Arbitrage Pricing Theory

Arbitrage Pricing Theory (APT) is a theory that models the relationship between risk and return. It is one of the main alternatives to the Capital Asset Pricing Model (CAPM). Unlike CAPM, APT states that an investment's return is dependent on a number of risk factors (instead of just one factor).

APT does not state what those factors are. However, through the years, researchers have identified four different factors as being the most promising to incorporate into the model.

The risk factors identified as the best candidates include unanticipated changes in:

The level of industrial activity
The rate of inflation
Spread between long- and short-term interest rates
Spread between low- and high-quality corporate bonds

Both CAPM and APT agree that investors are concerned mainly with risk that cannot be diversified away by holding many investments and investors require extra expected return for taking on extra risk.