Fama-Macbeth:

1a) Simple CAPM verification:

Create time series regression: excess stock return = intercept + beta(excess market return)

To estimate betas.

Using these betas, we use cross sectional regression to calculate “gammas”:

Excess stock return = intercept + (estimated betas)(excess market return)

Now to verify if CAPM holds:

Conduct hypothesis test: H0 : intercept = 0 , H1 : intercept =/= 0

We want to hopefully find intercept = 0 (for capm to hold)

Evaluation – if not why not! What assumptions did we make? How did we group data – does that make a difference? Does it make a difference if we use value weighted opposed to equal weights??

b) Liquidity factor based model