy is projected to grow by 4% in 2023, driven by domestic demand, government spending, and new stimulus measures. Services, such as tourism, retail, and other services, are expected to contribute significantly to the growth. The annual inflation rate in 2022 is expected to remain modest, averaging around 3%.

The FTSE Bursa Malaysia KLCI index (KLSE) returned reasonable returns in 2022, indicating a better-than-expected year for the KLSE. A combination of domestic and global factors contributed to the KLSE's growth, despite the challenges posed by the COVID-19 pandemic. The Bursa Malaysia continues to be an established player in the Southeast Asian market. It is also a source of opportunities for investors looking to take advantage of Malaysia's economic recovery as we move into 2023.

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Risk-Free Rate

Risk-free rates refer to rates of return on investments that are guaranteed to be secure and without default risk. A risk-free rate is the minimum rate of return an investor would expect on their investments.

Finance practitioners sometimes refer to an adjusted long-term sovereign bond yield as a risk-free rate. However, this paper will not discuss various potential adjustments to calculate the risk-free rate.

For illustration purposes, we use the 10-year Malaysian Government Securities yield as a risk-free rate to arrive at the base cost of equity.

Base Cost of Equity

The Cost of Equity is the rate of return an equity investor requires by the investment's potential return.

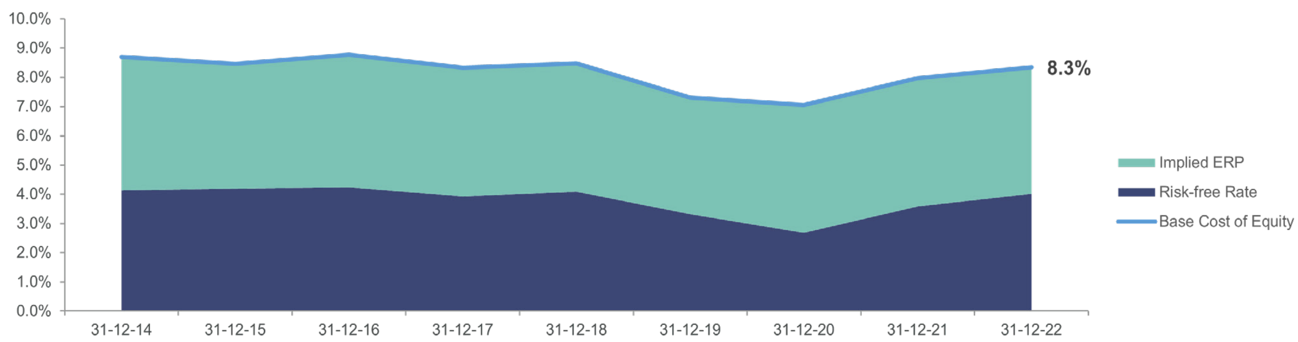
It is reasonable for investors to expect an inevitable return on investments in the equity market. The base cost of equity provides an estimation based on the current market conditions.

A base cost of equity is computed using the CAPM, assuming a beta of 1.0 for the overall Malaysian equity market with the reported risk-free rate.

The base cost of equity is computed using a bottom-up implied premium estimate. The bottom-up implied premium method estimates a forward-looking premium using current market prices.

The base cost of equity in the Malaysian equity market as of 31 December 2022 is as follows:

The Base Cost of Equity in Malaysia stood at 8.3% as of 31 December 2022. It resembles the historical average since 2014.



Source: Mazars' Analysis

Implied ERP

When all the ingredients are available, it should be relatively easy to derive the implied ERP. The implied ERP can be computed by subtracting the risk-free rate from the base cost of equity.

The computed implied ERP is determined using information as at on 31 December 2022, but market conditions and risks may require specific changes over time. There will be a negative impact on the valuation of investments on a global scale as a result of heightened levels of uncertainty. A reevaluation of the cost of capital assumptions is warranted due to the uncertainty generated by these events.

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