Report on Bachelor / Master Thesis

Institute of Economic Studies, Faculty of Social Sciences, Charles University in Prague

Student:	Hrachovec, Miloš
Advisor:	Doc. Ing. Tomáš Cahlík CSc.
Title of the thesis:	Equity Premium Puzzle: Literature Review and the Czech Data

OVERALL ASSESSMENT *(provided in English, Czech, or Slovak):*

Miloš analyzes two interrlated puzzles – the equity premium puzzle, and the risk-free rate puzzle – in the Czech setting. He empirically analyzes the existence of these two puzzles in the Czech Republic between 1995 and 2011 and concludes that the equity premium puzzle is not present while the risk-free rate puzzle is present in the used dataset.

There seem to be two major components of the author's contribution. First, Miloš provides an extensive litrature review that systematizes the exisitng literature. Second, he empirically estimates the magnitude of the puzzles in the Czech Republic. I find both of the two components problematic.

First, I do not find contributing with a literature review (regardless of the quality) sufficiently ambitious for a Master's Thesis (unlike in a Bachelor's Thesis). In addition, a literature review can be valuable in case it provides new insights and discovers unnoticed connections between the studies. I do not find many new enlightening perspectives in the provided review. Besides, the classification of research streams sometimes seems counter-intuitive, e.g. *"These include risk-based explanations, non-risk based explanations and behavioral finance perspective."* (abstract). To me behavioral finance explanations are typically treated as (a type of) non-risk based explanations. Hence, some parts of the review seem confusing. Should these perhaps be called "microstructure-based explanations"? How should the "habbit formation" be classified in this setting? Finally, I would expect the author to include some synthesis at the end of the literature review section to inform the reader about the "current state of the discourse" rather than simply enumerating the individual streams.

Second, the estimation of the puzzles may be severely affected by the small and very illiquid Czech market where the premia may simply reflect compensation for microstructure imperfections rather than investor preferences. In addition, is the realized inflation (measured by CPI) likely to correspond with the expected inflation in the Scech setting (esp. in the transformation years)? Were the Czech governmental bonds considered risk-free in 1990s? May this have an impact on the documented risk-free rate puzzle? Besides, long time-series are typically required for reasonable tests of these anomalies/puzzles. These do not exist for emerging markets, e.g. Prague Stock Exchange. See for example Dimson, Marsh, Staunton (2008). Finally, it does not seem to me that the empirical analysis can help up discriminate betweeh the individual competing explanations outlined in the first section, which should be the ultimate aim of any empirical work.

The thesis is longer than what would be necessary to cover the discussed material well.

At the oral defence the committee may ask Miloš to explain why the high level of equity premium is in fact a puzzle. Cannot we simply say that people are quite risk averse and hence require a farily high compensation to hold risky assets relative to the riskless one? What evidence do we have that contradicts this alternative and more benign explanation?

The thesis is quite well written and structured and all the major building blocks in place. Despite of its merits, the original contribution should be better motivated with the emphasis on the potential implications of the study.I recommend the grade **"1 - výborně"** for the thesis in case the author is able to clarify my concerns at the oral defence.

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SUMMARY OF POINTS AWARDED (for details, see below):

CATEGORY		POINTS
Literature	*(max. 20 points)*	16
Methods	*(max. 30 points)*	26
Contribution	*(max. 30 points)*	22
Manuscript Form	*(max. 20 points)*	18
TOTAL POINTS	*(max. 100 points)*	**82**
GRADE	**(1 – 2 – 3 – 4)**	1

NAME OF THE REFEREE: Jiří Novák

DATE OF EVALUATION: **January 17, 2013**

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Referee Signature