Beta and Return

This article mainly states that Fama speech and research is wrong . He misinterprets his own data . Fama said that the beta is not an appropriate variable to use in return but the author denied this speech and came up with his data and research and said that Beta is a valuable investment tool if the line is as steep as CAPM .

Data Mining is when the researcher tries many ways to study and use many explanatory factors , various periods and various models . But if he reports only the more successful runs , it would have to take more time to interpret .

The size effect (1981) suggests that it had done well but after publication the performance was inconsistent . Lately the publisher suggested that there is no size effect at all . But Fama states that there is a size effect and it is one of the variables that capture average return . Also , Fama mentioned book value to market value that helps to capture return . But the favor idea is the ratio captured rationally priced risk rather than market overreaction .

The authors have thought of many ways to come up with the beta factor and finally they choose the way to minimize the data mining by using a simple portfolio strategy by choosing securities from historical betas .

Updating the BJS study , the author used monthly data and he did not try to estimate changes in residual risk through the time because it might lead to data mining . In addition , he uses NYSE listed stocks .

From the data , we can indicate that Low beta stock did better than the CAPM predicts ,and high beta did worse . This portfolio captures the relative behavior of stock with different betas . Since stocks that differ in beta also tend to differ in other ways , it combines the effects of all characteristics correlated with beta . For example , high beta stocks tend to be stocks with high return , standard deviation and issuers of high-beta stock tend to be high leverage firms .

The result of this study is that the announcement of death in beta is still too soon . Even if the line is flat , Beta is still an essential tool to evaluate and make investment decisions . The investor or firms should continue to use CAPM and beta to analyze the portfolio strategy .

The application in real life can be used in corporate finance . Some might think that a corporation should use a discount rate when it evaluates proposed investments . In effect , it should shift its asset mix toward high risk assets because its investors face borrowing restrictions . If the corporation does not face borrowing restrictions and makes its investment decisions to maximize its stock price , the market for corporate assets should be governed by the ordinary CAPM . But corporations do face the borrowing restrictions and worry about the leverage that may downgrade from rating agencies so that means the corporate assets are priced like common stocks , low beta assets may be underpriced while high beta assets are overpriced . So the expected return to beta for corporate assets may be flatter than CAPM .

So any corporation that is free to borrow and wants to maximize its stock price should use ordinary CAPM to value its investments and should use lots of leverage . Low beta will look attractive because of positive alpha . Similar to investor where rational corporation will introduce a low beta asset and a lot of leverage . So beta is a important tools for investment decisions