Summary of "Common risk factors in the returns on stocks and bonds"

- This paper studies the common risk factors in stock and bond returns and tests whether these shared risks capture the cross-section of average returns. There are at least five common factors in returns. Three stock-market factors produce common variation in stock returns. Except for low-grade corporate bonds, the stock-market factors have little role in returns on government and corporate bonds. The stock and bond markets are linked, however. through two shared term-structure factors.

- The paper shows that the three stock-market factors, R,LfO, SJIB. and H.LIL. are largely uncorrelated with one another and with the two term-structure factors, TER.LI and DEF. The regressions in table 8 that use RXIO. .S.!IB. H.ML, TER.LI, and DEF to explain stock and bond returns thus provide a good summary of the separate roles of the five factors in the volatility of returns and in the cross-section of average returns.

- For stocks, the slopes on the two term-structure returns in table 8 are all around 0.8. The standard deviations of TER,CI and DEF. 3.01% and 1.60% per month. then say that TERAI accounts for similar variation in the returns on all the stock portfolios, on the order of that captured by R&IO, while DEF captures less common variation in returns.

- The average TER:CI and DEF returns are only 0.06% and 0.02% per month. so they explain almost none of the average excess returns on stocks. But the expected TERM and DEF returns vary through time with business conditions Thus TER:bI and DEF produce interesting time-series variation in expected bond and stock returns.

- Fama and French (1992b) find that book-to-market equity is related to relative profitability. On average, low-BEjiVfE tirms have persistently high earnings and high-BE/'iVfE firms have persistently poor earnings. The evidence here then suggests that HML, the difference between the returns on high- and low-BE/IME stocks, captures variation through time in a risk factor that is related to relative earnings performance. HbfL lowers the average returns on low-BE/ME stocks because their negative slopes on HML indicate that they hedge against the common factor in returns related to relative profitability.

- At a minimum, our results show that five factors do a good job explaining common variation in bond and stock returns and the cross-section of average returns. We think there is appeal in the simple way we define mimicking returns for the stock-market and bond-market factors. But the choice of factors, espe- cially the size and book-to-market factors, is motivated by empirical experience.

- Without a theory that specifies the exact form of the state variables or common factors in returns, the choice of any particular version of the factors is somewhat arbitrary. Thus detailed stories for the slopes and average premiums associated with particular versions of the factors are suggestive. but never definitive.