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MALAYSIA EQUITY RISK PREMIUM

JANUARY 2026

A Bottom-Up Analysis of Malaysia's Market Risk Premium

School of Business and Economics,
Universiti Putra Malaysia

Forvis Mazars in Malaysia
31 December 2025

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Foreword from the School of Business and Economics

As Dean of the School of Business and Economics (SBE) UPM, I am proud to present this landmark study on Malaysia's equity risk premium (ERP). This achievement is the result of strong collaboration and teamwork with Roger's and the dedicated professionals at Forvis Mazars Advisory Sdn Bhd. I extend my sincere gratitude to all involved for their commitment in accomplishing this project and for delivering Malaysia's own ERP using a methodology that is both suitable and comparable to international standards.

This study is among the first of its kind in Malaysia. The computed ERP, derived through a bottom-up implied technique, is more relevant and depicts our economic realities more accurately than estimates based on Damodaran's sovereign rating adjustments or historical geometric mean returns. Yet, it remains comparable and does not deviate excessively from those benchmarks, ensuring both credibility and defensibility.

Damodaran's ERP for Malaysia is primarily anchored in the US market premium and adjusted with sovereign ratings, which may lag behind real market dynamics. Historical geometric averages, meanwhile, assume the future will resemble the past, but Malaysia's crises in 1997 and 2008 distort those estimates. In contrast, the bottom-up implied technique is forward-looking, Malaysia-specific, and grounded in actual market expectations, making it conceptually superior for our context.

The practical applications of Malaysia's ERP are wide-ranging. Industries can employ this estimate in cost of equity calculations under CAPM, ensuring valuations are robust and defensible. It provides a reliable input for discounted cash flow (DCF) models, supporting investment decisions in mergers, acquisitions, and IPOs. Corporates can use it in capital budgeting, evaluating whether new projects, from factories to renewable energy initiatives, generate returns above the required threshold. Asset managers, meanwhile, can apply it in portfolio allocation, comparing expected equity returns against bonds or global equities to guide sectoral strategies.

This publication fills a critical gap in Malaysian valuation practice and establishes thought leadership in the region. By adopting a methodology that is rigorous, transparent, and Malaysia-specific, it offers practitioners a defensible benchmark that strengthens both academic inquiry and professional application.

I am confident that this study will serve as a valuable reference for valuation professionals, regulators, and industry leaders, and I commend the collaborative effort that has made it possible.

Professor Dr Bany Ariffin Amin Noordin
Dean
School of Business Economics (SBE)
Universiti Putra Malaysia

Foreword from Forvis Mazars in Malaysia

The equity risk premium sits at the heart of almost every valuation engagement, yet for too long, Malaysian practitioners have had to rely on international estimates not built with our market in mind. This publication is our attempt to change that.

Forvis Mazars in Malaysia is pleased to have partnered with the School of Business and Economics at Universiti Putra Malaysia in producing what we believe is the first professionally published, methodologically rigorous estimate of Malaysia's equity risk premium derived through a bottom-up implied approach. The collaboration brought together academic expertise in financial economics and the practical experience of our Advisory team, and we are proud of the results.

From a practitioner's standpoint, the absence of a locally grounded ERP estimate has long been an uncomfortable reality. When defending a valuation before a client, a regulator, or a court, the question of where the equity risk premium came from matters. Pointing to a sovereign rating adjustment anchored in the US market is a reasonable starting position, but it is not a complete answer for a market with Malaysia's specific characteristics. This publication gives practitioners a more defensible reference point, one that is forward-looking, grounded in KLCI constituent data, and cross-validated against independent benchmarks.

We hope this serves as a practical resource that professionals can reference with confidence in their day-to-day work, whether that is a purchase price allocation, a discounted cash flow model for an M&A transaction, or a capital budgeting assessment. The methodology is fully documented, precisely so that users can understand and, where necessary, explain the basis of the estimate.

