THE GROUNDWORK — ARTICLE 03

Risk Premium Explained

What it is, why it exists, and how it differs across the assets in your portfolio

In the previous two articles, we established two things. First, that **beta** — passive, diversified market exposure — is the most reliable source of long-term returns. Second, that doing nothing with your capital has a real and compounding cost. The mechanism connecting these two ideas is the **risk premium**: the excess return that assets offer above the return on cash, as compensation for bearing risk.

We have used the term several times already, but we have not examined it closely. In this article, we will. Understanding the risk premium — what drives it, where it comes from, and why it varies across asset classes — is the key to understanding why a diversified portfolio works, and why some portfolios work better than others.

The Basic Mechanics

Every asset that carries risk offers an expected return above the return on cash. This excess return is the risk premium. It is not guaranteed in any given year — assets can and do lose money over short periods — but it is positive in expectation, and it has been positive in realisation over every sufficiently long time horizon in recorded financial history.

The logic is structural. Cash is useful: it can be spent, it can be lent at a known interest rate, and it carries no price risk. For an investor to give up these advantages and buy an asset that might be worth less tomorrow, they need a reason to expect a higher return. If risky assets offered the same expected return as cash, nobody would hold them. Demand would collapse, prices would fall, and the expected return would rise until a premium was re-established.

This is a self-correcting mechanism. The risk premium cannot be permanently eliminated because its absence would trigger the very market dynamics that restore it. This is why the premium has persisted across centuries, across geographies, and across every asset class with meaningful market risk. It is not a market anomaly. It is a market necessity.

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Different Assets, Different Premiums

Not all risk premiums are the same. Different asset classes expose you to different types of risk, and the premiums they offer reflect those differences. Understanding this is essential for building a portfolio that collects risk premiums from genuinely independent sources — which is the foundation of diversification.

Equities

When you buy a stock, you are buying a claim on the future earnings of a business. Those earnings are uncertain. The economy might slow, the company might face competition, its sector might fall out of favour. The equity risk premium compensates you for this uncertainty. Historically, the equity risk premium has been the largest of the major asset class premiums, reflecting the fact that equities are among the most volatile mainstream assets. Over long horizons, equities have delivered real returns in the range of 5–7% per year above cash. But the path is rough — drawdowns of 30–50% have occurred multiple times per century.

Nominal Bonds

A government bond pays you a fixed coupon and returns your principal at maturity. The risk is that interest rates change: if rates rise, the market value of your bond falls. The longer the maturity, the more sensitive the bond is to rate changes. This **duration risk** is compensated by the **term premium** — the extra yield you earn for lending over a longer period rather than rolling short-term deposits. The term premium is typically smaller than the equity premium, reflecting the lower volatility of bonds. But bonds serve a critical portfolio role: they tend to perform well when equities struggle, particularly during recessions and deflationary shocks.

Inflation-Protected Bonds

Inflation-protected bonds (such as US TIPS or global equivalents) adjust their principal for inflation, guaranteeing a real return if held to maturity. The risk premium here comes from two sources: the real interest rate you earn, and a compensation for the fact that these instruments are less liquid and less widely held than nominal bonds. Their particular value in a portfolio is that they perform well in the one environment where both equities and nominal bonds tend to struggle: **rising inflation**. This makes them a critical diversifier.

Commodities

Commodity investments provide exposure to the prices of physical goods — energy, metals, agriculture. The risk premium in commodities is more complex than in financial assets. Part of it comes from the **convenience yield** — the value of having physical access to the commodity. Part comes from the tendency of commodity futures to be priced below expected future spot prices, rewarding the long investor (a phenomenon known as *backwardation*). Commodities are particularly valuable in a portfolio because they respond strongly to inflationary pressures and supply shocks — environments where financial assets often struggle.

Gold

Gold occupies a unique position. It pays no yield, generates no earnings, and has limited industrial use. Its value comes from its role as a store of value and a hedge against monetary debasement. Gold tends to perform well when confidence in fiat currencies declines, when fiscal deficits widen, and when real interest rates are low or negative. The "premium" in gold is less about a traditional risk premium and more about the price markets assign to owning an asset that no government can print. In a portfolio context, gold provides diversification that is genuinely independent of both equities and bonds.

