Q. Reference: Dr. Booth Evidence, Page 46, Lines 16-17: Given Dr. Booth's testimony that current bond yields are not being determined by ordinary investors trading off risk versus return, as assumed in standard risk premium models, would Dr. Booth agree that the CAPM is not producing reliable results under current market conditions and is essentially "broken"? Please explain.

A. Not at all.

All risk premium models suffer the same problem and it is simply an identification problem in terms of what is the correct risk free rate to use in the CAPM. This problem goes back to Fischer Black "Capital Market Equilibrium with Restricted Borrowing," Journal of Business, (July 1972).

The CAPM is the standard equilibrium model in use in finance, since it recognizes that all assets have to be held and the central role of the market portfolio. The main contenders like the Fama-French model in Dr. Booth's Schedule 3 are not equilibrium models. Further, it is easy to show that in equilibrium the CAPM can be given a multi-factor interpretation that makes it incredibly difficult to identify one versus the other. Finally models like the Fama-French model do not significantly change cost of capital estimates as Dr. Booth's Schedule 3 shows and have not been accepted when presented before regulatory boards in Canada, since the parameters are even more difficult to estimate and implement.