This is also a statement of intent. Forvis Mazars in Malaysia is committed to advancing valuation practice in this country. We intend for this to be a living reference, updated as market conditions evolve, and we welcome engagement from fellow practitioners, regulators, and academics on both the methodology and its applications.

We extend our sincere gratitude to Professor Dr. Bany Ariffin and his team at UPM for their intellectual partnership, and to our Advisory professionals whose rigour made this possible.

Roger Loh Kit Seng
Director
Forvis Mazars in Malaysia

Executive Summary

The equity risk premium represents the most critical unobservable input in business valuation and corporate finance. For Malaysia, determining a defensible equity risk premium requires rigorous methodology and cross-validation against established benchmarks. This publication presents our comprehensive assessment of Malaysia's equity risk premium as of 31 December 2025, employing a bottom-up analysis of KLCI constituents.

KEY FINDINGS

Equity Risk Premium Estimate (CDS-Adjusted):
7.36% equity risk premium (31 December 2025)

Equity Risk Premium Estimate (Conventional):
6.74% equity risk premium (31 December 2025)

Methodology:
Bottom-up implied premium from KLCI constituent analysis

Risk-Free Rate (Nominal MGS):
3.49% (10-year Malaysian Government Securities)

CDS-Adjusted Risk-Free Rate:
2.87% (MGS yield minus CDS spread)

Cross-Validation:
Estimate validated against Damodaran (5.78%), historical data (4.16%), and practitioner surveys

Our estimate of 7.36% derives from a forward-looking implied equity risk premium approach that extracts market expectations from current KLCI prices and consensus analyst forecasts for constituent companies, combined with a CDS-adjusted risk-free rate methodology that removes sovereign credit risk embedded in Malaysian Government Securities yields. This bottom-up methodology provides greater precision than top-down country risk approaches, as it directly incorporates Malaysia-specific growth expectations and payout dynamics rather than relying solely on sovereign credit ratings.

Cross-validation against alternative methodologies confirms the robustness of our estimate. Professor Damodaran's country risk framework yields a 5.78% risk premium for Malaysia, whilst historical geometric mean returns indicate 4.16% (1982-2025). For practitioners preferring conventional Malaysian market practice (using unadjusted MGS yields), the corresponding equity risk premium estimate is 6.74%. The convergence of these independent approaches, despite their different estimation philosophies, provides confidence in our primary estimate while acknowledging the inherent uncertainty in measuring the equity risk premium.

Introduction and Purpose

The equity risk premium (ERP) is a foundational element in valuation and corporate finance. In Malaysia, its practical applications are extensive and directly shape decision-making across industries. For corporates, the ERP provides the benchmark for cost of equity under the CAPM framework, ensuring that valuations are both rigorous and defensible. It serves as a critical input in discounted cash flow (DCF) models, guiding investment choices in mergers, acquisitions, and IPOs. In capital budgeting, firms rely on the ERP to assess whether new initiatives (whether building factories or investing in renewable energy) are expected to generate returns above the required threshold. Asset managers, meanwhile, use the ERP to inform portfolio allocation, weighing expected equity returns against bonds or global equities to refine sectoral strategies. In each of these contexts, Malaysia's ERP functions as more than a number: it is the anchor that connects financial theory to practical, high-stakes decisions.

Although the equity risk premium is fundamental to finance, it remains one of the most debated parameters. Unlike observable variables such as stock prices or interest rates, the ERP is inherently forward-looking and must be estimated through historical data, model-based approaches, or survey evidence.

In emerging markets like Malaysia, determining ERP using these data and approaches is even more challenging. Historical returns are shaped by major structural breaks (such as the 1997 Asian Financial Crisis and the 2008 Global Financial Crisis), which can distort long-term averages and therefore reduce the accuracy of the ERP. Survey evidence often suffers from limited sample sizes and anchoring biases, reducing reliability. Forward-looking models, while useful, typically draw on patterns from mature markets. Because Malaysia's market dynamics differ significantly, adopting such models requires careful calibration to ensure they remain relevant.

