

Tail Risk and Asset Prices

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The Review of Financial Studies, Volume 27, Issue 10, October 2014, Pages 2841–2871, <https://doi.org/10.1093/rfs/hhu039>

Published: 16 June 2014

Abstract

We propose a new measure of time-varying tail risk that is directly estimable from the cross-section of returns. We exploit firm-level price crashes every month to identify common fluctuations in tail risk among individual stocks. Our tail measure is significantly correlated with tail risk measures extracted from S&P 500 index options and negatively predicts real economic activity. We show that tail risk has strong predictive power for aggregate market returns. Cross-sectionally, stocks with high loadings on past tail risk earn an annual three-factor alpha 5.4% higher than stocks with low tail risk loadings. We explore potential mechanisms giving rise to these asset pricing facts.

Published by Oxford University Press on behalf of The Society for Financial Studies 2014. This work is written by US Government employees and is in the public domain in the US.

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