

FOUNDATIONS
OF
FINANCE

*PORTFOLIO DECISIONS
AND
SECURITIES PRICES*

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Contents

Preface xv

CHAPTER 1

The Behavior of Stock Market Returns	3
I. Some Statistical Concepts	3
A. <i>Random Variables</i>	3
B. <i>The Mean</i>	4
C. <i>The Standard Deviation</i>	5
D. <i>Characterization of Normal Distributions by Their Means and Standard Deviations</i>	6
E. <i>The Sample Mean and Standard Deviation</i>	7
F. <i>Testing for Normality: The Studentized Range</i>	8
G. <i>Statistical Models and Reality</i>	11
II. The Definition of Return	12
III. Indexes or Portfolios of Stock Market Returns	13
IV. Average Return and Variability: A Quick Look	14
V. The History of Return Variability	15
VI. Distributions of Stock Market Returns	17
A. <i>Motivation and Theory</i>	17
B. <i>Daily Returns</i>	21
C. <i>Monthly Returns</i>	26
VII. Conclusions	38

CHAPTER 2

The Distribution of the Return on a Portfolio	41
I. A Portfolio's Return as a Function of Returns on Securities	41
II. The Mean and Variance of a Portfolio's Return	43
A. <i>The Mean or Expected Value of the Return on a Portfolio</i>	44
B. <i>The Variance of the Return on a Portfolio</i>	48
III. Portfolio Risk and Security Risk	58
IV. Conclusions	62

CHAPTER 3

The Market Model: Theory and Estimation	63
I. The Multivariate Normal Distribution of Returns on Securities	63
A. <i>Normal Portfolio Returns and Multivariate Normal Returns on Securities</i>	63
B. <i>Some Properties of the Multivariate Normal Distribution</i>	64
C. <i>Bivariate Normality of Pairwise Security and Portfolio Returns</i>	65
II. Bivariate Normality and the Market Model	66
A. <i>The Market Model: Fundamental Properties</i>	66
B. <i>Some Formal Justification</i>	69
C. <i>Some Additional Properties of the Model</i>	73
D. <i>The Market Model in the Empirical Literature</i>	76
III. The Estimators	77
A. <i>The Generality of the Procedures</i>	78
B. <i>The Estimating Equations</i>	79
C. <i>Some Algebraic Properties of the Estimators</i>	81
IV. The Sampling Distributions of the Estimators	84
A. <i>Unbiasedness</i>	84
B. <i>The "t" Distributions of the Standardized Estimators</i>	87
C. <i>Why the "t" Distribution?</i>	89
V. The Reliability of the Estimators	91
A. <i>Classical Confidence Intervals</i>	92
B. <i>Classical Hypothesis Testing</i>	94
C. <i>The Bayesian Approach</i>	96
VI. Conclusions	98

CHAPTER 4

The Market Model: Estimates	99
I. Estimating the Market Model: A Detailed Example	99
A. <i>The Market Model: Summary of Equations and Properties</i>	99
B. <i>Market Model Estimates for IBM</i>	101
C. <i>The Fit of the Estimated Regression</i>	104
D. <i>The Reliability of the Market Model Coefficient Estimates for IBM</i>	106
E. <i>Testing the Assumptions Underlying the Coefficient Estimators</i>	109
II. Evidence on the Risks or Market Sensitivities of NYSE Common Stocks	121
A. <i>Comments on Market Model Estimates for Larger and Smaller Firms</i>	121
B. <i>Evidence on the Assumptions Underlying the Market Model Estimates</i>	124
C. <i>Comparison of Prewar and Postwar Market Model Parameter Estimates</i>	128
D. <i>The Reliability of the Risk Estimates</i>	131
III. Conclusions	132

CHAPTER 5

Efficient Capital Markets	133
I. An Efficient Capital Market: Introduction	133
II. An Efficient Capital Market: Formal Discussion	134
III. Four Models of Market Equilibrium	137
A. <i>Expected Returns Are Positive</i>	137
B. <i>Expected Returns Are Constant</i>	142
C. <i>Returns Conform to the Market Model</i>	151
D. <i>Returns Conform to a Risk-Return Relationship</i>	166
IV. Conclusions and Some Fine Points of the Theory	167