This publication addresses a fundamental gap in Malaysian valuation practice: the absence of a published, methodologically rigorous estimate of the equity risk premium from a professional services firm. Whilst international benchmarks exist, they often apply generic frameworks that may not fully capture Malaysia's specific characteristics. Our objective is to provide valuation professionals with a defensible estimate of the equity risk premium suitable for professional applications.

THE IMPORTANCE OF METHODOLOGICAL RIGOUR

In contentious valuations, opposing parties often challenge the assumption of the equity risk premium. A well-documented methodology with cross-validation against multiple independent sources provides critical defensibility. This publication serves several purposes:

First, it establishes a transparent, replicable methodology that can withstand professional scrutiny.

Second, it provides cross-validation against established benchmarks, demonstrating that our estimate is neither an outlier nor arbitrary.

Third, it explains the conceptual advantages of the bottom-up approach versus alternative methodologies.

Fourth, it introduces the CDS-adjusted risk-free rate methodology, which removes sovereign credit risk, thereby enhancing international comparability and theoretical rigour.

Methodology: Bottom-Up Implied Approach

CONCEPTUAL FRAMEWORK

Our methodology uses a forward-looking implied ERP framework, which derives the risk premium ex-ante from prevailing market valuations rather than relying on historical realised returns or subjective surveys. The underlying mechanic is a reverse-engineering of the standard valuation model: by anchoring on observable market prices and integrating consensus estimates for future cash flows, we solve for the internal rate of return (IRR). The equity risk premium is then isolated by subtracting the risk-free rate from this total expected return.

ERP = (Internal Rate of Return) - (Risk-Free Rate)

This forward-looking orientation captures the aggregate expectations and risk appetite currently embedded in market pricing. This approach offers significant methodological advantages in emerging markets, where structural breaks, regime shifts, or high volatility frequently compromise historical datasets. Instead of assuming the market will eventually return to old patterns, this model uses current market conditions to define what we should expect for future risk.

CDS-ADJUSTED RISK-FREE RATE METHODOLOGY

Malaysian Government Securities yields embed both the time value of money and Malaysia's sovereign credit risk. For valuation applications requiring internationally comparable risk-free rates, we apply the CDS-adjusted methodology

CDS-Adjusted Risk-Free Rate = (MGS Yield) - (CDS Spread)

For practitioners who prefer conventional Malaysian market practice (unadjusted MGS yields), we also provide the calculated equity risk premium based on the nominal MGS yield.

DATA SOURCES AND INPUTS

Our analysis begins with the FTSE Bursa Malaysia KLCI, which closed at 1,680.11 on 31 December 2025. The KLCI represents Malaysia's 30 largest companies by free float market capitalisation, spanning diverse sectors including financial services, telecommunications, plantations, energy, and consumer goods.

For each KLCI constituent, we gather consensus earnings forecasts from sell-side analysts. These forecasts represent the collective view of professional analysts who cover Malaysian equities and have access to company management, financial statements, and industry intelligence. Current dividend yields, payout ratios, and profitability metrics are sourced from market data providers and company financial statements.

The risk-free rate of 3.49% represents the yield on 10-year Malaysian Government Securities as of 31 December 2025. We use a 10-year maturity to match the typical investment horizon for equity investors and to align with international practice.

CALCULATION PROCESS

The calculation proceeds through several stages, each incorporating professional judgment calibrated to Malaysian market realities:

Stage 1: Earnings Projection

We begin with consensus earnings-per-share forecasts for each KLCI constituent. These near-term forecasts (typically covering 3 years) reflect analyst expectations for company-specific growth. Beyond the explicit forecast period, we trend earnings growth toward sustainable long-term rates that cannot exceed nominal GDP growth.

