



MARKET RISK AND EFFICIENCY

A Framework for Identifying Accounting Characteristics for Asset Pricing Models, with an Evaluation of Book-to-Price

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We provide a framework for identifying accounting numbers that indicate risk and expected return. Under specified accounting conditions for measuring earnings and book value, book-to-price (B/P) indicates expected returns, providing justification for B/P in asset pricing models. However, the framework also points to earnings-to-price (E/P) as a risk characteristic. Indeed, E/P, rather than B/P, is the relevant characteristic when there is no expected earnings growth, but the weight shifts to B/P with growth. Using this framework we resolve a puzzle: in contrast to previous empirical research, we find that leverage is positively associated with future returns, as predicted by theory.

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