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A Study On

The Capital Asset Pricing Model and solutions to its Inadequacies

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1. Abstract: The Capital Asset Pricing Model (CAPM), which calculates an asset's expected return depending on its risk, is a commonly used tool in this regard. Despite being widely used, the CAPM has come under fire for a number of shortcomings, including its presumptions regarding investor behavior, market efficiency, and market portfolio constraints. In order to increase the CAPM's accuracy, this study addresses its shortcomings and offers substitute ideas. The Fama-French Three-Factor Model and the Arbitrage Pricing Theory are suggested as alternatives to the CAPM in order to address its shortcomings.

2. Introduction: The Capital Asset Pricing Model (CAPM), which calculates an asset's expected return depending on its risk, is a commonly used tool in this regard. The concept, which William Sharpe first proposed in 1964, is predicated on the rationality of investors' behaviour, the efficiency of the market, and the market portfolio's exclusivity as a source of systematic risk. The CAPM has received criticism for its shortcomings in spite of its widespread adoption. The CAPM is discussed in this study along with its shortcomings and potential improvements to its accuracy.

3. Literature Review: According to the literature, the CAPM is flawed in a number of ways, including its assumptions regarding investor behaviour, market efficiency, and market portfolio constraints. To get around the drawbacks of the CAPM, other research have suggested substitute models, such as the Fama-French Three-Factor Model and the Arbitrage Pricing Theory. These models provide more precise estimates of predicted returns since they take into account additional variables including size, value, and velocity.

4. Methodology: In order to evaluate the CAPM and its shortcomings, this paper takes a qualitative approach. Secondary sources used in the study include academic publications, research articles, and textbooks. The study then does a content analysis of the data to highlight the primary shortcomings of the CAPM and the alternate solutions suggested by earlier studies.

5. Results: The study's findings indicate that the CAPM is lacking in a number of areas, including its presumptions regarding investor behaviour, market efficiency, and market portfolio constraints. These deficiencies lead to incorrect resource allocation and estimates of projected returns. Additionally, the Fama-French Three-Factor Model and the Arbitrage Pricing Theory are found to provide more precise estimates of expected returns and address the shortcomings of the CAPM, according to the study.

6. Discussions: The study's findings have a number of ramifications for policymakers, financial experts, and investors. To make more accurate investment decisions, financial analysts and investors should take the CAPM's drawbacks into account and turn to alternate models. When creating rules and policies that have an impact on the financial markets, policymakers should take the shortcomings of the CAPM into account.

7. Conclusion: The Capital Asset Pricing Model (CAPM), which calculates an asset's expected return depending on its risk, is a commonly used tool in this regard. However, the CAPM has a number of flaws that lead to incorrect resource allocation and inaccurate estimates of expected returns. Alternative models that address the shortcomings of the CAPM provide more precise estimates of expected returns. Examples include the Fama-French Three-Factor Model and the Arbitrage Pricing Theory. To make better investment choices and create rules and laws that influence the financial markets, investors, financial analysts, and politicians should take into account the limits of the CAPM and employ other models.

8. References:

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