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Can Growth Options Explain the Trend in Idiosyncratic Risk?

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Abstract

While recent studies document increasing idiosyncratic volatility over the past four decades, an explanation for this trend remains elusive. We establish a theoretical link between growth options available to managers and the idiosyncratic risk of equity. Empirically both the level and variance of corporate growth options are significantly related to idiosyncratic volatility. Accounting for growth options eliminates or reverses the trend in aggregate firm-specific risk. These results are robust for different measures of idiosyncratic volatility, different growth option proxies, across exchanges, and through time. Finally, our results suggest that growth options explain the trend in idiosyncratic volatility beyond alternative explanations.