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Finance

Critique of the relevance and validity of applying the capital asset pricing model in the context of investment choices Critique of the relevance and validity of applying the capital asset pricing model in the context of investment choices

The Capital Asset Pricing Model (CAPM) marks the start of asset pricing theory. It is still used extensively in applications like estimating the capital costs for organizations and evaluating the performance of portfolios. The attraction of CAPM is the fact that it gives powerful and instinctively pleasing predictions on the way to measure risk and the link between risk and expected return in investments. However, the relevance of CAPM has always been less significant than its duty in mobilizing attention and to define constructs. It may be argued that CAPM is not completely realistic, since most of its assumptions are not precisely satisfied in the real world. Undeniably, the CAPM model rules out active investment and management research, and therefore abolishes many applications merely by using a pen, by virtue of the idealistic assumptions made by it (Perold, 2004).

Some common applications often depend on the correctness of the modest CAPM, or rather the extensions in defining equilibrium returns. In fact, an imprecise understanding of the market portfolio may not be a vital factor in this. The approximated investment portfolio maintain an essential role in the reconstructed submission that arise from realization of the falsehood of CAPM. In this sense therefore, the application of this model to investment choices can have meaning only on condition that CAPM is false. The conclusion can be that the investment portfolio seems to play a natural role, making possible specifications errors to be unimportant (Shanken, 1987).

References

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