Institute of Local Public Finance
Working Paper 02-2017
November 2017

The Neglect Effect in Security Beta Estimates - An observation of the US stock market from 1933 until 2016

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Abstract

Security betas play a crucial role in capital markets and corporate finance as a determinant of firms' cost of equity. While investors apply betas to value stocks, CFOs use it to set appropriate hurdle rates and evaluate projects. The underlying model's popularity has thereby persisted despite of its obviously rigid and seemingly unrealistic assumptions as well as the lack of empirical support. However, estimating appropriate betas is challenging. Academic research has shown that delayed reactions of stock prices to market-wide news can result in distorted regression betas even if monthly returns data is used. This problem can be mitigated if betas are estimated through multiple regressions incorporating lagged market returns. We show that adjusting betas this way results in higher betas especially for securities that are likely subject to subdued investor attention and trading activity (defined as neglected stocks). We furthermore show that delayed reaction to market-wide news is more likely to occur in markets characterized by small-stock outperformance, bull markets and during periods of economic expansion.

JEL Classification: H7; H2; H1

Keyword: Security Beta, Cost of Equity, Neglected Stocks, Capital Asset Pricing Model

The working paper 02-2017 was published as Fabian Scheler, Frank Ecker and Jan Werner (2018): The Neglect Effect in Security Beta Estimates - An observation of the US stock market from 1933 until 2016 in in Sucky et al (2018) Mobility in Globalised World 2017, Logistik & Supply Chain Management Issue 19, Bamberg, Germany, University of Bamberg Press, page 177-183.