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Expected stock returns and forward variance*

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Abstract

Bakshi, Panayotov, and Skoulakis (2011) show that forward variances are predictive of real economic activity and asset returns. In this paper, we study this relation by using CBOE VIX term structure data between January 1992 and August 2009. We find that certain combinations of the 3-, 6-, and 9-month forward variances (single forward variance factor) are predictive of stock market returns at 1-, 3-, and 6-month horizons. Forward variances constructed from seven out of nine sectors are also predictive of stock market returns and real economic activity. Out-of-sample analysis confirms the prediction power of the single forward variance factor.

Keywords: Stock returns; Forward variance; Predictability

JEL classification: C5; G12; G13

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