

Idiosyncratic Risk and the Cross-Section of Expected Stock Return: A Threshold Regress Approach

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Abstract: Modern portfolio theory indicates that idiosyncratic risk should not bear a relationship with expected stock returns because it can be eliminated by holding a well-diversified portfolio of stocks. However in reality, investors may not hold such perfectly diversified portfolio. This research employs a new method threshold regression model to uncover the underlying relationship between idiosyncratic risk and the cross-section of expected stock returns. We hypothesize that investor behavior will differ significantly in normal market and extremely negative market. There will be a positive relation in normal market due to incomplete information where Investors need risk premium to compensate for idiosyncratic risk. While a negative relation exists if the market is extreme pessimistic, because High idiosyncratic risk are often related to financially distress firms and pessimistic markets exacerbate financial distress effect expectations.