

Firm-Specific Return Variation and Cross-Sectional Stock Returns

Yihui Lan

The University of Western Australia, Australia
yihui.lan@uwa.edu.au

Ha Nguyen

The University of Western Australia, Australia
thuha.nguyen@research.uwa.edu.au

Abstract:

This paper investigates the relation between firm-specific return variation and expected stock returns, using the U.S. stocks from 1925 to 2016. Specifically, we focus on two measures of firm-specific return variation, namely (absolute) idiosyncratic volatility and nonsynchronicity, which is also called relative idiosyncratic volatility. We relate these two measures to firm-specific return characteristics by considering return residual momentum, skewness, jumps and information signal formation as measured by information discreteness. We find a robust positive return on a high-minus-low zero-investment quintile portfolio sorted on the relative measure. We decompose the relative measure into: (i) idiosyncratic risk and (ii) systematic risk captured by the variances and covariances among the Fama-French factors as well as factor sensitivities. The Fama-Macbeth regression results show that absolute and relative measures have importantly different effects on explaining the cross-sectional returns. We find that a positive association between the relative measure and stock returns is mainly driven by systematic risks across firms.

Keywords: Asset Pricing, Firm-Specific Return Variation, Idiosyncratic Volatility, Stock Price Nonsynchronicity, Cross-Sectional Stock Returns

JEL Codes: G12, G14