Raw versus adjusted beta, what is the difference?

#TheValueInValuations

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A raw beta represents the exact beta as computed through a linear regression calculation using the actual data points of a company's share price relative to the overall stock market.

This raw beta will inevitably either be greater or less than 1, and very rarely will it be equal to 1. Using the principles of mean reversion, it is believed that, over time, the variance of all equity returns will revert to the variance of the market returns (which includes the equity investment). Consequently, the raw beta of an equity is, in time, expected to revert to 1.

Consequently, the concept of an adjusted beta has been developed, which essentially weights the exact/raw beta with a portion of the market beta, namely 1 (also known as the "Blume adjustment").

This is to incorporate an element of conservatism in that all equity betas will, in time, revert to the market beta. Financial literature has confirmed the weightings as a one-third weight towards the market beta, and a two-thirds weight towards the raw beta, as follows:

Adjusted beta =
(Raw beta * 2/3) + (1 * 1/3)

KPMG agrees with this view and believes that it is appropriate to use adjusted betas as opposed to raw betas.

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