

Capital Asset Pricing Model

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- CAPM provides the expected return on an equity, given the risk-free return and the risk-weighted market premium of the stock in question
- Beta (β) is a measure of the sensitivity of company's return on equity to a change in the overall market return

$$R = R_f + \beta(R_m - R_f)$$

Diagram illustrating the CAPM formula with labels:

- Expected rate of return (points to R)
- Risk-free rate (points to R_f)
- Beta (points to β)
- Market return (points to R_m)

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Example

The shares of Booker Industries have a beta of 0.85. The share market is expected to return 10% and the risk-free rate of return is 3%. What is the expected return on the shares of Booker Industries?

$$\begin{aligned} R &= R_f + \beta(R_m - R_f) \\ &= 3\% + 0.85(10\% - 3\%) \\ &= 3\% + 5.95\% \\ &= 8.95\% \end{aligned}$$

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