

which employed the same level of assets in an industry for an entire year and whose assets were financed solely by common equity, the ideal book rate of return would be:

$$\text{Net Income—Total Assets}$$

However, such a company is quite unusual, for most American corporations employ a seasonally changing level of assets, which are financed in varying degrees by both debt and equity capital. Therefore, measuring total assets at any point in time (and, consequently, at a particular season), one would find some industries with a higher than average level of assets while others would be below average due to seasonal factors. Further, net income for highly levered firms would represent a much smaller portion of the total return to the invested resources, than would it for an all equity financed company which had no fixed charges to pay.

To overcome these objections we have developed the concept of total return to total permanently investable funds. Total return is defined as "Net Income plus Fixed Charges," while total permanently investable funds is "Total Assets minus Current Liabilities." It will be immediately recognized that our asset base measure—"Total Investable Funds" is the familiar Total Capitalization (Common and Preferred Equity plus Long Term Debt) while our total return measure is the sum of the returns to both the equity and debt capital suppliers. We prefer to use the more general terms for they allow us to consider financial as well as industrial industries in the analyses.

To summarize then, in order to adjust for industry differences in peak-seasons and financing we have defined the book value rate of return as:

$$B = \frac{\text{Net Income} + \text{Fixed Charges}}{\text{Total Asset} - \text{Current Liabilities}}$$

For comparisons we have also considered other commonly used but, for our analysis, less meaningful measures of book return. They are:

$$B' = \frac{\text{Net Income}}{\text{Common Equity}}$$

and:

$$B'' = \frac{\text{Net Income}}{\text{Total Assets}}$$

B' is objectionable because it considers neither the totality of assets invested in the enterprise nor the totality of return. As indicated above, B'' is a misleading measure when comparing industries with different degrees of leverage.

Before defining our measure of market value rate of return it is important to emphasize one point. When we relate book return to entrepreneurial risks, we are asking whether resources are being efficiently allocated in the real economy. However, when we relate market returns to market risks we are concerned with the efficiency of the capital markets as allocators of financial instruments. A company may be experiencing monopoly returns (returns higher than justified by risk) on its book assets (i.e., monopoly real returns) while the holder of its equity instruments would receive a "normal" return if the monopoly profits were capitalized when the stock was issued. Although, the relationship between market return and risk does not directly bear on the question of efficient resource allocation it is of interest to us. The testing of the relationship offers an addition-