

# Capital asset pricing model

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CAPITAL ASSET PRICING MODEL Affiliation Capital Asset Pricing Model The capital asset pricing model (CAPM) has a number of components that determine the individual stock. The components that determine in entirety the individual stock and hence the CAPM they include the risk free rate in the CAPM, the Beta of the security, the expected market return and the equity market premium. The risk free rate is the government bond ideally, that has a fix ten years. The Beta is the true measure of the risk that is in the stock that one has invested on.

With the risk in it, measure the volatility of the investment. It is in this Beta that determines the wave of up and down the price of stock will oscillate. The expected market returns are all dependent on the Beta and the equities of the premiums in predicting the volatility of the stock that one can invest in. Mathematically, the CAPM is calculated with the as shown below:

$$R_a = R_f + B_a (r_m - R_f)$$

Where:

$R_f$  = Risk free rate

$B_a$  = Beta of the security

$R_m$  = Expected market return

$R_m + R_f$  = Equity market premium

According to Pahl (2009) most of the traders with stock they have embraced the predictability of the CAPM premium to know where it is worthy to invest in the stock. The CAPM pricing model consider simplification and the assumption such as there are no taxes or transaction cost, the investors in the stokes have an identical investment dimensions and all investment have the same opinion about expected return, volatilities and correlation of available investment. With such assumption then the formula will yield the <https://assignbuster.com/capital-asset-pricing-model/>

expected results.

#### Reference

Pahl, N. (2009). Principles of the Capital Asset Pricing Model and the Importance in Firm Valuation. München: GRIN Verlag GmbH.