ECONOMIC RESEARCH
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WORKING PAPER SERIES

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Authors	Hui Guo, and Jian Yang
Working Paper Number	2005-026C
Revision Date	October 2006
Citable Link	https://doi.org/10.20955/wp.2005.026
Suggested Citation	Guo, H., Yang, J., 2006; Is Value Premium a Proxy for Time-Varying Investment Opportunities: Some Time Series Evidence, Federal Reserve Bank of St. Louis Working Paper 2005-026. URL https://doi.org/10.20955/wp.2005.026

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Is the Value Premium a Proxy for Time-Varying Investment Opportunities: Some Time Series Evidence

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First Version: April 2004
This Version: October 2006

Abstract

We uncover a positive, empirical risk-return tradeoff in the stock market after controlling for the covariance of stock market returns with the value premium. The underlying premise is that, as conjectured by Fama and French (1996), the value premium is a proxy for time-varying investment opportunities. By ignoring the value premium, early specifications suffer from an omitted variable problem that leads to a downward bias in the estimate of the risk-return tradeoff. The paper also documents a new finding on a significantly positive relation between the value premium and its conditional variance.

Keywords: ICAPM, value premium, stock return predictability, realized variance, and GARCH.
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Abstract

We uncover a positive, empirical risk-return tradeoff in the stock market after controlling for the covariance of stock market returns with the value premium. The underlying premise is that, as conjectured by Fama and French (1996), the value premium is a proxy for time-varying investment opportunities. By ignoring the value premium, early specifications suffer from an omitted variable problem that leads to a downward bias in the estimate of the risk-return tradeoff. The paper also documents a new finding on a significantly positive relation between the value premium and its conditional variance.

Keywords: ICAPM, value premium, stock return predictability, realized variance, and GARCH.

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1. Introduction

The capital asset pricing model (CAPM) developed by Sharpe (1964) and Lintner (1965) fails to explain the stock return data along two important dimensions. First, Fama and French (1993), for example, show that the CAPM doesn't account for the cross-section of stock returns, e.g., the value premium and the size premium.[1] Second, many authors, e.g., Campbell (1987), Glosten, Jagannathan, and Runkle (1993), Whitelaw (1994), and Brandt and Kang (2004), find a weak or negative risk-return tradeoff in the stock market across time, in contrast with the positive relation stipulated by the CAPM.

The CAPM-related anomalies suggest that the stock market might act as a hedge against changes in investment opportunities, as illustrated in Merton's (1973) intertemporal CAPM (ICAPM). In particular, Fama and French (1996) argue that the value and size premia move closely with investment opportunities and include them as additional risk factors in their three-factor model—perhaps one of the most influential and successful empirical asset pricing models. Consistent with Fama and French's conjecture, Liew and Vassalou (2000) find that the value premium forecasts output growth in many industrial countries. Campbell and Vuolteenaho (2004), Brennan, Wang, and Xia (2004), Hahn and Lee (2006), and Petkova (2006) show that the value premium is correlated with innovations in their measures of investment opportunities. Also, Gomes, Kogan, and Zhang (2003), Zhang (2005), and Lettau and Wachter (2006) develop equilibrium models to establish a link between the value premium and investment opportunities.

Motivated from Fama's (1991) conjecture of an explicit link between the cross-sectional and time-series stock return predictability, we investigate in this paper whether the value

[1] The value premium is the return on a portfolio that is long in stocks with a high book-to-market value ratio (value stocks) and short in stocks with a low book-to-market value ratio (growth stocks). The size premium is the return on a portfolio that is long in stocks with small capitalizations and short in stocks with big capitalizations.

premium constructed from the cross-section of stocks sheds light on the on-going debate about the intertemporal relation between stock market risk and return. Our time-series test also provides a robustness check for the cross-sectional evidence of the empirical ICAPM, which is potentially sensitive to the choice of priced state variables (e.g., Chen and Zhao [2005]) and alternative econometric specifications (e.g., Lewellen, Nagel, and Shanken [2006]).

