

University of Zurich

Department of banking and finance

Chair in financial economics

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Bachelor thesis

CAPM variations for emerging markets and their implications for a strategic asset allocation

How capital asset pricing model variations for emerging markets influence the cost of equity and consequently, affect the investor's strategic asset allocation.

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Abstract

Investments in emerging markets may be very beneficial to an investor's portfolio, since they have shown historically high returns. Their valuation must however account for the different circumstances in contrast to developed markets. Emerging markets may for instance come with significant differences in market integration with the world, which translates into a composition of risk and return different from the one predicted by the global portfolio and implied by the classic capital asset pricing (CAPM) theory. To further understand these conditions, this thesis first gives a literature review on the search for the correct estimation of the cost of emerging market equity and then applies its theories and ideas to compare the different methods offered by current research to do a valuation. Finally, it concludes with an exemplary application of different suggested CAPM modifications for a strategic asset allocation, giving investors more awareness of the potential problems when examining the inclusion of emerging markets in their portfolio. The results clearly show the danger of choosing among different models without having a theoretical or economical explanation behind the selection. In that sense, it is crucial for the practitioner to have a sense of the undiversifiable risk premium behind her or his own individual portfolio when valuating emerging market investments.