

When the equity risk premium fades, alpha shines

- As the equity risk premium fades, alpha becomes a critical return driver
- Quant alpha is robust during low-return markets and economic downturns
- Future low equity returns might shift investors back from passive to active

Historically, the market (beta) gave great returns just by being in it. But those days may be ending. In a future where the market returns less, investors will need to rely more on alpha – returns from skill and strategy.

For the past century, US equities have delivered an average annual return of 10%. The equity risk premium (ERP), in other words, the extra return investors get for investing in stocks over other asset classes, has long been a cornerstone of investing. Historically the ERP has provided a 5% excess return over bonds and 6% over cash. In this framework, alpha – the additional return from fundamental or quantitative active management – was often considered a secondary benefit, contributing only a modest share of total returns even for the best investors.

However, the conditions that fueled this historical ERP are changing. Expanding valuation multiples, strong earnings growth, favorable demographics, and US market dominance in the last decades were the key tailwinds supporting those high equity returns. And today, many of these forces are weakening. Valuation multiples are at all-time highs, dividend yields are subdued, and real earnings growth faces structural headwinds. As the tailwinds of beta diminish, the role of alpha will become increasingly vital.

The equity premium mean reverts

From 2015 to 2024, the realized US equity premium averaged 10.6%, well above the long-term historical average of 6.2% (1926–2024). Many investors active today have in fact never experienced negative equity returns, and have grown accustomed to strong performance. However, history tells a different story, with prolonged periods of weak or even negative returns in the 1930s, 1970s, and early 2000s.

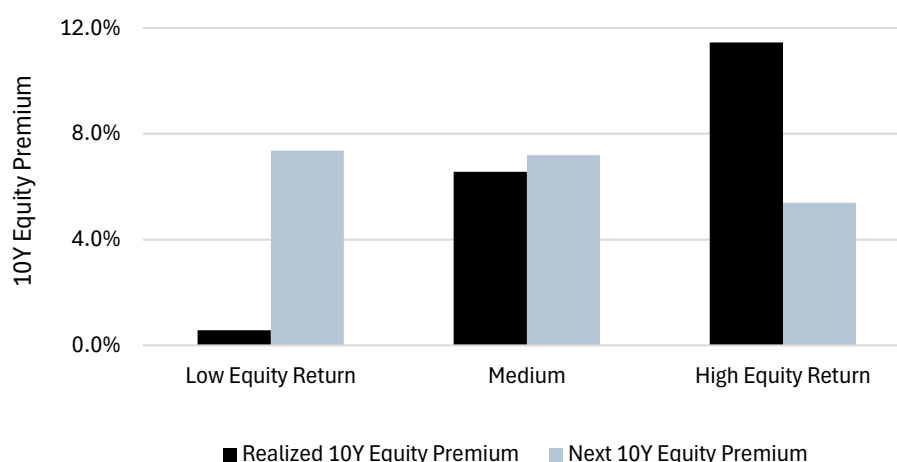
A simple way to assess future equity returns is to examine past equity return patterns. What does a strong 10-year return tell us about the decade to come? To explore this, we categorize historical 10-year realized equity premiums into three groups – low, medium, and high – and analyze the returns that followed.

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Figure 1 | Realized and subsequent US 10-year equity premiums

Source: Robeco and Kenneth French Data library. US stock market returns 1926-2024. This graph is for illustrative purposes only and does not represent an actual product or strategy.

The data supports the principle of mean reversion: strong equity market returns are often followed by weaker returns, and vice versa. Historically, after a decade of high returns, the following decade has tended to underperform by approximately 1% relative to the long-term average. Conversely, after a weak decade, returns have typically been about 1% above the long-term average.

Is the equity risk premium shrinking to zero?

