

# **Idiosyncratic Volatility, Stock Market Volatility, and Expected Stock Returns**

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## Abstract

We show that the value-weighted idiosyncratic stock volatility and aggregate stock market volatility jointly exhibit strong predictive abilities for excess stock market returns, although they don't do so individually. While we uncover a positive risk-return relation in the stock market, as stipulated by the CAPM, the idiosyncratic volatility is *negatively* related to future stock returns. One potential explanation for the latter result is that the idiosyncratic volatility is a measure of divergence of opinion, which, as argued by Miller (1977), could lead a stock to be overvalued initially and to suffer capital losses subsequently. However, we find that the idiosyncratic volatility forecasts stock returns mainly because of its negative co-movements with the consumption-wealth ratio, which, as argued by some recent authors, is a proxy for the liquidity premium.

Keywords: Idiosyncratic Stock Volatility, Stock Market Volatility, Consumption-Wealth Ratio, Stock Return Predictability, Out-of-Sample Forecast, Stock Market Timing Strategies, and Portfolio Choices.

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