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Capital Asset Pricing Tests in the China Stock Markets

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Abstract

Under the globalization trend and the development of the emerging markets, the China stock markets have become the world's second largest equity market which plays more and more important roles in the world economy. This paper tests various factor asset pricing models and investigates their performance in both the Shanghai and Shenzhen stock markets. Among various factor models, we find that the liquidity four-factor model has the best performance. The liquidity four-factor model is constructed by adding a liquidity factor into the Fama and French (1992) three-factor model. The result shows that the model has strong explanatory power with high R-squares, insignificant intercepts, and significant coefficients on the market premium, size, book-to-market and liquidity factors. We also test the momentum four-factor model and find results similar with the liquidity four-factor model but with lower R-squares. We also perform robustness tests on the impact of high moment, conditional up- and down- markets and seasonality on the model but detect no particular irregular pattern. We hope that our finding would provide a better understanding on factor models in the China stock markets. We expect our results can provide both individuals and institutions a more accurate benchmark to evaluate their cost of capital, portfolio performance, and risk-return relation on their investment.