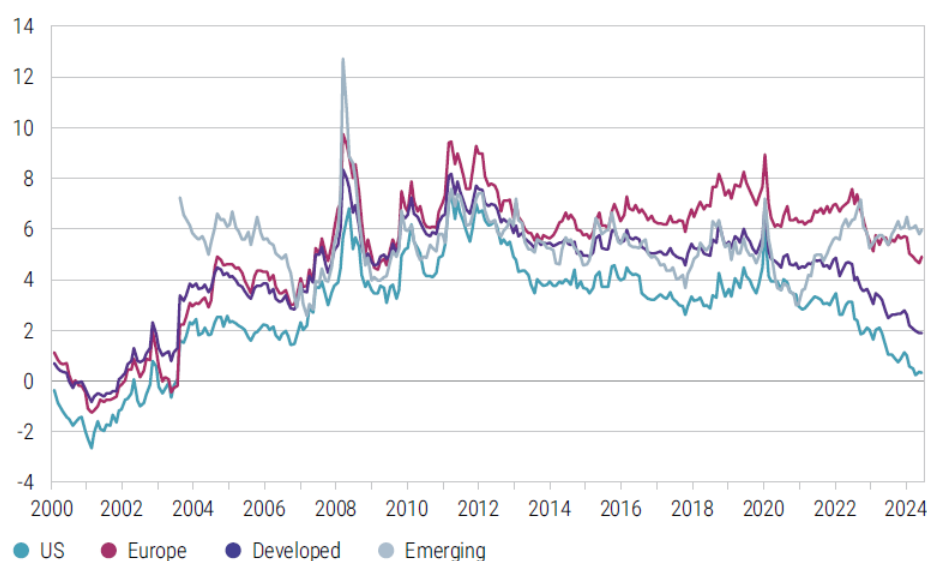
While mean reversion provides a useful framework, it oversimplifies the drivers of future returns. A deeper analysis of historical return decomposition reveals what fueled past performance. Our recent research shows that the recent US equity rally was not only driven by earnings growth but also by a significant expansion in valuation multiples—particularly in large-cap growth stocks.¹ Less recognized is that small caps and low-volatility stocks delivered strong fundamentals but remained undervalued.

This raises concerns about the sustainability of future returns, especially as valuations remain historically elevated and the US market now comprises 74% of the total global market capitalization. A more comprehensive approach, rooted in economic first principles, considers the fundamental components of the equity risk premium—dividends, valuation changes, and expected earnings growth—over a 10-year horizon.

Estimating expected equity returns requires sophisticated assumptions, and methodologies vary across asset managers. Yet, despite these differences, a common theme emerges: most asset managers forecast low future equity returns. Valuation-based models from Research Affiliates, Vanguard, AQR, and GMO suggest that the forward-looking equity risk premium (ERP) for US equities could approach zero—or even turn negative.

One key indicator supporting this outlook is the cyclically adjusted price-to-earnings (CAPE) ratio, which remains near historic highs for US markets. A broader, multi-metric valuation approach yields a similar conclusion. Robeco's five-year outlook 2025-2029, which integrates multiple valuation metrics along with growth estimates, projects the US equity premium will be close to zero. However, the global outlook is more favorable—driven by more attractive valuations in Europe and emerging markets, where the global ERP stands at approximately 2%.

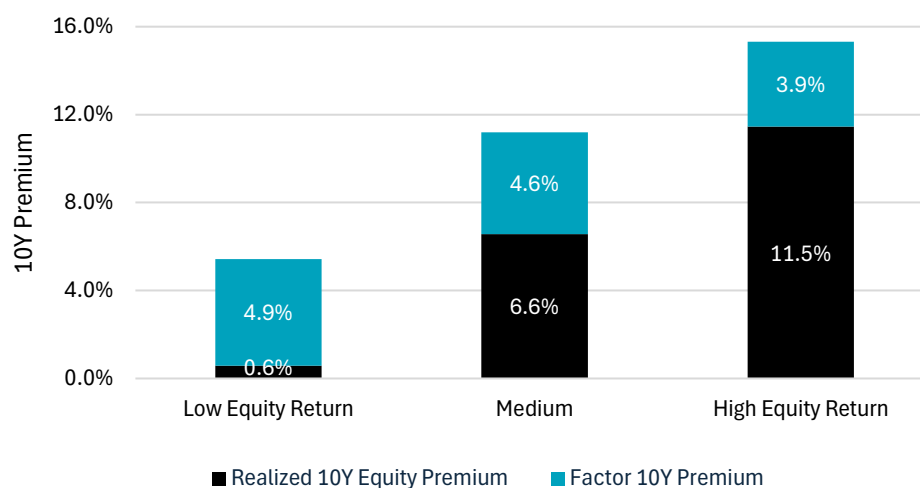
¹ Blitz, D. 'Decomposing equity returns: Earnings growth vs multiple expansion', Robeco white paper, 2025.

Figure 2 | Implied equity risk premiums

Source: Robeco 5-year outlook: 'Atlas Lifted: Expected Returns 2025-2029'. This graph is for illustration purposes only and does not represent an actual product or strategy.

Lower equity premium, higher factor premium?

