

"CAPM is based on senseless assumptions"

A no-holds-barred critique of the Capital Asset Pricing Model (CAPM). What's wrong with this Nobel-prize winning and immensely popular model?



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"An absurd model" is how IESE's [Pablo Fernández](#) describes the immensely popular, Nobel-prize winning Capital Asset Pricing Model (CAPM). His critique of CAPM is now a chapter in the 2017 book, *Economic Ideas You Should Forget*.

So, why should we be skeptical about CAPM, used by many Fortune 500 firms to estimate their cost of equity? In short, "CAPM is a model (a) based on senseless assumptions, and (b) none of its predictions happen in our world," Fernández explains.

As the professor explains to students (and recaps in the book chapter), the CAPM is meant to describe the relationship between "risk" and expected returns in determining prices. In a nutshell, CAPM states that the expected return on an asset is the risk-free rate plus a market rate premium (MRP) that is adjusted, via the beta (measuring volatility), to reflect the market risk of the asset.

But CAPM calculations are based on assumptions about what *all* investors are holding and what they expect, for starters. The real world is not so homogeneous: individual investors hold different portfolios and have different expectations. What's more, volatility/beta is not the best measure of "risk" because bankruptcies and crashes matter, too.

By relying on the CAPM, we fall prey to many mistakes in assessing potential investments, company valuations, fund performances, and more.

So what replacement does Fernández suggest? Simple reasoning — and common sense.

More info

["Don't buy into the market-portfolio hype"](#)

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