Example of the cross-section of expected stock returns article review

Business, Marketing

Expected stock return reefers to the amount expected to be received on an investment such as stock, which has diverse known rated of return. For instance, in a stock, which had 20% probability of producing 5% profit and a 20% probability of producing 2% loss, the expected return would be 0. 1% (0. 2* 0. 05+0. 2-0. 02). This essay seeks to examine the two measureable variables, which are used to capture the cross sectional variation in average stock returns attributed with the market β, size, earning price, leverage and book-to market equity. The variables include are size and book to market equity.

As a point of departure, the article gives a glimpse on how the Asset-Pricing Model of Sharper-Linter-Black (SLB) has changed and defined the manner in which academics and practitioners perceive the average returns and risk. The primary forecast of the model is that the market portfolio of invested stock relates with the mean variance efficient (Fama and French, 3). The author of this article urges economists and finance students to realize that the efficiency of the market portfolio has the following implications

- Expected returns on securities represent a positive linear function of the respective market β
- Market βs avail an explanation of the cross-section’s expected returns

The article articulates that, several empirical contradictions of the Sharper-Linter-Black (SLB) model exists, with the most predominant being the size effect of the Banz (1981), where the market equity, ME adds to the description of the cross-section of average returns, which the market βs avails. This explains that the average returns on small ME stocks are extremely high because the respective estimates of βs, and average returns

on large stocks are extremely low. The other inconsistency of the SLN model involves the positive correlation between leverage and average return that is documented by Bhandari (1988). It is notable that, the leverage is correlated with risk and expected return, however, in SLB model, leverage risk has to be captured by the market βs (Fama and French, 4). The point Bhandari drives home in this case is the ability of leverage helping in giving an explanation about the cross-section of average stock returns in experiment test that considers the size (ME) and the β.

In addition, the article offers further disapproval explanations and tests by Stattman (1980), which asserts that the average returns on U. S stocks are positively correlated to the ratio of a firms' book value of universal equity to its ME, has a strong responsibility in explaining the cross-section of average returns on Japanese stocks. Another assertion that adds weight and evidence on the primary attributes used to capture the cross sectional variation in average stock returns, is the earning-price test done by Basu on the U. S stocks and turned positive when including the size and market β (Fama and French, 6). It is notable that, all these methods aid in scaling out stock prices and extraction of information related to prices, risks and expected returns.

- B does not aid in explaining the cross section of average stock returns
- The amalgamation of size and book to market equity has ability to absorb the responsibility of leverage and E/P in the consideration of average stock returns.

The above observations are arrived at b y a though consideration of various explanations of diverse economic models such as SLB by diverse authors and researchers over years. These assumptions may give the reads the true and

needed perspective about the two measureable variables, which are used to capture the cross sectional variation in average stock returns (Fama and French, 8).

Considering the above assumptions, the rationally priced assets are associated multidimensional stock risks. On the same note, the one dimensional risk is considered to be small and can be proxied by size and ME. Similarly, the dimension of risk can be proxied by BE/ME. This association helps in explaining the the cross-section of average stock returns (Fama and French, 12).

In conclusion, the author of this article succeeds to informal the readers that, size and book to market equity are the two measureable variables, which are used to capture the cross sectional variation in average stock returns in a simple way. In essence, this article asserts that the two variables offer a simple and strong characterization of the cross section of average stock returns.

Work cited

Eugene F. Fama and Kenneth R. French. The Cross-Section of Expected Stock Returns. 2001. Print.