Expected Returns, Yield Spreads, and Asset Pricing Tests

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Abstract

We use information contained in yield spreads to recover investors' *ex ante* required rates of return on corporate securities, and then use these *ex ante* returns to study the pricing of risky assets. Differently from the standard approach, our asset pricing tests do not rely on the use of *ex post* average equity returns as proxies for expected equity returns. We find that: (i) the market beta plays a significant role in the cross-section of expected equity returns, and its role persists even after size and book-to-market factors are accounted for; (ii) the risk premia associated with size and book-to-market are positive, significant, and countercyclical; and (iii) there is little evidence on positive momentum profits. We also find that systematic risk, as captured by common equity factors, is the main driver of the cross-sectional variation in bond yield spreads.

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