CHAPTER 6

Short-Term Interest Rates as Predictors of Inflation	169
I. The Market for U.S. Treasury Bills	169
A. <i>Treasury Bills: What Are They?</i>	169
B. <i>Real and Nominal Returns on a One-Month Bill</i>	170

xii

Contents

- II. Inflation and Efficiency in the Bill Market: Theory 175
 - A. Market Efficiency in a World of Perfect Foresight 175
 - B. Market Efficiency in a World of Uncertainty 175
- III. A Model of Market Equilibrium 178
 - A. Why Do We Need a Model of Market Equilibrium? 178
 - B. The Model 178
- IV. Testable Implications on Market Efficiency When the Equilibrium Expected Real Return Is Constant Through Time 179
 - A. The Real Return 179
 - B. The Nominal Interest Rate as a Predictor of Inflation 180
 - C. Summary and Reinterpretation of the Proposed Tests 184
- V. The Data 186
- VI. The Major Results for One-Month Bills 188
 - A. The Information in Past Inflation Rates 191
 - B. Tests of Market Efficiency 191
 - C. The Expected Real Return 192
- VII. The Behavior of $\bar{\Delta}_t$ 197
- VIII. Results for Bills with Longer Maturities 200
- IX. Interest Rates as Predictors of Inflation: Comparison with the Results of Others 204
- X. Extension of the Results to the Period of Price Controls 206
- XI. Conclusions 210

CHAPTER 7

The Two-Parameter Portfolio Model 212

- I. Introduction 212
- II. Normal Distributions, Risk Aversion, and the Efficient Set 213
 - A. The Framework 213
 - B. The Simplifications Obtained When Portfolio Return Distributions Are Normal 214
 - C. The Simplifications Obtained When Investors Are Risk-averse 214
 - D. Geometric Interpretation 216
- III. The Geometry of the Efficient Set 219
 - A. The Geometry of Combinations of Two Securities or Portfolios 219
 - B. The Efficient Set: No Risk-free Asset 231
 - C. The Efficient Set with a Risk-free Asset 235

<i>Contents</i>	<i>xiii</i>
IV. Portfolio Risk, Security Risk, and the Effects of Diversification	240
A. <i>Portfolio Risk and Security Risk in a Two-Parameter World</i>	241
B. <i>Portfolio Risk and Security Risk: Empirical Examples</i>	245
C. <i>The Effects of Diversification</i>	252
V. Conclusions	256

CHAPTER 8

Capital Market Equilibrium in a Two-Parameter World	257
I. Introduction	257
II. The Relationship Between Expected Return and Risk in an Efficient Portfolio	258
A. <i>The Risks of Securities and Portfolios</i>	258
B. <i>The Mathematics of Minimum Variance Portfolios</i>	260
C. <i>Interpretation of the Results</i>	267
III. Market Relationships Between Expected Return and Risk When There Is Risk-free Borrowing and Lending	271
A. <i>Complete Agreement</i>	271
B. <i>The Efficient Set When There Is Risk-free Borrowing and Lending</i>	273
C. <i>Market Equilibrium When There Is Risk-free Borrowing and Lending</i>	274
D. <i>Criticisms of the Model</i>	277
IV. Market Relationships Between Expected Return and Risk When Short-Selling of Positive Variance Securities Is Unrestricted	278
A. <i>The Efficiency of the Market Portfolio</i>	279
B. <i>Efficient Portfolios as Combinations of the Market Portfolio M and the Minimum Variance Portfolio Z</i>	285
V. Variants of the Model of Market Equilibrium When There Is Unrestricted Short-Selling of Positive Variance Securities	288
A. <i>Market Equilibrium When There Is a Risk-free Security But It Cannot Be Sold Short</i>	288
B. <i>Market Equilibrium When There Is Risk-free Borrowing and Lending But at Different Interest Rates</i>	293
C. <i>Market Equilibrium When There Is Risk-free Borrowing and Lending But There Are Margin Requirements</i>	295
VI. Comparison of and Comments on the Various Two-Parameter Models of Market Equilibrium	298

VII.	Market Equilibrium When There Are No Risk-free Securities and Short-Selling of Positive Variance Securities Is Prohibited	301
	A. Preliminary Discussion	301
	B. The Efficient Set Without Short-Selling or Risk-free Securities	303
VIII.	Market Equilibrium: Mathematical Treatment	305
	A. Consumption-Investment Decisions and Equilibrium Prices	305
	B. Counting Equations and Unknowns	313
	C. Market Equilibrium Without Complete Agreement	314
IX.	Conclusions	319

CHAPTER 9

	The Two-Parameter Model: Empirical Tests	320
I.	Introduction	320
II.	Testing the Model: General Discussion	321
	A. Hypotheses about Expected Returns	321
	B. Competing Hypotheses	322
	C. The Portfolio Approach to the Tests	323
	D. Least Squares Coefficients as Portfolio Returns	326
	E. Getting the Most Powerful Tests: General Discussion	329
	F. The Reliability of the Least Squares Portfolio Returns	336
	G. Capital Market Efficiency: The Behavior of Returns Through Time	338
III.	Details of the Methodology	340
	A. Application of the Approach to the Equally Weighted Market Portfolio	341
	B. The Portfolio Approach to Estimating Risk Measures	343
IV.	Results	356
	A. Preliminary Discussion	356
	B. Tests of the Major Hypotheses	362
	C. The Sharpe-Lintner Hypothesis	368
V.	Some Applications of the Measured Risk-Return Relationships	370
	A. A Two-Factor Market Model	371
	B. Market Efficiency and the Two-Factor Models	375
	C. Market Efficiency and Company-Specific Information	376
	D. Portfolio Selection and Performance Evaluation	380
VI.	Conclusion	382
	References	383
	Index	389

Preface

Among the various fields of economics, finance is somewhat unique in terms of the correspondence between theory and evidence. The purpose of this book is to introduce the theory of finance and the empirical tests of the theory. I concentrate on that part of finance which is concerned with portfolio decisions by investors and the pricing of securities in capital markets.

