

## 7.11: Empirical Findings of the SML

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While the CAPM/SML met with a lot of early success and became the standard for estimating required returns in the field of finance very quickly, it ran into problems in the 1990's and is deemed less reliable at the moment. (Fama and French, 1992) There have been some alternative models ([Fama-French 3-Factor model](#), [Carhart 4-Factor model](#), [Fama-French 5-Factor model](#), and the [q-Factor model](#)) introduced since then, however there has not been a new standard-bearer to take its place. As of right now, the SML is still commonly used in practice, however there is growing focus on the alternatives. My view is that it is critical for you to know and understand the basic premise of the CAPM and SML (that role of market risk in explaining returns) but also to be aware of some of the problems (listed below).

- While market returns play a major role in explaining returns of individual stocks, Beta doesn't do a very good job of explaining future returns. In other words, after controlling for other factors, it is not clear that high beta stocks actually outperform.
- Small firms seem to earn higher returns than can be explained by beta.
- Firms with a low market-to-book ratio (MV/BV) tend to earn higher returns than can be explained by beta.
- Firms that have been top performers in the past 6-12 months tend to earn higher returns in the following 6-12 months than can be explained by beta.

Again, the above flaws do not mean that the CAPM/SML are useless. They provide a simplified framework for understanding how market risk relates to returns. However, recognize that they are not perfect models and the process of understanding stock returns is more complex than the SML indicates. As our knowledge increases, better models will likely evolve.

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