7.10: Important Implications of the CAPM/SML

- According to the SML, high beta stocks should, on average, earn higher returns than low beta stocks.
- According to the SML, the only factor that should cause consistent differences in returns across stocks is beta.
- When interest rates rise, required returns should increase and (all else equal) cause stock prices to decline.
- When investors become more risk-averse, the risk premium $\left(\bar{k_m} - k_{RF}\right)$ should increase which will increase required returns and (all else equal) cause stock prices to decline.

Under equilibrium conditions, the required return should equal the expected return. Let's consider this for a minute. In our example above, we estimated that the required return for stock B should be 13.4%. What would happen if the expected return $\bar{k}$ for this stock was 16%?

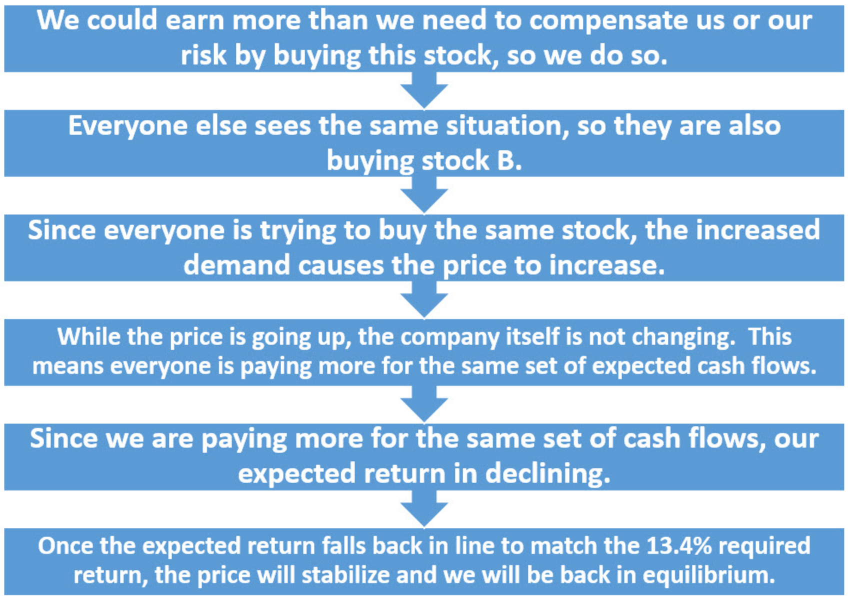

Figure 7.10.1: Flow chart

For practice in understanding this concept, think through what would happen if the required return was 13.4% and the expected return was 9%. Also, think about what types of things may push us out of equilibrium and why this is relevant for explaining stock price movements.