

The Value Impact of Using Total Market Return and its Implications for Valuation Practice

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Abstract

The objective of this paper is to analyze the suitability of the Total Market Return approach within the requirements of the capital asset pricing model, and for the purpose of business valuation, particularly in light of its endorsement by the institute of German auditors (IDW). First, we question the use of the total market return approach on a theoretical basis. Then, we analyze whether total market returns influence the institute's recommendation for the market risk premium in a meaningful way and show the implications of a rigorous application for a large sample of valuation reports authored by German auditors. Our results reject the suitability of the Total Market Return approach for the purpose of business valuation on theoretical grounds, show that its rigorous application would have led to much lower company valuations, and highlight the necessity of revising the reasoning behind the recommended bandwidth of market risk premia.

Keywords: Market risk premium, Total market return, Company valuation, Discounted cash flow

JEL Classification: G12, G32, G34

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