

EconWorld2020@Porto

Firm-Specific Return Variation and Cross-Sectional Stock Returns

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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 firmspecific 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 G12, G14