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Idiosyncratic Risk, Costly Arbitrage, and the Cross-Section of Stock Returns

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Highlights

- We test a limits to arbitrage hypothesis that the cross-sectional relation between expected stock return and idiosyncratic risk will depend on the direction of mispricing.
- We use an exponential GARCH model to forecast idiosyncratic volatility and combine several well-known anomalies to measure a stock's relative mispricing.
- Average stock returns monotonically increase (decrease) with idiosyncratic risk for relatively undervalued (overvalued) stocks.
- For stocks which are neither undervalued nor overvalued, returns are unrelated to idiosyncratic risk.
- Systematic risk exposures, firm characteristics and other arbitrage cost measures cannot account for the role of idiosyncratic risk.
- Overall, the results support limits to arbitrage theory and idiosyncratic risk as an important arbitrage cost.