Equilibrium Cross-Section of Returns

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Abstract

We construct a dynamic general equilibrium production economy to explicitly link expected stock returns to firm characteristics such as firm size and the book-to-market ratio. Stock returns in the model are completely characterized by a conditional CAPM. Size and book-to-market are correlated with the true conditional market beta and therefore appear to predict stock returns. The cross-sectional relations between firm characteristics and returns can subsist even after one controls for typical empirical estimates of beta. These findings suggest that the empirical success of size and book-to-market can be consistent with a single-factor conditional CAPM model.