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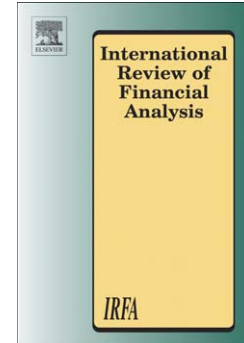
The Conditional Pricing of Systematic and Idiosyncratic Risk in the UK Equity Market

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The Conditional Pricing of Systematic and Idiosyncratic Risk in the UK Equity Market**John Cotter^a Niall O' Sullivan^b Francesco Rossi^c**

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Abstract

We test whether firm idiosyncratic risk is priced in a large cross-section of U.K. stocks. A distinguishing feature of our paper is that our tests allow for a conditional relationship between systematic risk (beta) and returns, i.e., conditional on whether the excess market return is positive or negative. We find strong evidence in support of a conditional beta/return relationship which in turn reveals conditionality in the pricing of idiosyncratic risk. We find that idiosyncratic volatility is significantly negatively priced in stock returns in down-markets. Although perhaps initially counter-intuitive, we describe the theoretical support for such a finding in the literature. Our results also reveal some role for liquidity, size and momentum risk but not value risk in explaining the cross-section of returns.

JEL Classification: G11; G12.**Key Words:** asset pricing; idiosyncratic risk; turnover; conditional beta.

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