Stage 2: Dividend Expectations

Current payout ratios may be temporarily high or low due to cyclical conditions. We adjust observed payout ratios toward sustainable levels that balance dividend distributions with reinvestment requirements

Stage 3: Terminal Value

The terminal value calculation assumes perpetual growth at the risk-free rate, consistent with long-term equilibrium in which real earnings match economic expansion and inflation converges to central bank targets. This conservative assumption prevents mathematical impossibilities that arise when terminal growth rates exceed sustainable levels.

Stage 4: Discount Rate Solution

We solve iteratively for the discount rate that sets the present value of expected dividends equal to the current index level. This implied cost of equity represents the return that investors require, given their expectations for future cash flows. Subtracting the risk-free rate yields the equity risk premium.

Market capitalisation weights ensure that larger companies have proportionally greater influence on the aggregate premium, consistent with their economic significance. This weighting approach more accurately captures the marginal investor's required return than equal-weighted or median-weighted approaches.

KEY ASSUMPTIONS

Three critical assumptions underpin our methodology:

Earnings growth projections: Near-term analyst forecasts provide company-specific expectations. Beyond the explicit forecast horizon, we assume earnings growth converges to rates consistent with nominal GDP growth, preventing perpetual high-growth assumptions.

Sustainable payout ratios: We adjust current payout ratios toward long-term sustainable levels that enable companies to fund growth whilst returning meaningful cash to shareholders.

Terminal growth rate: Perpetual growth at the risk-free rate reflects a long-term equilibrium in which real earnings match economic expansion, and inflation stabilises around Bank Negara Malaysia's medium-term target.

These assumptions represent professional judgements calibrated to the realities of the Malaysian market. Whilst each assumption carries uncertainty, the cross-validation against independent methodologies provides confidence that our estimate is neither arbitrary nor an outlier.

Comparative Analysis: Validating the Estimate

No single methodology provides definitive answers to estimating the equity risk premium. Best practice requires cross-validation against multiple independent approaches. This section presents our estimate alongside established benchmarks, explaining the sources of variation and demonstrating the defensibility of our approach.

SUMMARY OF ESTIMATES

Methodology	ERP Estimate	Date/Period
The estimated ERP (Bottom-Up Implied, CDS-Adjusted)	**7.36%**	**31 Dec 2025**
The estimated ERP (Bottom-Up Implied, conventional)	6.74%	31 Dec 2025
Damodaran (Top-Down Country Risk)	5.78%	Jan 2026
Historical (Geometric Mean 1982-2025)	4.16%	43 years
Historical (Arithmetic Mean 1982-2025)	7.10%	43 years
Practitioner Surveys (Regional)	6 to 8%	2024

Table 1: Malaysia Equity Risk Premium - Comparative Estimates

DAMODARAN COUNTRY RISK FRAMEWORK: A TOP-DOWN APPROACH

Professor Aswath Damodaran of NYU Stern School of Business maintains the most widely used country risk premium database in professional valuation practice. His January 2026 update estimates Malaysia's total equity risk premium at 5.78%.

Damodaran's methodology employs a top-down approach. He begins with the mature-market equity risk premium (4.23% for the US, derived from the S&P 500 implied premium) and adds a country risk premium based on sovereign credit ratings. Malaysia's A3 rating from Moody's translates to an adjusted default spread of 1.02%, which is then multiplied by an equity volatility factor to derive the 1.55% country risk premium.

Practitioners favour this framework because it provides systematic, regularly updated estimates across countries. However, this approach assumes sovereign credit ratings fully capture equity market risk. By focusing only on country-level metrics, it does not explicitly incorporate company-specific growth expectations, sectoral composition differences, or market-implied payout dynamics that our bottom-up methodology directly captures.

HISTORICAL RETURNS: THE BACKWARDS-LOOKING PERSPECTIVE

Historical return analysis examines actual realised returns over extended periods. Our analysis of KLCI price returns from 1982 through 2025 yields a geometric mean of **4.16%** and an arithmetic mean of **7.10%.**

However, several factors severely limit the reliability of historical estimates for Malaysia. The 1997 Asian Financial Crisis produced a 52% single-year decline, representing an existential crisis that fundamentally altered Malaysia's policy framework (including the 1998 capital controls and ringgit peg). The 2008 Global Financial Crisis created another major disruption. With an annual return standard deviation of 25.68%, the confidence intervals around historical mean estimates are extremely wide (standard error of 3.92%).

