The Value Uncertainty Premium

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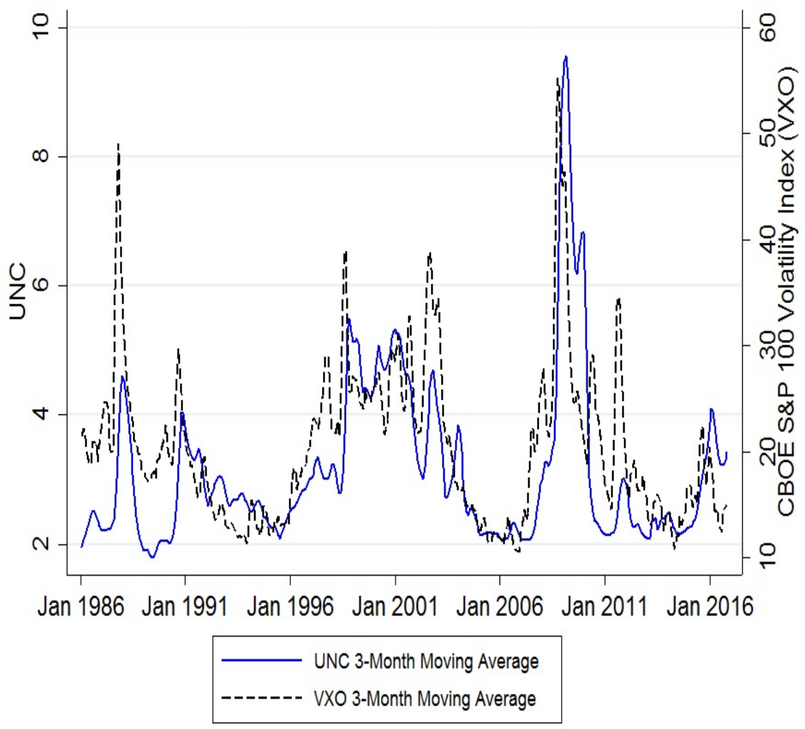
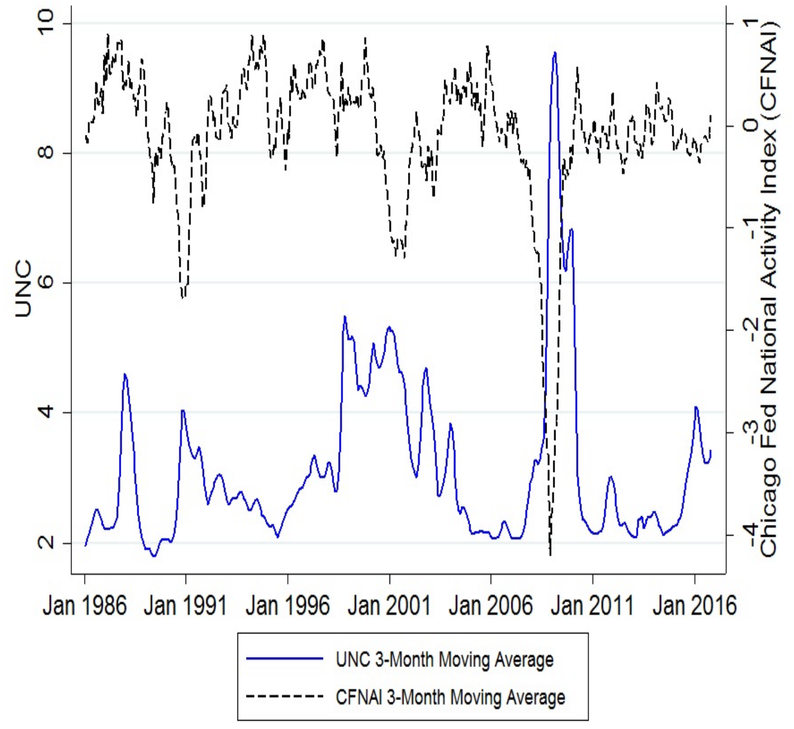
Abstract

- ✓ We investigate whether the time-series volatility of book-to-market (BM), called value uncertainty **(UNC)**, is priced in the cross-section of equity returns.
- ✓ A size-adjusted value-weighted factor with a long (short) position in high-UNC (low-UNC) stocks generates an annualized alpha of 6-8%.
- ✓ UNC premium is not explained by established risk factors or firm characteristics.
- ✓ At the aggregate level, UNC is correlated with macroeconomic fundamentals and predicts future market returns and market volatility.
- ✓ Findings are explained within a rational asset-pricing framework.

UNC versus Uncertainty and Macroeconomic Indices





Motivation & Intuition

- ✓ We show that UNC is more informative than the expected value of the BM ratio concerning the risk associated with profitability and the quality of available accounting information.
- ✓ If BM captures some form of fundamental risk, UNC is partly driven by difficulties in generating clear expectations about the sources of this risk.
- ✓ The aggregate measure of UNC is positively associated with the interaction between ΔC and ΔP, implying higher productivity and consumption risk for stocks with high-UNC.
- ✓ Thus, risk-averse investors demand extra compensation when holding high-UNC stocks.

Data & Variables

- ✓ US stocks: CRSP, COMPUSTAT, and I/B/E/S.
- ✓ January 1985 to December 2016.

Findings & Contributions

1. Volatility of "value" matters and is priced!
2. A significant premium is required by investors to hold high-UNC firms that is not explained by common risk factors.
3. We provide rational asset pricing explanation for this premium.
4. A value uncertainty index (UNC^{avg}) is strongly associated with standard uncertainty indices.

		Risk-Adjusted Return		
UNC Dec.	Exc. Ret.	5F	QF	7F
1 (Low)	0.52	0.00	0.02	-0.04
2	0.77	-0.02	-0.03	-0.08
3	0.73	0.07	0.05	0.03
4	0.71	-0.04	-0.04	-0.05
5	0.91	0.13	0.21	0.16
6	0.85	0.04	0.08	0.04
7	1.03	0.17	0.19	0.21
8	1.02	0.40	0.48	0.48
9	0.93	0.23	0.42	0.35
10 (High)	1.46	0.86	1.08	1.00
High−Low	0.95	0.85	1.06	1.04
t-stat	(3.17)	(3.48)	(4.15)	(4.25)

5. UNC^{avg} can be viewed as proxy for sources of fundamental economic uncertainty reflecting ambiguity about the true current value of the underlying investment in operating productive assets.
6. ΔUNC^{avg} can be a state variable candidate of the ICAPM satisfying Maio and Santa-Clara's (2012) restrictions.

References

Maio, P. and Santa-Clara, P. (2012). Multifactor models and their consistency with the ICAPM. *Journal of Financial Economics*