If the value premium is a proxy for investment opportunities, Merton's (1973) ICAPM indicates that the conditional excess stock market return, $E_t(R_{t+1})$, is determined by its conditional variance, $\sigma^2_{M,t}$, and its conditional covariance with the value premium, $\sigma_{MH,t}$:

(1) $$E_t(R_{t+1}) = \gamma_M \sigma^2_{M,t} + \gamma_H \sigma_{MH,t}.$$

The parameter γ_M is the coefficient of relative risk aversion and should be positive. The coefficient γ_H is equal to $-\frac{J_{WF}}{J_W}$, where $J(W(t), F(t), t)$ is the indirect utility function of the representative agent with subscripts denoting partial derivatives, $W(t)$ is wealth, and $F(t)$ is a vector of state variables that describe investment opportunities. Similarly, the conditional value premium, $E_t(HML_{t+1})$, is determined by its conditional variance, $\sigma^2_{H,t}$, and its conditional covariance with the stock market return, $\sigma_{MH,t}$:

(2) $$E_t(HML_{t+1}) = \gamma_M \sigma_{MH,t} + \gamma_H \sigma^2_{H,t}.$$

For robustness, as in French, Schwert, and Stambaugh (1987), we estimate equations (1) and (2) using both the realized variance model advocated by Merton (1980) and the ARCH model advanced by Engle (1982). We obtain qualitatively similar results using both techniques, and our main findings can be summarized as follows. First, over the period 1963 to 2005, there is a weak risk-return relation in the U.S. stock market.[2] However, it becomes significantly positive after we control for the covariance of stock market returns with the value premium; conditional stock market returns are positively related to the covariance as well. Second, we document a new finding on a significantly positive relation between the value premium and its conditional variance after controlling for its covariance with stock market returns. Many authors, e.g., Fama and French (1996), Lettau and Ludvigson (2001a), and Zhang (2005), suggest that value stocks are riskier than growth stocks especially during business downturns. Consistent with this hypothesis, we find that the conditional value premium tends to move countercyclically. Lastly, to address the potential concern over the data miming, we estimate the ICAPM using Fama and French's (1998) international data, and find qualitatively similar results for the world market as well as most of the other G7 countries. Overall, our results are consistent with the conjecture that the value premium is a proxy for investment opportunities.

Scruggs (1998) estimates a bivariate GARCH model using the long-term interest rate as a proxy for investment opportunities. However, his results are somewhat sensitive to the assumption of a constant correlation coefficient between stock market returns and the long-term interest rate (e.g., Scruggs and Glabadanidis [2003]). Guo and Whitelaw (2006) use the consumption-wealth ratio proposed by Lettau and Ludvigson (2001b) as a proxy for investment opportunities and find results very similar to ours.[3] Guo and Whitelaw (2006) focus on the stock

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[2] Recent studies, e.g., Campbell and Vuolteenaho (2004), Ang and Chen (2005), Petkova and Zhang (2005), and Fama and French (2005), find that the CAPM explains the value premium in the early period 1926 to 1962. One possible explanation is that Campbell and Vuolteenaho (2004) find that the value premium is a poor proxy for changes in investment opportunities. Consistent with their evidence, we find that the value premium doesn't help uncover the positive risk-return tradeoff in the early period.

[3] We can use Campbell and Shiller's (1988) log-linearization method to show that the scaled stock price, e.g., the consumption-wealth ratio, is a linear function of conditional stock market variance and conditional covariance of stock market returns with the shock to investment opportunities. Consistent with the hypothesis that the value premium is a proxy for investment opportunities, we find that the predictive power of the value premium for stock market returns is very similar to that of the consumption-wealth ratio.

market risk-return tradeoff; by contrast, our main motivation is to test the hypothesis of whether the value premium proxies for investment opportunities.[4] Moreover, Scruggs (1998) and Guo and Whitelaw (2006) use only U.S. data, while we provide international evidence as well. In a paper circulated after the first version of this paper, Brandt and Wang (2006) use the value premium as a proxy for investment opportunities to investigate the time-varying risk-aversion.