PRACTITIONER SURVEYS: COLLECTIVE WISDOM

Survey-based approaches capture what valuation professionals actually use in practice. The most comprehensive academic survey comes from Professor Pablo Fernandez of IESE Business School, who surveys companies, analysts, and academics globally. Regional Southeast Asian estimates typically fall in the **6 to 8% range,** with considerable variation reflecting individual firm circumstances and professional judgment.

Surveys offer the advantage of capturing collective wisdom and revealing actual practice. However, they face methodological challenges, including small sample sizes (particularly for Malaysia-specific data), anchoring bias (respondents clustering around textbook values), and procyclical tendencies (estimates rising after strong market performance). Despite these limitations, the broad alignment between survey evidence and our estimate provides useful validation.

Why Bottom-Up Outperforms Top-Down

The 158 basis-point differential between our CDS-adjusted estimate (7.36%) and Damodaran's framework (5.78%) reflects a methodological rather than a fundamental disagreement. Understanding this differential illuminates the conceptual advantages of our bottom-up approach.

CONCEPTUAL COMPARISON

Dimension	Damodaran Implied Premium	Bottom-Up Implied Premium
Starting Point	US market premium	Malaysian company fundamentals
Country Risk	Sovereign rating-based adjustment	Implicitly captured in analyst forecasts
Growth Expectations	Not explicitly modelled	Company-specific analyst forecasts
Sector Composition	Assumed similar to the US	Malaysia's actual sector mix
Market Prices	Used only for the US market	Directly incorporate Malaysian prices
Key Advantage	Systematic, regularly updated	Precise, Malaysia-specific

Table 2: Conceptual Comparison of Methodologies

FOUR CRITICAL ADVANTAGES

1. Direct Market Incorporation

The bottom-up approach directly incorporates Malaysian market prices and expectations. When KLCI constituents trade at premium or discount valuations, when growth expectations shift, or when payout policies change, these factors immediately influence our estimate. Top-down approaches adjust only when sovereign ratings change, potentially lagging actual market conditions by months or years.

2. Malaysia-Specific Growth Dynamics

Malaysia's economic structure differs meaningfully from that of the United States. Plantations, Islamic banking, and export-oriented manufacturing play larger roles. Government-linked companies represent a significant index weight. Earnings growth patterns, cyclicality, and sensitivity to commodity prices all differ from US patterns. Our methodology captures these Malaysia-specific dynamics by incorporating local knowledge into analyst forecasts.

3. Sector Composition Realism

The KLCI's sector composition differs substantially from the S&P 500. Financial services, consumer goods, and telecommunications comprise larger index weights, whilst technology represents a smaller weight. These sectoral differences carry implications for growth, profitability, and risk. Bottom-up aggregation automatically reflects Malaysia's actual sector mix rather than assuming similarity to developed markets.

4. Analyst Expertise Incorporation

Sell-side analysts covering Malaysian equities possess deep knowledge of company strategies, competitive dynamics, regulatory environments, and management quality. Their consensus forecasts aggregate this expertise across dozens of professionals. Whilst analysts may exhibit optimism bias or herding behaviour, their forecasts represent the most robust bottom-up assessment available. Top-down approaches necessarily ignore this granular intelligence.

THE CASE FOR 7.36% (CDS-ADJUSTED) AND 6.74% (CONVENTIONAL)

Our CDS-adjusted estimate of 7.36% reflects Malaysia's positioning as a liquid, institutionally developed emerging market with specific growth characteristics. The differential from Damodaran's estimate reflects primarily:

CDS adjustment methodology: Removing sovereign credit risk from the Malaysian Government Securities yield isolates the truly risk-free component, increasing the measured equity risk premium compared to conventional methodology.

