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Abstract

Any risk-return tradeoff analysis in aggregate equity markets relies on appropriate measures of risk, in most studies based on (co-)variance relations. Consequently, in integrated global markets, country-specific expected return is priced with a world price of covariance risk. This study relates domestic excess stock returns to the world downside risk. Evidence shows that downside tail risk (as a multiplier of volatility) has long memory cointegration properties; hence the underlying risk aversion behavior in an integrated market is associated with the conditional quantile ratio, the correlation of stock returns, and the cointegrating coefficient of downside risk. Our empirical results based on G7 countries indicate that investors are averse to downside risk, which via Cornish-Fisher expansions is related to higher moment risk and interpretable in a utility-based decision framework.

JEL classification: G11, G12, G15, C24, F30

Keywords: downside risk; value-at-risk; long memory; fractional integration; risk-return;