The value premium is an empirically motivated risk factor and has limitations, for example, it has some difficulties in explaining the dynamic of stock returns (Ferson and Harvey [1999]). Nevertheless, our evidence raises the bar for some alternative hypotheses by uncovering a close link between time-series and cross-sectional stock return predictability. Such a link is well established in Merton's (1973) ICAPM; however, it poses a challenge to the irrational pricing (e.g., Lakonishok, Shleifer, and Vishny [1994]) and data mining (e.g., MacKinlay [1995]) explanations for the value premium.

The remainder of the paper is organized as follows. We present the estimation results of the realized variance model in Section 2 and the bivariate GARCH model in Section 3. We provide the international evidence in Section 4 and discuss the main findings in Section 5. We offer some concluding remarks in Section 6.

2. The Realized Variance Model

2.1. Data Descriptions

We obtain daily and monthly data of the Fama and French three factors from Ken French at Dartmouth College. Daily data are available over the period July 2, 1963, to December 31,

[4] A few recent studies also uncover a positive risk-return tradeoff by using (1) alternative measures of the conditional stock market variance (Ghysels, Santa-Clara, and Valkanov [2005]); (2) alternative measures of the conditional stock market return (e.g., Graham and Harvey [2003] and Pastor, Sinha, and Swaminathan [2006]); (3)

2005, and monthly data are available over the period July 1926 to December 2005. Following Merton (1980) and Andersen, Bollerslev, Diebold, and Labys (2003), among many others, we use the sum of the squared daily returns in a quarter as a measure of realized variance for both stock market returns and the value premium.[5] Realized covariance is measured as the sum of the cross-product of daily excess stock market returns with the daily value premium. We also construct quarterly return data by aggregating monthly returns through simple compounding.

Figure 1 plots realized stock market variance, $v_{M,t}^2$ (dashed line), along with realized covariance between the stock market return and the value premium, $v_{MH,t}$ (solid line). The variable $v_{M,t}^2$ rose dramatically during the 1987 stock market crash and reverted to the normal level shortly after. Because many authors, e.g., Schwert (1990), argue that the 1987 crash is unusual in many ways, we follow Campbell, Lettau, Malkiel, and Xu (2001) and replace realized variance for 1987:Q4 with the second largest observation in the sample. The variable $v_{MH,t}$ is almost always negative, suggesting that the market provides a hedge for changes in investment opportunities, given the premise that they are proxied by the value premium. The absolute value of $v_{MH,t}$ tends to be relatively high just before or during business recessions (dated by the National Bureau of Economic Research (NBER)), as denoted by the shaded areas. The two variables in Figure 1 usually move in opposite directions. Figure 2 shows that realized variance of the value premium, $v_{H,t}^2$ (solid line), is also negatively related to $v_{MH,t}$ (dashed line); and Figure 3 shows that realized variance of the stock market return (dashed line) is closely related to

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longer historical stock return data (Lundblad [2006]); and (4) conditioning variables extracted from a large set of macroeconomic variables (Ludvigson and Ng [2006]).

[5] We focus on quarterly data rather than monthly data because Ghysels, Santa-Clara, and Valkanov (2005) argue that realized variance is a function of long distributed lags of squared past returns. Also, as in French, Schwert, and Stambaugh (1987), we find essentially the same results by correcting the serial correlation in daily return data. For brevity, these results are not reported here but are available on request.

the realized variance of the value premium (solid line). As we show in the next subsection, these patterns help explain why ignoring the hedge for changes in investment opportunities leads to a downward bias in the estimation of risk-return tradeoff.

