Metadata

```
Course:   DS 5100
Module:   05 Numpy
Topic:    Capital Asset Pricing Model (CAPM) HW KEY
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Objectives

- Use numpy and functions to compute a stock's CAPM beta
- Perform sensitivity analysis to understand how the data points impact the beta estimate

Background

In finance, CAPM is a single-factor regression model used for explaining and predicting excess stock returns.

There are better, more accurate models, but it has its uses.

For example, the **market beta** is a useful output.

Here is the formula for calculating the expected excess return:

$$E[R_i] - R_f = \beta_i(E[R_m] - R_f)$$

where:

ER_i = expected return of stock i

R_f = risk-free rate

β_i = beta of the stock

$ER_m - R_f$ = market risk premium

Review the instructions below to complete the requested tasks.

TOTAL POINTS: 10

Set Up

Import NumPy

```python
import numpy as np
```

Define Risk-free Treasury rate

You will use this constant below.

```python
R_f = 0.0175 / 252
```

Data Preparation

We import the data and convert it into usable Numby arrays.

Read in the market data

The values are closing prices, adjusted for splits and dividends.

The prefixes of the second two columns are based on the following codes:

- SPY is an ETF for the S&P 500 (i.e. the stock market as whole)
- AAPL stands for Apple

```
data_file = "capm_market_data.csv"
```

```
data_2D = np.array([row.strip().split(',') for row in open(data_file, 'r').readlines()])
```

Separete columns from the data

```
COLS = np.str_(data_2D[0])
```

```
COLS
```

```
"['date' 'spy_adj_close' 'aapl_adj_close']"
```

Separate columns by data types

Numpy wants everything to in a data structure to be of the same type.

```
DATES = data_2D[1:, 0]
```

```
RETURNS = data_2D[1:, 1:].astype('float')
```

Instructions

Q1 (1 PT)

Print the first 5 rows of the `RETURNS` table.

```
# PRINT ROWS
```

Q2 (1 PT)

Print the first five values from the SPY column in `RETURNS`.

Then do the same for the AAPL column.

Use one cell for each operation.

```
# PRINT VALUES FOR SPY
```

```
# PRINT VALUES FOR AAPL
```

Q3 (1 PT)

Compute the excess returns by subtracting the constant `R_f` from `RETURNS`.

Save the result as numpy 2D array (i.e. a table) named `EXCESS`.

Print the LAST five rows from the new table.

```
# COMPUTE EXCESS
```

```
# PRINT ROWS
```

Q 4 (1 PT)

Make a simple scatterplot using Matplotlib with SPY excess returns on the x-axis, AAPL excess returns on the y-axis.

Hint: Use the following code:

```
from matplotlib.pyplot import scatter

scatter(<x>, <y>)
```

Replace `<x>` and `<y>` with the appropriate vectors.

You may want to save the vectors for the SPY and AAPL columns as `x` and `y` respectively. This will make it visually easier to answer question 6.

```
# ENTER CODE
```

Q5 (3 PTS)

Use the normal equation, listed below, to compute the Regression Coefficient Estimate of the data plotted above, $\hat{\beta}_i$.

Note that x^T denotes transpose of x.

$\hat{\beta}_i = (x^T x)^{-1} x^T y$

Use the Numpy functions for matrix to do this - multiplication, transpose, and inverse.

Note, however, that since x in this case a single column matrix, i.e. a vector, the result of $x'x$ will be a scalar, which is not invertable. So you can just invert the result by division, i.e.

$\hat{\beta}_i = \frac{1}{x^T x}(x^T x)$

Be sure to review what these operations do, and how they work, if you're a bit rusty.

You should find that $\hat{\beta}_i > 1$.

This means that the risk of AAPL stock, given the data, and according to this particular (flawed) model, is higher relative to the risk of the S&P 500.

```
# ENTER CODE
```

Q6 (3 PTS)

Measuring Beta Sensitivity to Dropping Observations (Jackknifing)

Let's understand how sensitive the beta is to each data point.
We want to drop each data point (one at a time), compute \(\hat\beta_i\) using our formula from above, and save each measurement.

Write a function called `beta_sensitivity()` with these specs:

- Take numpy arrays x and y as inputs.
- For each observation i, compute the beta without the current observation. You can use a `lambda` function for this.
- Return a list of tuples each containing the observation row dropped and the beta estimate, i.e. something like `(i, beta_est)`, depending how you've named your variables.

Hint: `np.delete(x, i)` will delete observation i from array x.

Call `beta_sensitivity()` and print the first five tuples of output.

```
# ENTER FUNCTION
```

```
# CALL FUNCTION
```

```
# READ DATA
```