

Is There a Latent Factor in Stock Returns?

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Abstract

The measurement problems encountered while trying to exhibit the influence of market risk factor on asset returns may be numerous. It seems then difficult to highlight the unique common latent factor underlying stock return evolutions in the market. So far, excess return relationships are mainly and broadly considered. Moreover, basic and common studies require a market factor proxy (i.e., market portfolio benchmark). The chosen proxy usually impacts related results (see Roll [1977]). To bypass such problems, we resort to Kalman filtering methodology to exhibit the common latent factor underlying stock market returns. Of course, when this one exists...

Keywords: CAPM, idiosyncratic risk, Kalman filter, market risk, stock returns, systematic risk.

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