

1 Q. Page 52: Dr. Booth states that "the big advantage of the CAPM is that it is  
2 difficult to make big mistakes". What does Dr. Booth consider is the range of "mistakes"  
3 that wouldn't be "big"?

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5 A. This sentence should be read in conjunction with the qualifications at the top of  
6 the page:

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8 *"I have traditionally viewed my DCF estimates as "checks" on my CAPM*  
9 *estimates, since in my view CAPM estimates have usually been in the right "ball-*  
10 *park." However, the recent very low long Canada bond yields have forced me to*  
11 *re-evaluate this and look at what drives the difference between the DCF and*  
12 *simple CAPM estimates. This is because they should be consistent."*

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14 With that qualification a normal market risk premium of 5-6.0% means that the  
15 difference between a low risk utility with a beta of 0.5 and a high risk company, like a  
16 tech company, with a beta of 1.5 is 5-6%.

17 In contrast, Dr. Booth has seen decades of very good MBA students implementing the  
18 constant growth DCF model, when long Canada bond yields were 5%, and saying things  
19 like:

- 20 • *The firm has a dividend yield of 3% and management indicates limited growth*  
21 *prospects of 1% so we take the equity cost to be 4%;*  
22 • *The firm does not pay a dividend, but is expected to earn 20-25% over the*  
23 *medium term so we take the equity cost to be 22.5%.*

24  
25 In both cases the firm does not fit the requirements to use the constant growth DCF  
26 model and instead some form of finite or multi-stage growth model is needed. The use of  
27 the long Canada bond yield immediately questions the first estimate while the diagnostic  
28 check that the growth rate goes on for infinity rules out the second. As a result, that

1 spread of 18.5% is directly the result of the inappropriate use of the constant growth DCF  
2 model.

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4 The fact that we start with the long bond yield and an estimate of the overall market  
5 return means that the mistakes made by the CAPM are rarely as bad as the above  
6 mistakes using the DCF model. Dr. Booth had many animated discussions with his late  
7 colleague, Professor Myron Gordon, who created the constant growth DCF model over  
8 exactly these issues.