Growth expectations: Current analyst forecasts for KLCI constituents exceed the mature-market baseline embedded in Damodaran's framework.

Market-specific factors: KLCI valuation levels, current profitability, and payout dynamics may diverge from theoretical predictions based solely on sovereign ratings.

Structural considerations: Malaysia's sector composition, government-linked company dynamics, and commodity exposure create risk-return characteristics not fully captured by country risk premiums.

For practitioners who prefer conventional Malaysian market practice, the 6.74% estimate (using the unadjusted MGS yield) provides a familiar benchmark while retaining the benefits of the bottom-up methodology.

The discount to the historical arithmetic mean (7.10%) reflects the reality that crisis periods such as 1997 and 2008 produced outlier losses unlikely to repeat with identical severity. The premium to historical geometric mean (4.16%) suggests current expectations exceed the long-term realised average, consistent with improved institutional frameworks and deeper financial markets.

Conclusion and Implications

This publication establishes Malaysia's equity risk premium as of 31 December 2025, using a rigorous bottom-up methodology that derives market expectations from current prices and consensus analyst forecasts. Our primary estimate and alternative estimate provide valuation professionals with a defensible parameter suitable for professional applications.

DEFENSIBILITY THROUGH CROSS-VALIDATION

The robustness of our estimate derives from convergence across independent methodologies. Damodaran's widely adopted country risk framework yields 5.78%, differing by only 158 basis points from our CDS-adjusted estimate and 102 basis points from our conventional estimate. Historical data provide boundary conditions between 4.16% (geometric mean) and 7.10% (arithmetic mean). Practitioner surveys suggest regional consensus in the 6-8% range. Our estimate sits comfortably within these benchmarks, neither outlier nor arbitrary.

Cross-validation is essential when valuations face scrutiny. In contentious engagements, demonstrating that multiple independent methodologies converge provides stronger defensibility than relying on a single approach. The transparent, replicable methodology presented here withstands professional questioning.

CONCEPTUAL SUPERIORITY OF BOTTOM-UP ANALYSIS

Beyond defensibility, our bottom-up approach offers conceptual advantages over top-down alternatives. By starting with Malaysian company fundamentals rather than US market premiums adjusted for country risk, we directly capture Malaysia-specific growth expectations, sector composition, and market dynamics. The methodology incorporates the collective expertise of sell-side analysts whilst avoiding the stale information that plagues rating-based approaches.

These details are especially important for Malaysia. Traditional country ratings do not always show the full picture of the economy, the unique role of government-linked companies, or how much the country relies on commodities like oil and palm oil. Instead of assuming Malaysia acts like a Western market, our 'bottom-up' method looks at the actual companies to see what is really happening.

ESTABLISHING THOUGHT LEADERSHIP

This publication represents Malaysia's first study of the equity risk premium, co-authored by an academic institution and a professional services firm.

The absence of published, methodologically rigorous estimates from the industry has created a gap in Malaysian valuation practice. Practitioners often rely on international benchmarks without Malaysia-specific analysis or apply ad hoc adjustments without a transparent rationale. This publication addresses that gap, providing the valuation community with a professional-grade reference that can be cited with confidence.

PRACTICAL APPLICATION

Valuation professionals can apply our estimate directly in cost of equity calculations, discounted cash flow models, and investment analysis. When engagement circumstances warrant a deviation from this estimate, practitioners should document the rationale and consider a sensitivity analysis within the 6-8% range.

For contentious valuations where the selection of the equity risk premium may be challenged, this publication provides comprehensive documentation supporting the Equity Risk Premium estimate. The cross-validation against Damodaran's widely adopted framework, the alignment with practitioner surveys, and the conceptual advantages of the bottom-up methodology all strengthen the defensibility of this parameter choice.

FOR FURTHER INFORMATION

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School of Business and Economics

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