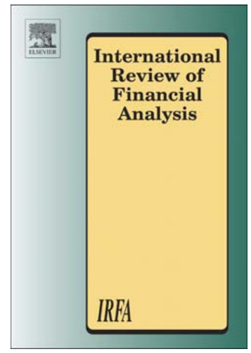
Accepted Manuscript



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

John Cotter, Niall O'. Sullivan, Francesco Rossi

PII: S1057-5219(14)00132-X
DOI: doi: 10.1016/j.irfa.2014.10.002
Reference: FINANA 754

To appear in: *International Review of Financial Analysis*

Received date: 20 December 2013
Revised date: 31 July 2014
Accepted date: 3 October 2014

Please cite this article as: Cotter, J., Sullivan, N.O.'. & Rossi, F., The Conditional Pricing of Systematic and Idiosyncratic Risk in the UK Equity Market, *International Review of Financial Analysis* (2014), doi: 10.1016/j.irfa.2014.10.002

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

John Cotter[a] Niall O' Sullivan[b] Francesco Rossi[c]

This version: July 2014

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.

a UCD School of Business, University College Dublin, Blackrock, Co. Dublin, Ireland.
Email: john.cotter@ucd.ie (Corresponding Author).
b School of Economics and Centre for Investment Research, University College Cork, Ireland.
c UCD School of Business, University College Dublin, Blackrock, Co. Dublin, Ireland.

Acknowledgements:

Cotter acknowledges the support of Science Foundation Ireland under Grant Number 08/SRC/FM1389.