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How Domestic is the Fama and French Three-Factor Model? An Application to the Euro Area

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Abstract

The euro area has faced a high number of monetary and policy changes in the recent past as a consequence of the European integration process and, naturally, these developments have important implications for portfolio diversification and asset pricing. Therefore, this paper concentrates on the performance of a specific asset pricing model: the Fama and French three-factor model. Griffin (2002) shows that the Fama and French factors are country specific for the U.S., the U.K, Canada, and Japan. We apply the same methodology to the euro area countries and find that even in this very integrated area the domestic three-factor model outperforms the euro area three-factor model. However, the relative performance of the euro area wide model is increasing, especially for countries with a high number of listed stocks. This could be interpreted as evidence of a higher level of equity market integration caused by lower investment barriers and a changing point of view of institutional investors. Furthermore, we extend the methodology and also test an industry-specific three-factor model. Our findings suggest that lower pricing can be acquired using an industry-specific model relative to the euro area three-factor model.

Keywords: Asset pricing, Fama-French factors, industry factor model, European integration, euro area stock markets, size factor, value factor

JEL Classification: G12, F20, F36

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