

From the cross-section data . The average return on US common stocks shows little relationship between either market beta of the asset pricing model or the consumption beta of the intertemporal asset pricing model . In contrast , there are a couple of variables that do not stand out in asset pricing models but show some relation with the cross section average return , including size[ME] , leverage , E/P and book to market equity .

The author studied the joint roles of market Beta from these variables and found that using the variable alone has less impact on the slope of the regression [Beta] . However , used alone of size , E/P leverage and book to market equity . The result showed that size and book to market equity do a good job explaining the cross-section of average return on NYSE , Amex and NASDAQ stocks . This paper extends the asset pricing tests in 3 ways , 1. If the market integrated a single model should also explain bond returns . 2.) Expand the set of the variables eg . term-structure variables that play an important role in bond return and 3.) The test use cross section regressions of Fama and Macbeth to explain average returns . This paper uses a time-series regression approach . Monthly returns on stocks and bonds are regressed on the returns to a market portfolio of stocks and mimicking portfolio for size , book to market equity and term-structure risk factors in returns . The slopes of regression are factors that have a clear interpretation as risk-factor sensitivities for bonds as well as for stocks .

The time-series regression is easy to observe . If assets are priced rationally , variables that are related to average returns eg . size and book-to-market equity , must proxy for sensitivity to common risk factors in returns . The slopes and R -squared values shown whether mimicking portfolios for risk factor shared variation in stock and bond return , not the other factors

For stock , portfolios constructed to mimic risk factors related to size and BE/ME capture strong common variation in returns . Indicating that size and BE/ME is a good proxy for sensitivity to common risk factors in stock returns . For bonds , the mimicking portfolios for the two term-structure factors capture most of the variation in the returns on government and corporate bonds . The common variation in stock returns is largely captured by three stock-portfolio returns, and the common variation in bond returns is largely explained by two bond-portfolio returns. Stock and bond markets are far from stochastically segmented but when stock market factors are included in regressions , all of the stock portfolio loads in the same way. As a result, a market portfolio of stocks captures the common variation in stock returns associated with the market factor and the two term-structure factors.

The results suggest that there are ,at least , three stock - market sectors and two term-structure factors in returns and stock return linked to bond return through shared variation in the two term structure factors .

Fama and French find that BE/ME to equity is related to relative profitability . On average , low - BE/ME firms have persistently high earning and high BE/ME firms have poor earnings .The difference between the return of high and low captures variation through time in a risk factor that is related to relative earnings performance .Its lower the average returns on low stock because the slope suggest that its hedge against the common factor in returns related to relative profitability .

One more thing is that the results show that five factors [RMO , HML , SMB , TERM and DEF] do a good job explaining common variation in bond and stock returns .

