Discussion of Cho and Salarkia (2025)

"Which Asset Pricing Model Do Firms Use? A Revealed Preference Approach"

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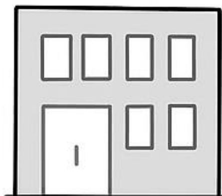
E(astern)FA Annual Meeting 2025

Recap

THE PUZZLE

Is our stock overvalued or undervalued?

Let's see which one best predicts equity issuance decisions!



BUYBACK STOCK

Recap

Objective

- Identify which asset pricing model best aligns with firms' perceived cost of equity by examining their equity issuance and repurchase decisions

Approach

- Revealed preference to infer firms' internal asset pricing model
- Focus on direction (not the magnitude) of net issuance
- Focus on (i) financially unconstrained firms and (ii) repeat with share repurchases

Result

- CAPM outperforms more sophisticated models in issuance decisions
- Firms systematically ignore factor risks in capital structure decisions

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Plan for Discussion

1. Intuition for the Methodology
2. Type of Firms and Generalizability
3. Role of Financial Intermediaries

Point 1. Intuition for the Methodology

Background

Economic agents behaving as if they use CAPM isn't a new idea.

- Berk and van Binsbergen (2016)
  If investors use a particular risk model to assess mutual fund performance, then capital flows should respond positively to positive alpha under that model.

- Barber, Huang, and Odean (2016)
  Decompose fund returns into alpha and factor components → Test which components investors respond to in flows

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This Paper: Shift focus to **firm managers**, not investors

- Core Idea: “Let's watch what firms do, and see which model's definition of mispricing lines up best with these actions”

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Key Assumptions:

1. Firm managers maximize future long-horizon alphas (vs. past short-horizon alphas)
2. Issuance partially corrects mispricing, but not fully (as they are a monopolist)
3. Firms have an informational or behavioral edge over investors.

Threats to Methodology

Potential Threats

1. Issuance is not just about mispricing.
    - Focus on financially unconstrained firms
    - Use share repurchases, for which mispricing is a bigger deal
    - Control for investment opportunities

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2. Measuring ex-post mispricing
   - Run tests with different horizons and get similar results
   - Using ranks (instead of the alpha magnitudes)

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1. Manager biases? (Firms may issue/repurchase based on non-model-based beliefs)

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   - The fact that CAPM outperforms multi-factor models suggest that either:

     (a) manager biases are not systematically linked to characteristics

     (b) managers are not biased and are acting on perceived mispricing in a way that’s aligned with CAPM.

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Suggestion 1a: Are some firms “issuers” and “repurchasers” regardless of α?

Suggestion 1b: Does managerial sentiment predict issuance controlling for mispricing?

- Use data from Graham & Harvey CFO surveys (e.g., optimism, expected returns)

Suggestion 1c: Using CEO turnover as shocks to managerial biases

- Assumption: CEO turnover only affects biases but not internal risk models

Point 2. Types of Firms and Generalizability

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- Paper focuses on financially unconstrained firms.
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- Question: Are those firms also acting like CAPM users when choosing when to issue? Or are they just taking whatever window is open, regardless of model-implied mispricing?

- If constrained firms also time issuance based on CAPM signals, that would suggest CAPM beliefs are deeply ingrained — like second nature.
- If not, maybe the “luxury” of using valuation models only exists when you don’t actually need the money.

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- **Suggestion 2a**: Expand scope using proxies for “issuance urgency”
  - Use debt maturities or cash burn rates as proxies / instruments for issuance urgency
  - See if firms with less urgency behave more like CAPM timers, and those with more urgency just grab what they can

- **Suggestion 2b**: Issuances around market dislocations
  - In crisis periods (e.g., 2008, COVID crash), some firms issue just to survive

Point 3. Role of Financial Intermediaries

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- Example: Equity Capital Markets (ECM) group in investment banks
- Banks offer information on market conditions, investor appetite, pricing strategies and maybe push issuance for fee-driven reasons

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- Yet interpreting issuance as a clean signal of model use by the firms need to rule out that intermediaries do not systematically distort firm intent
- Ignoring banks might be fine for large firms with internal capital markets teams and repeat issuance experience → Revealed preference more valid

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- Ignoring banks might be fine for large firms with internal capital markets teams and repeat issuance experience → Revealed preference more valid for larger firms

Suggestion 3. Split sample by issuance channel

- Compare direct repurchases vs. underwritten SEOs vs. private placements to reveal how much of the "CAPM preference" is bank-filtered behavior

More broadly, this affects how we interpret corporate finance decisions — are they internally optimized or externally steered?

Final Thoughts

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  - Addressing remaining considerations regarding methodology
  - Completing the paper's narrative by expanding on the set of firms and considering intermediation channels for issuance decisions

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- **A few questions prompted by the paper for the future:**
  - Who are the sophisticated factor model users?
  - What else can we "back out" by revealed preference argument?