1 **Q. Reference: Dr. Booth's Evidence, Page 43, Line 27 to Page 44, Line 5**
2
3 **Please explain the theoretical basis for the Conditional CAPM. Please provide**
4 **any academic literature that supports the use of the Conditional CAPM to**
5 **adjust for the artificially low interest rate environment that has been created**
6 **by monetary policy.**
7
8 A. The foundation are the two papers by Paul Samuelson and Robert Merton in the
9 Review of Economic and Statistics (August 1969) who both derived a multi-period
10 asset-pricing model. Both are Nobel prize winners and Merton showed in
11 continuous time and Samuelson in discrete time the restrictions required to generate
12 the single period CAPM in a multi-period asset-pricing model. One of these
13 restrictions was that the risk free rate has to be non-stochastic. Otherwise, the CAPM
14 changes with changes in the risk free rate and individuals hedge against these
15 changes. Other parts of the opportunity set also have to evolve in a non-stochastic
16 manner.