



# Downside Risks and the Cross-Section of Asset Returns\*

Adam Farago<sup>†</sup>      Roméo Tédongap<sup>‡,§</sup>

February 28, 2017

## Abstract

In an intertemporal equilibrium asset pricing model featuring disappointment aversion and changing macroeconomic uncertainty, we show that besides the market return and market volatility, three disappointment-related factors are also priced: a downstate factor, a market downside factor, and a volatility downside factor. We find that expected returns on various asset classes reflect premiums for bearing undesirable exposures to these factors. The signs of estimated risk premiums are consistent with the theoretical predictions. Our most general, five-factor model is very successful in jointly pricing stock, option, and currency portfolios, and provides considerable improvement over nested specifications previously discussed in the literature.

**Keywords:** Generalized Disappointment Aversion, Downside Risks, Cross-Section

**JEL Classification:** G12, C12, C31, C32

---

\*An earlier version of this paper has been circulated under the title “Volatility Downside Risk”. For helpful comments and discussions, we thank Alexander Barinov, Joost Driessen, Andras Fulop, Michael Halling, Bryan Kelly, Frederik Lundtofte, Steve Ohana, Artur Rodrigues; seminar participants at Georgia State University, BI Norwegian Business School, the Banque de France, York University, Maastricht University and the Swedish House of Finance; and participants at the 30th Annual Congress of the European Economic Association, 2015 BI-SHoF Conference, 2nd Empirical Finance Workshop at ESSEC, 2013 Annual Meetings of the European Financial Management Association, 4th World Finance Conference, International Risk Management Conference 2013, 20th Annual Conference of the Multinational Finance Society, 3rd International Conference of the Financial Engineering and Banking Society, and ABG Sundal Collier Nordic Quant Seminar.

<sup>†</sup>University of Gothenburg, Vasagatan 1, Gothenburg 40530, Sweden

<sup>‡</sup>ESSEC Business School Paris-Singapore, 3 Avenue Bernard Hirsch, CS 50105 CERGY, 95021 Cergy-Pontoise Cedex, France

<sup>§</sup>Corresponding author. E-mail address: [tédongap@essec.edu](mailto:tédongap@essec.edu). Telephone: +33 1 34 43 97 34.

Download English Version:

<https://daneshyari.com/en/article/7361732>

Download Persian Version:

<https://daneshyari.com/article/7361732>

[Daneshyari.com](https://daneshyari.com)