My view is that the student's motivation to master a theory is enhanced when evidence is presented to show that the theory has some power to explain real world phenomena. Moreover, my classroom experience is that pointless squabbles about the realism of a theory or the assumptions from which it is drawn can be avoided if relevant empirical evidence is presented along with the theory. This is the approach taken in this book.

The first four chapters of the book provide the background statistical material. The goals are (a) to review the statistical tools that are necessary for any nonsuperficial study of finance and (b) to familiarize the reader with the descriptive evidence on the behavior of securities prices that forms the empirical foundation for the theory of finance and the formal tests of that theory. The approach in these chapters is to introduce statistical concepts first and then to use them to describe the behavior of returns on securities. Thus, Chapter 1 studies probability distributions and the properties of samples and then uses the concepts to examine distributions of common stock returns. Chapters 2 and 3 take up the statistical tools that are needed to study the relationships between returns on securities and portfolios. To motivate the study of these tools, some of the rudiments of portfolio theory are introduced in Chapter 2. Chapter 4 uses the statistical concepts presented in Chapters 2 and 3 to study empirically the "market sensitivity" of New York

Stock Exchange common stocks, examining evidence on the extent to which the returns on individual securities are related to market returns.

The core of the book is in Chapters 5 to 9. Three related topics are treated: (a) theory and evidence on capital market efficiency, (b) portfolio theory, and (c) theory and evidence on the relationship between expected return and risk. In an efficient capital market, prices of securities "fully reflect" available information. Chapters 5 and 6 discuss theory and empirical work on capital market efficiency; the former is concerned with the stock market, the latter with the bond market. Chapter 7 develops in detail the portfolio model introduced in Chapter 2 and presents empirical evidence on the effects of diversification in reducing risk. Chapter 8 then considers the characteristics of equilibrium security prices when investors make portfolio decisions according to the model of Chapter 7. The relationship between expected return and risk that comes out of the model of capital market equilibrium in Chapter 8 is put to the test in Chapter 9.

Problems for the reader are scattered through the text. The word "scattered" is used advisedly. The problems are not tucked neatly at the ends of sections, but rather appear whenever I want to reinforce a point or give pause for thought. The problems are an integral part of the text; results contained in them are often referred to in later parts of the text. In light of this, fairness and convenience argue that answers to problems follow the problems in the text. This raises the temptation—and thus the probability—that the problems will not be treated as such, but it is in the student's interest to resist this temptation. The problems allow the reader to keep tabs on his understanding of the material and so to avoid unwarranted euphoria.

The technical prerequisites for reading this book are minimal. Mathematics beyond elementary algebra appears only briefly in two chapters and is not critical to understanding the important material in either chapter. Moreover, I try always to supplement even elementary mathematical arguments with verbal discussions; in cases where the details of a mathematical argument can be skipped, this is so indicated. The book is, however, heavy with formal notation, and the reader is well advised to master the notation as quickly as possible.

Although finance is properly regarded as a branch of economics, the ambitious reader could understand this book without previous formal exposure to economics. Financial economics is, however, easier to grasp if one has some familiarity with habits of economic analysis. Thus, although no specific material is needed, some prior exposure to economics is helpful. Likewise, the book reviews the statistical concepts that it uses, but the presentation is more effective if the reader has had some previous exposure to statistics, though

*Preface**xvii*

not necessarily to the specific statistical concepts that are most useful in finance.

This book is meant to be an introduction to finance, with approximately equal emphasis on theory and evidence. As with any introduction, some picking and choosing of topics is necessary. I have chosen to focus on topics where there is sufficient empirical evidence to draw coherent conclusions about the descriptive power of a theory. I do not claim to cover all the topics that meet this criterion, and one can argue that my choices reflect much personal prejudice. The goal of the book is met, however, if I familiarize the reader with the common methods of analysis in finance sufficiently to tackle original works, both those already available and those yet to come, on his own.

Finally, I am pleased to acknowledge the help of Linda Huegel, who typed several versions of the manuscript; proofreading was provided by Agnes Farris, Vicky Longawa, and Jane Miller. Nicholas Gonedes and Harry Roberts, my colleagues at the University of Chicago, made many valuable comments on the manuscript. My debt to the pioneers of modern finance, who did the original work on which this book is based, is obvious.