

THE CAPITAL ASSET PRICING MODEL

The capital asset pricing model, almost always referred to as the CAPM, is a centerpiece of modern financial economics.

The model gives us a precise prediction of the relationship that we should observe between the risk of an asset and its expected return. This relationship serves two vital functions. First, it provides a benchmark rate of return for evaluating possible investments. For example, if we are analyzing securities, we

might be interested in whether the expected return we forecast for a stock is more or less than its “fair” return, given risk. Second, the model helps us to make an educated guess as to the expected return on assets that have not yet been traded in the marketplace. For example, how do we price an initial public offering of stock? How will a major new investment project affect the return investors require on a company’s stock? Although the CAPM does not

fully withstand empirical tests, it is widely used both because of the insight it offers and because its accuracy suffices for many important applications.

In this chapter we start with the basic version of the CAPM. We also show how the simple version may be extended without losing the insight and applicability of the model.

