

We study the performance of conditional asset pricing models in explaining the German cross-section of stock returns. Our test assets are portfolios sorted by size and book-to-market as in the paper by Fama and French (1993). Our results show that the empirical performance of the Capital Asset Pricing Model (CAPM) can be improved substantially when allowing for time-varying parameters of the stochastic discount factor. A conditional CAPM with the term spread as conditioning variable is able to explain the cross-section of German stock returns about as well as the Fama-French model. The model specification passes parameter stability tests – a finding which is not true for the Fama-French model. Unconditional model specifications however do a better job than conditional ones at capturing time-series predictability of the test portfolio returns.