Table 1 presents summary statistics for the excess stock market return and the value premium as well as their realized variances and covariance over the period 1963:Q4 to 2005:Q4. Panel A shows that the excess stock market return, R_t, is negatively related to the value premium, HML_t, with a correlation coefficient of –0.46. Also, consistent with Figures 1 to 3, the variables $v^2_{M,t}$, $v^2_{H,t}$, and $v_{MH,t}$ are closely related to each other; however, the correlation is far from perfect. Panel B shows that the realized second moments are relatively persistent: The autocorrelation coefficients are 0.53, 0.72, and 0.56 for $v^2_{M,t}$, $v^2_{H,t}$, and $v_{MH,t}$, respectively. Therefore, realized variances and covariance are good predictors of their future levels.

2.2. *Estimation Results of Merton's (1973) ICAPM*

We can rewrite equations (1) and (2) in the realized return form and use realized variances and covariance as proxies for their conditional values:

$$\begin{aligned} R_{t+1} &= \alpha_M + \gamma_{MM} v^2_{M,t} + \gamma_{HM} v_{MH,t} + \varepsilon_{M,t+1} \\ HML_{t+1} &= \alpha_H + \gamma_{MH} v_{MH,t} + \gamma_{HH} v^2_{H,t} + \varepsilon_{H,t+1} \end{aligned}, \quad (3)$$

where $\varepsilon_{M,t+1}$ and $\varepsilon_{H,t+1}$ are shocks to the market return and the value premium, respectively. Merton's (1973) ICAPM also imposes restrictions on the coefficients in equation (3): $\alpha_M = \alpha_H = 0$, $\gamma_{MM} = \gamma_{MH} = \gamma_M$, and $\gamma_{HM} = \gamma_{HH} = \gamma_H$. We estimate equation (3) using the GMM (generalized methods of moments) advanced by Hansen (1982) and report the estimation results in Table 2.

Row 1 of panel A, Table 2 replicates the familiar result that realized stock market variance, $v_{M,t}^2$, has weak forecasting power for the excess stock market return, R_{t+1}: Its coefficient is positive but only marginally significant, with an adjusted R-squared of 1.6%. However, it remains positive and becomes significant at the 1% level after we control for realized covariance of stock market returns with the value premium, $v_{MH,t}$ (row 2). Interestingly, the effect of $v_{MH,t}$ is also significantly positive, and the adjusted R-squared increases to 4.8% from 1.6% in row 1. Because $v_{M,t}^2$ and $v_{MH,t}$ are negatively correlated (as shown in Figure 1), our results suggest that the specification in row 1, panel A, suffers from a classic omitted variable problem, which leads to a downward bias in the estimate of the risk-return tradeoff.[6]

Row 1 of panel B, Table 2, shows that the relation between realized value premium variance, $v_{H,t}^2$, and the one-quarter-ahead value premium, HML_{t+1}, is positive but statistically insignificant. However, the coefficient of $v_{H,t}^2$ becomes marginally significant after we control for realized covariance of the value premium with stock market returns, $v_{MH,t}$ (row 2). Because $v_{H,t}^2$ and $v_{MH,t}$ are negatively correlated with each other (as shown in Figure 2), these results suggest that the specification in row 1, panel B, also suffers from an omitted variable problem.

In row 3 of Table 2 we estimate the two equations jointly. We use a constant, $v_{M,t}^2$, and $v_{MH,t}$ as instrumental variables for the stock return equation and a constant, $v_{H,t}^2$, and $v_{MH,t}$ for the value premium equation. Thus the equation system is just-identified and the point estimates

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[6] Because of the correlation between $v_{M,t}^2$ and $v_{MH,t}$, there is a potential concern over multicollinearity. However, multicollinearity cannot explain our results because it usually leads to low t-statistics, in contrast with the increase of t-statistics when both variables are included. Moreover, the characteristic-root-ratio test proposed by Belsley, Kuh, and Welsch (1980) confirms that multicollinearity is unlikely to plague our results.

