

Cost of Capital

Applications and Examples

Fifth Edition

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WILEY

Criticism of CAPM and Beta versus Other Risk Measures¹

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INTRODUCTION

Even though the capital asset pricing model (CAPM) is the most widely used method of estimating the cost of equity capital, the accuracy and predictive power of beta as the sole measure of risk have increasingly come under attack. As a result, alternative measures of risk have been proposed and tested. That is, despite its wide adoption, academics and practitioners alike have questioned the usefulness of CAPM in accurately estimating the cost of equity capital and the use of beta as a reliable measure of risk.

While the CAPM explains how investors should act and price risk, empirical research has shown that investors often act differently than predicted by CAPM. This chapter explores these criticisms, alternative measures of risk, and the other methods used to estimate the cost of equity capital.

¹The authors want to thank Niel Patel of Duff & Phelps LLC for preparing material for this chapter.