Approximate CAPM When Preferences Are CRRA *

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In general equilibrium models of financial markets, the capital asset pricing formula does not hold when agents have von Neumann–Morgenstern utility with constant relative risk aversion. In this paper we examine under which conditions on endowments and dividends the pricing formula provides a good benchmark for equilibrium returns. While it is easy to construct examples where equilibrium returns are arbitrarily far from those predicted by CAPM, we show that there is a large class of economies where CAPM provides a very good approximation. Although the pricing formula does not hold exactly for the chosen specification, it turns out that pricing-errors are extremely small.

*Herings, P.J.J., and F. Kubler (2007), "Approximate CAPM When Preferences Are CRRA," Computational Economics, 29, 13-31. http://researchers-sbe.unimaas.nl/jeanjacquesherings/wp-content/uploads/sites/9/2013/04/Approximate-CAPM-when-preferences-are-CRRA.pdf

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