are identical to those reported in row 2. Note that from row 3 on, we report the R-squared rather than the adjusted R-squared (as in rows 1 and 2) in the column under $\overline{R}^2$. In row 4 we impose the ICAPM restrictions that the constant terms are zero in both equations. The restrictions can be tested using Hansen's (1982) J-test, which has a chi-squared distribution with 2 degrees of freedom. The J-test statistic is essentially zero, indicating that the restrictions cannot be rejected at any conventional significance level. Row 5 shows that we cannot reject the restrictions that the risk prices are equal across assets, and row 6 shows that we cannot reject the restrictions of no intercepts and the equal risk prices across assets. As expected, imposing the ICAPM restrictions improves the estimation efficiency and the standard errors in the restricted specifications are substantially smaller than those reported in row 3. After imposing all the ICAPM restrictions, row 6 shows that the slope coefficients are significant at the 1% level. Our results provide strong support for a positive risk-return tradeoff in the stock market after controlling for changes in investment opportunities, as proxied by the value premium.

Early authors, e.g., Fama and French (1989) and Campbell (1987), find that the dividend yield, the default premium, the term premium, and the stochastically detrended risk-free rate forecast stock market returns. Ferson and Harvey (1999) show that these variables also have predictive power for the value premium. One possibility is that these variables comove with the variance and covariance terms in equation (3) at the business-cycle frequency. To address this issue, we include them as instrumental variables, in addition to those used in row 6 of Table 2. Row 7 shows that the model is not rejected at the 20% significance level, suggesting that the stock return predictability documented by early authors is indeed consistent with the ICAPM.

Lettau and Ludvigson (2001b) argue that the consumption-wealth ratio, CAY_t, is a strong predictor of stock market returns. If we also add CAY_t to the instrumental variable set (row 8,

Table 2), only at the 5% significance level is the model not rejected; however, the other results are very similar to those reported in rows 6 and 7. Therefore, again, our results suggest that the value premium reflects intertemporal pricing, although it might be a noisier measure of investment opportunities than some other stock return predictors proposed in the literature.

In Figures 1 to 3, realized variances and covariance exhibit a big spike around the latest recession in our sample, during which stock prices first increased sharply and then collapsed with the burst of the technology bubble. To investigate whether this seemingly unusual episode has any special effect on our inference, we analyze a shorter sample spanning the period 1963:Q4 to 1997:Q4 and report the results in rows 9 and 10 of Table 2, which have the same specifications as those in rows 7 and 8, respectively. We find that the results are very similar to those obtained using the full sample.

2.3. The Value Premium and Other Proxies of Investment Opportunities

Guo and Whitelaw (2006) use the consumption-wealth ratio, CAY_t, and the stochastically detrended risk-free rate, $RREL_t$, as proxies for investment opportunities. Guo and Savickas (2006) find that, when combined with stock market variance, a measure of value-weighted idiosyncratic variance, IV_t, forecasts stock market returns possibly because it is a proxy for realized variance of a risk factor omitted from the CAPM. Table 3 investigates whether the predictive power of the value premium for stock returns is related to that of those variables. Row 1 shows that the forecasting power of $v_{M,t}^2$ and $v_{MH,t}$ is qualitatively unchanged in the presence of $RREL_t$, of which the coefficient is negative and marginally significant. By contrast, $v_{MH,t}$ loses the predictive power after we control for CAY_t (row 2) or IV_t (row 3), while the effect of $v_{M,t}^2$ on expected stock returns remains positive and highly significant.

One can show that under some conditions the expected stock market return is a linear function of $v_{M,t}^2$ and $v_{H,t}^2$, and such a specification holds even if the value premium is not perfectly corrected with the shock to investment opportunities. For brevity, we do not provide the derivation here but it is available on request. Row 4, Table 3 shows that, as expected, the coefficients of $v_{M,t}^2$ and $v_{H,t}^2$ are both significant, with an adjusted R-squared of 7.7%.[7] Nevertheless, row 7 shows that the effect of $v_{H,t}^2$ becomes insignificant at the 10% level after controlling for IV_t. To summarize, our results suggest that the value premium is related to the alternative measures of investment opportunities.

