The research of Elroy Dimson, PaulMarsh and Mike Staunton on long-run global asset returns has a potential impact on every investment decision made by individuals, institutional investors and companies. Praised by Nobel Laureate William F Sharpe as “a Herculean task” their work has had a far bigger impact than they anticipated 15 years earlier when they first embarked on it.

In 1999, with a new millennium approaching, Dimson, Marsh and Staunton (or DMS as they’re collectively known) decided to mark the occasion by assembling a 100-year record of UK stock market and other asset returns. This involved extending their earlier study on returns since 1955, using the London Share Price Database, which was set up at London Business School in the 1970s. Staunton is Director of the Database. Dimson and Marsh are both Finance Professors at the School.

Global ambitions: assembling the facts

Friends in the City, however, urged them to be more ambitious, and to cover other countries as well. Rising to the challenge, DMS painstakingly assembled data for 12 countries. At the start of 2000, their findings were published as the Millennium Book. A millennium, is, of course, 1000 years, but as Dimson explains, “if you have 100 years of data for 12 countries, you have well over a millennium of country-years”.

The Millennium Book generated great interest among investors, bankers, companies, regulators and other academics. Encouraged by this, DMS expanded the project and, in 2002, published an influential investment book on long-run returns, Triumph of the Optimists. Since then, the project has grown, and each year the latest DMS findings are published in the Global Investment Returns Yearbook and a companion Sourcebook. Their data now embraces 23 countries, covers all the major asset classes, and spans 114 years since 1900. It includes countries like Russia and China where people lost all their money following revolutions, and Germany, Japan and Austria-Hungary where investment returns were damaged by world wars.

Key findings

“To most people it’s not immediately obvious why finance professionals get excited about long-run historical asset returns,” says Dimson. “But the reason is simple. An analysis of past returns provides us with the only guidance we have as to what we can expect from our investments in the future – in terms of risk and return.”

As Marsh explains: “When we started this project, we were concerned that everything that people thought they ‘knew’ about investment returns came from a set of US figures. Yet America has been the world’s most successful economy over the last century. So US numbers were likely to suffer from success bias and be higher than elsewhere, and indeed higher than Americans can expect in the future. And that was precisely what we found.”

The DMS research challenged what’s often referred to as the “most important number in finance” – the equity risk premium (ERP). This is the premium, or extra return that investors need in order to induce them to invest in risky equities rather than safe cash. Prior to the DMS research, conventional wisdom based on US data indicated an ERP figure of 6–7 per cent.

But the DMS research found that historically, the world index – as opposed to just the United States – had generated a much lower ERP of only just over 4 per cent. Their analysis also indicated that even this was too high as, historically, investors had benefitted from favourable factors that were unlikely to be repeated. In effect, they’d got lucky – hence the title of DMS’s book, Triumph of the Optimists. The DMS analysis suggested that prospectively, the ERP was likely to be between 3 and 3½ per cent – around half the figure previously believed.

The impact of the research

The DMS research findings have a huge potential impact. For example, individuals who are saving, whether for their future retirement, school fees or their daughter’s wedding, need to decide how much to put aside each year. They’ll base this decision on the returns they expect to achieve. If these are lower than previously believed, they’ll need to put aside more.

Similar considerations apply to institutional investors who are investing on behalf of pensions funds, acting as wealth managers for individuals or offering financial savings products. Indeed, a recent review by the UK’s Financial Services Authority, which leaned heavily on DMS’s research, resulted in a downward revision of the investment returns that financial product manufacturers and distributors were allowed to project.

The DMS research also has important implications for companies. When deciding whether to go ahead with a new project, companies look at their expected rates of return, and compare this with their cost of capital. If the ERP is lower than previously believed, so is their cost of capital. So projects that might previously have seemed
marginal will now look more attractive. As Staunton explains: “Numerous companies have used the DMS research to recalibrate their cost of capital.”

Regulators, too, are concerned with the ERP as they need to ensure that regulated utilities don’t overcharge their customers. Companies are allowed to earn a fair rate of return that covers their cost of capital, which of course depends on the ERP. A lower ERP implies lower prices for consumers. In the UK all the major regulators covering water, gas, electricity, rail, aviation and communications have made heavy usage of the DMS data in their rulings on what constitutes a fair return. Regulators in many other countries have also placed reliance on the DMS data.

Not surprisingly the DMS findings have had huge coverage in the press – since 1999 the team’s research has been described and cited in more than 2,200 press articles in at least 50 countries.

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