Interestingly, periods of strong equity performance often coincide with lower factor premiums, and vice versa. To explore this relationship, we use the US value and momentum factors as a rough proxy for active quantitative investing. We split the sample into three segments based on realized 10-year equity premiums.

Figure 3 | Realized US equity premiums

Source: Robeco and Kenneth French Data library. Sample US 1926-2024. This graph is for illustrative purposes only and does not represent an actual product or strategy.

The results reveal that factor premiums remain stable – and even rise slightly – when equity returns are low. The annualized alpha increases from 3.9% to 4.6% to 4.9% as equity returns decline. The low-volatility factor is excluded here, as its premium is, by definition, most pronounced during periods of weak market performance – making it even more skewed to low-return environments.

Most strikingly, when viewed as a share of total returns, the contribution from alpha surges from 25% (3.9% of 15.4%) to 89% (4.9% of 5.5%) as equity returns fall. In such environments, alpha shifts from a complement to the dominant source of performance. This inverse relationship between alpha and market conditions is not only observable in data, but also well-supported by academic research.

The dynamics of alpha

Academic studies have extensively analyzed how active mutual fund managers perform across different market regimes, particularly during economic expansions and recessions. Kosowski (2011) finds that mutual funds generate higher alpha during economic downturns – precisely when investors need it most.² His study shows that during recessions, which occur roughly 12% of the time, mutual funds achieve an average alpha of +4.1%, whereas during expansions, alpha turns negative at -1.3%. This highlights the potential value of active management in challenging market environments, where skill-based strategies can provide a meaningful edge.

Research on factor investing further supports this asymmetry in alpha. Blitz (2023) finds that factor alphas tend to rise when equity market returns are lower, reinforcing the importance of factors in a low-equity-premium environment.³ Even if factor alphas remain constant across regimes, their relative contribution to total returns increases when market beta weakens. In such periods, factors like value, low volatility, quality, and momentum offer an alternative, uncorrelated source of alpha.

A broader historical perspective confirms this resilience. Using a global sample dating back to 1870, Baltussen, Swinkels, and van Vliet (2023) find that these factor premiums performed well across market cycles, particularly during periods of high inflation and low economic growth.⁴ This underscores their role as a compelling strategy for generating alpha when traditional equity returns fall short.

Beyond beta: Investing in a low ERP world

Over the past decade, the US ERP averaged 10.6%, far above the long-term norm of 6.2% – and well above forward-looking estimates that suggest a much lower, if not zero, premium ahead. What if the ERP collapses to zero over the next decade, erasing the elevated returns investors have come to expect from stocks?

In such a scenario, market beta would no longer be the primary driver of returns. With positive returns becoming scarcer, investors would be forced to rethink their approach. Traditionally, broad market exposure delivered most of the returns, with alpha serving as an enhancement. But in a low-ERP world, this dynamic reverses – alpha shifts from being an optional bonus to an essential source of return.

As traditional sources of return diminish, investors will be forced to seek alternatives, reshaping market dynamics. Strategies that have historically delivered alpha – whether through defensive factors, long-short approaches, or high-active-share investing – may attract substantial capital inflows, as investors seek more adaptive, uncorrelated return streams. This could elevate valuations for assets tied to proven alpha strategies, potentially distorting factor pricing and altering market behavior, reversing the multi-decade trend towards passive investing.

Meanwhile, a prolonged period of weak ERP in the US could accelerate a shift toward other markets, potentially ending the US's market dominance over the past decade. As of 2025, Europe and Asia already offer higher expected ERPs (see Figure 2), positioning them as key beneficiaries of shifting global capital flows. Small caps and equal-weighted strategies could also benefit in this environment.

² Kosowski, R. 'Do mutual funds perform when it matters most to investors? US mutual fund performance and risk in recessions and expansions,' *The Quarterly Journal of Finance*, 1(3), 607–664, 2011.

³ Blitz, D. 'The cross-section of factor returns', *The Journal of Portfolio Management*, 50(3), 74–89, 2023.

⁴ Baltussen, G., Swinkels, L., van Vliet, B., & van Vliet, P. 'Investing in deflation, inflation, and stagflation regimes', *Financial Analysts Journal*, 79(3), 5–32, 2023.