2.4. *Conditional Value Premium*

Consistent with equation (2), $v_{H,t}^2$ has some forecasting power for the value premium when combined with $v_{MH,t}$ (row 2 of Table 2). This result suggests that predictable variation in the value premium documented in some early studies (e.g., Ferson and Harvey [1999]) might be consistent with intertemporal pricing. To address this issue, in Table 4 we compare the forecasting power of $v_{H,t}^2$ with alternative measures of investment opportunities, namely,

[7] Some authors, e.g., Bossaerts and Hillion (1999), Goyal and Welch (2006), Ferson, Sarkissian, and Simin (2003), have challenged the robustness of the in-sample evidence of stock market return predictability. To address this issue, we use three statistics to compare the out-of-sample performance of the model using $v_{H,t}^2$ and $v_{M,t}^2$ as predictors with a benchmark model of constant excess stock returns: The mean-squared forecasting error ratio; Clark and McCracken's (2001) encompassing test; and McCracken's (1999) test of equal forecast accuracy. In the earlier versions of this paper, we show that these two variables have significant out-of-sample predictive power. For brevity, we do not report these results here but they are available on request.

$RREL_t$, CAY_t, and IV_t.[8] The effect of $v^2_{H,t}$ remains positive and marginally significant after controlling for $RREL_t$ (row 1) and CAY_t (row 2). However, it becomes insignificant when combined with IV_t (row 3).

Row 4 of Table 4 presents the regression results using $v^2_{M,t}$ instead of $v_{MH,t}$ in the forecasting equation. Consistent with the results reported in Table 3 for stock market returns, the alternative specification appears to provide a better fit for the value premium as well. Now the effect of $v^2_{H,t}$ is positive and significant at the 5% level; and the effect of $v^2_{M,t}$ is negative and significant at the 5% level. Also, the adjusted R-squared is 4.9%, which is noticeably higher than the 3.9% reported in row 2 of Table 2. The coefficient of $v^2_{M,t}$ is negative because of its negative correlation with $v_{MH,t}$ (Table 1), which in turn is positively correlated with the value premium.

The forecasting power of $v^2_{H,t}$ (as in row 4 of Table 4) is very similar to that of IV_t, as reported by Guo and Savickas (2006). These authors show that IV_t and $v^2_{M,t}$ jointly have strong predictive power for the value premium; moreover, while $v^2_{M,t}$ is negatively correlated with the one-quarter-ahead value premium, the relation is positive for IV_t. To formally address this issue, we also include IV_t in the forecasting equation, together with $v^2_{H,t}$ and $v^2_{M,t}$. Row 7 shows that, while the coefficient of $v^2_{M,t}$ remains significantly negative, the coefficients of both IV_t and $v^2_{H,t}$ become insignificant, indicating that the two variables indeed capture common variations in the value premium. This result should not be too surprising because Guo and Savickas (2006)

[8] The term premium, the default premium, and the dividend yield (as used by Ferson and Harvey [1999]) do not provide additional information about the future value premium, and including them does not change our results in any qualitative manner. To conserve space, these results are not reported here but are available on request.

point out that, by construction, IV_t is a proxy for realized variance of a risk factor omitted from the CAPM, which could be the value premium. However, by contrast with IV_t, controlling for $RREL_t$ (row 5) or CAY_t (row 6) does not affect our results in any qualitative manner.

Lastly, Figure 4 plots the fitted expected value premium (as based on the estimation results of the benchmark ICAPM reported in row 6, Table 2). It moves countercyclically and tends to increase sharply during the business recessions dated by NBER, as denoted by shaded areas. As we will discuss in Section 5, this pattern is consistent with the conjecture (e.g., Fama and French [1996], Lettau and Ludvigson [2001a], and Zhang [2005]) that value stocks are riskier than growth stocks especially during the economic downturn.