Risk Premiums Across Asset Classes

Asset Class	Risk You Bear	Premium Source	Typical ETF Proxy
Equities	Corporate earnings volatility, drawdowns	Equity risk premium	SPY, VEA, VWO
Nominal Bonds	Interest rate changes, duration risk	Term premium	TLT, IGOV
Inflation-Protected Bonds	Real rate changes, lower liquidity	Real rate + inflation compensation	TIP, WIP
Commodities	Supply shocks, roll yield volatility	Scarcity premium, inflation hedge	GSG, DBC

Gold	No yield, sentiment-driven	Monetary debasement hedge	GLD, SGOL

> *Each asset class compensates you for a different kind of discomfort. A portfolio that collects premiums from multiple independent sources is fundamentally more robust than one that relies on a single source of return.*

Why Risk-Adjusted Returns Tend to Equalise

A natural question follows: if the equity premium is larger than the bond premium, why not just hold equities? The answer lies in **risk-adjusted returns**. Equities offer a higher premium because they carry higher risk. When you adjust for the volatility and the severity of potential drawdowns, the premium per unit of risk is roughly comparable across asset classes. This is not a coincidence — it is the result of capital flowing between markets to arbitrage imbalances.

If bonds suddenly offered a higher risk-adjusted return than equities, investors would sell equities and buy bonds. Equity prices would fall (raising future equity returns) and bond prices would rise (lowering future bond returns) until equilibrium was restored. This is the mechanism that keeps risk-adjusted premiums roughly in line across asset classes over the long run.

The practical implication is profound: **you do not earn a better risk-adjusted return by concentrating in a single asset class**. You earn a better return by combining asset classes whose risks are different and ideally uncorrelated. This is the principle that underpins risk parity, and it is the reason the Desert Frontier Beta portfolios are built across equities, bonds, TIPS, commodities, and gold rather than being dominated by any one of them.

Risk Premiums Are Not Constant

While risk premiums exist in expectation, their size is not fixed. They fluctuate over time based on economic conditions, monetary policy, market sentiment, and the supply and demand for assets.

When markets are calm and investors are confident, they demand less compensation for holding risky assets. Premiums compress. Equity valuations rise, credit spreads tighten, bond term premiums shrink. When fear returns — a recession, a geopolitical shock, a banking crisis — investors flee to cash and demand much higher compensation to hold anything else. Premiums widen. Prices fall. Expected returns from that point forward increase.

This is the mechanism that makes market downturns painful but ultimately self-correcting. The very act of selling in a panic reduces prices and increases future expected returns for those who stay invested. Risk premiums are highest precisely when they feel most uncomfortable to collect. This is not a design flaw — it is the feature that makes the premium real.

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What This Means for You

If you are an individual investor, the implication is clear: a diversified portfolio that collects premiums from multiple asset classes is the most efficient way to build long-term wealth. No single asset class is best in all conditions. But a portfolio that spans equities, bonds, inflation-protected bonds, commodities, and gold can harvest premiums across growth, recession, inflation, and deflation. It is the all-weather approach to beta.

If you are managing corporate treasury or surplus capital, the same logic applies. Holding excess cash in deposits is accepting the lowest available risk premium — essentially zero in real terms. A conservative, diversified beta allocation on capital with a medium-term horizon can materially improve returns without introducing the governance burden of active management.

The Desert Frontier Beta portfolios are constructed with this principle at their core. Each asset class in the portfolio is there because it contributes a distinct risk premium. The portfolio is weighted so that no single premium dominates. And the result is a beta engine that collects compensation from multiple independent sources of risk, compounding steadily across market cycles.

The Bottom Line

The risk premium is the reason investing works. It is the compensation markets offer for the discomfort of uncertainty, and it is available across every asset class that carries risk. Different assets offer different premiums for different risks, and a portfolio that harvests them all simultaneously is more robust, more consistent, and more efficient than one that relies on any single source.

In the next article, we will explore the forces that drive risk premiums up and down — the role of central banks, the supply of government debt, and the shifting balance between the demand for safety and the supply of risky assets. Understanding these dynamics is what separates a static allocation from an informed one.

This article is part of The Groundwork — a series by Desert Frontier Advisors covering the foundations of beta investing.
Next in the series: Risk and Supply/Demand — What Drives Risk Premiums Up and Down.