Conclusion: Adapting to a low-ERP world

A declining equity risk premium does not signal the end of investing – but it does call for a more active approach. With beta-driven returns under pressure, investors must prioritize alpha. Systematic strategies with clear objectives can help investors to achieve meaningful capital growth using alpha from multiple factors. Robeco's quant strategies offer a structured approach to navigating this evolving investment landscape:

- **Active Quant Equities** provide diversified exposure to multiple factors and proprietary signals, with a strong emphasis on risk control – making them well-suited for a declining ERP environment. Since valuation is not a reliable timing indicator, this strategy remains effective even in buoyant markets, allowing investors to avoid the need to time this allocation.
- **Defensive Equities** tend to outperform in low-ERP environments. By reducing reliance on traditional beta-driven strategies and enhancing diversification, they strengthen long-term risk-adjusted performance. In volatile markets, they provide a cushioning effect, maintaining resilience in sideways, low-growth conditions and generating significantly higher alpha in downturns – proving that the key to winning is losing less.

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Appendix A: Selected Robeco quant strategies

Robeco's Quant Active Equities strategy employs a disciplined, systematic approach to capture high alpha by leveraging well-established factor premiums such as value, momentum, and quality. The strategy integrates multiple sustainability dimensions and utilizes a proprietary portfolio construction algorithm to balance risk, return, and sustainability considerations, aiming for stable excess returns. Since its inception in 2008, this approach has consistently delivered cost-efficient outperformance. Please visit the strategy page on the Robeco website for more information.

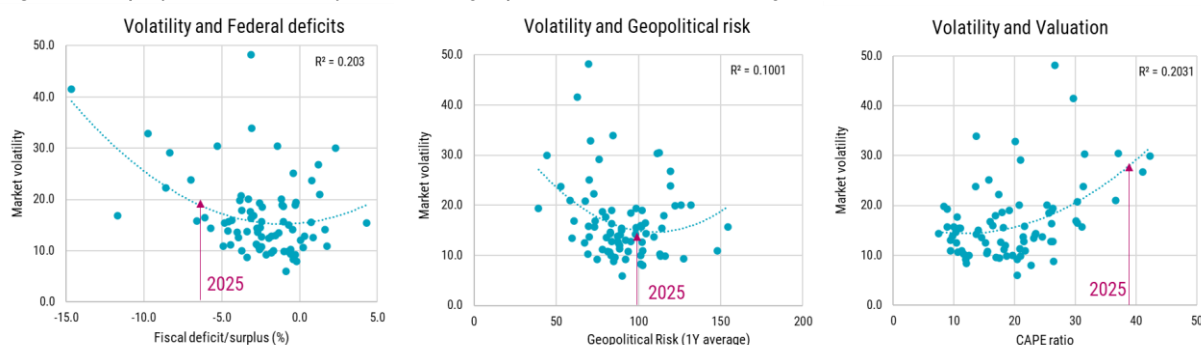
Robeco's Defensive Equities, launched in 2006, aims to achieve steady capital growth by focusing on capital preservation, portfolio diversification, and reliable dividend income. It leverages the low-risk anomaly, selecting defensive stocks through a proprietary process that combines multiple risk dimensions and return factors to enhance risk-adjusted returns over a full market cycle. The strategy employs both backward-looking risk measures and forward-looking distress indicators to limit downside risk and has successfully delivered positive alpha since inception. Please visit the strategy page on the Robeco website for more information.

Appendix B: What drives equity market volatility?

Despite a century of market data, there are only approximately ten truly independent 10-year return observations. To enhance predictive power, an alternative approach examines the underlying economic forces that drive equity market risk and their relationship with future equity returns. This method provides more independent observations and a clearer link between risk and future returns. When risk rises, stock prices tend to decline, leading to lower equity returns in subsequent years.

This brief analysis tests three commonly cited predictors of equity market volatility: government deficits, geopolitical risk, and market valuation.

Figure A | Equity market volatility and fiscal, geopolitical, and valuation regimes



Source: Robeco: St. Louis Fed (US deficits), policyuncertainty.com, Shiller Database. Market volatility is based on 260-day returns. Sample period US 1947-2024. These charts are for illustrative purposes only and do not represent any actual product or strategy.

Historically, US equity market volatility has averaged around 20% over a 260-day period. Among the tested factors, stock market valuation emerges as the strongest predictor of next-year volatility, followed by government deficits. Given current conditions, the outlook for 2025 suggests a significant increase in market volatility.

This finding aligns with earlier research we carried out in 2021, which established a significant positive relationship between the cyclically adjusted price-to-earnings (CAPE) ratio and future downside risk.⁵ High valuations have frequently coincided with increased market volatility, reinforcing the link between valuation levels and market fragility.

⁵ Van Vliet, P., 'Risky CAPE: Is there an alternative?', Robeco insight, 2021.

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