EXPLAINING THE CROSS-SECTION RETURNS IN FRANCE: CHARACTERISTICS OR COVARIANCES?

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ABSTRACT. Size and book to market ratio are both highly correlated with the average returns of common stocks. Fama and French (1993) argue that these effects are proxies for factors of risk. In this study, we test the three factor model of Fama and French and the Characteristic Model of Daniel and Titman (1997) on The French Stock Market. The sample is from July 1976 to June 2001. Yearly, we rank, independently, all stocks by size and book to market ratio. Then, we make another classification based on ex-ante HML, SMB or Mkt loadings. To test the two models, we use Daniel and Titman methodology to construct our characteristic-balanced portfolios. The characteristic-based model predicts that these portfolios should have an average return of zero. The factor model says that these returns should be positive. Our results reject the factor model with characteristic balanced portfolios that load on the HML, SMB and MKt factors. Moreover, the three factor model predicts that the intercepts of regressions of the returns of these characteristic-balanced portfolios on the Fama and French factor portfolios are indistinguishable from zero. In contrast, the alternative hypothesis of the characteristic model says that these intercepts should be negative. Our results are consistent with the factor pricing model and inconsistent with the characteristic-based pricing model. Because the size and the value premiums are relatively small, our conclusions must be interpreted carefully. In contrast, market premium allows more powerful tests of the two models.

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