2.5. The Value Premium Constructed with Small and Big Stocks

If the value anomaly reflects intertemporal pricing, we expect to find very similar results using the value premium constructed with both small and big stocks. To investigate this issue, we obtain from Kenneth French the daily return data for six portfolios, which are the intersections of two independent sorts—size (small and big) and the book-to-market value ratio (high, median, and low). Table 5 shows that we find qualitatively similar results using realized variance of the value premium constructed from small and big stocks.

3. Bivariate GARCH Model

3.1. Empirical Specifications

Several studies, e.g., Christensen and Prabhala (1998) and Fleming (1998), find that realized variance is not an efficient measure of conditional variance. To address this issue, in this section we estimate equations (1) and (2) using the more elaborate bivariate GARCH models, which might provide a better measure for the conditional second moments than the simple realized variance model.[9] Again, we rewrite equations (1) and (2) in the realized return form:

$$(4)\qquad \begin{aligned} R_{t+1} &= \alpha_R + \gamma_{MM}\sigma^2_{M,t} + \gamma_{HM}\sigma_{MH,t} + \varepsilon_{M,t+1} \\ HML_{t+1} &= \alpha_H + \gamma_{MH}\sigma_{MH,t} + \gamma_{HH}\sigma^2_{H,t} + \varepsilon_{H,t+1} \end{aligned},$$

where $\varepsilon_{M,t+1}$ and $\varepsilon_{H,t+1}$ are shocks to stock market returns and the value premium, respectively.

We use the asymmetric dynamic covariance (ADC) model proposed by Kroner and Ng (1998). These authors show that it is very flexible in describing the dynamic of covariance terms because it nests several commonly used multivariate GARCH models. In the ADC model, the dynamic of variances and covariances is governed by the following equation system:

$$(5)\qquad \begin{aligned} \sigma^2_{M,t} &= \theta_{MM,t+1} \\ \sigma^2_{H,t} &= \theta_{HH,t+1} \\ \sigma_{MH,t} &= \rho_{MH}\sqrt{\theta_{MM,t+1}\theta_{HH,t+1}} + \phi_{MH}\theta_{MH,t+1} \\ \theta_{ij,t+1} &= \omega_{ij} + b_i' H_t b_j + a_i' \begin{bmatrix} \varepsilon_{M,t} \\ \varepsilon_{H,t} \end{bmatrix} \begin{bmatrix} \varepsilon_{M,t} & \varepsilon_{H,t} \end{bmatrix} a_j + g_i' \begin{bmatrix} \eta_{M,t} \\ \eta_{H,t} \end{bmatrix} \begin{bmatrix} \eta_{M,t} & \eta_{H,t} \end{bmatrix} g_j, i, j \in (H, M) \end{aligned},$$

where H_t is the conditional variance-covariance matrix:

$$(6)\qquad H_t = \begin{bmatrix} h_{MM,t} & h_{MH,t} \\ h_{MH,t} & h_{HH,t} \end{bmatrix} = \begin{bmatrix} \sigma^2_{M,t-1} & \sigma_{MH,t-1} \\ \sigma_{MH,t-1} & \sigma^2_{H,t-1} \end{bmatrix}.$$

Glosten, Jagannathan, and Runkle (1993), among many others, find that a negative return shock leads to a higher subsequent volatility than does a positive return shock of the same magnitude.

[9] In an earlier version of the paper, we formally investigate the relative performance of the realized variance model and the GARCH model using the Monte Carlo simulation. In particular, we first estimate the bivariate GARCH model using daily return data. We then use the estimated GARCH model to generate simulated daily data, which are used to estimate the ICAPM. We find that both the quarterly realized variance model and the monthly GARCH model provide reliable inference for the risk-return tradeoff, while the GARCH model performs somewhat better. For brevity, we do not report these results here but they are available on request.

This asymmetric effect can be captured by the term $\begin{bmatrix} \eta_{M,t} \\ \eta_{H,t} \end{bmatrix} = \begin{bmatrix} \max[0, -\varepsilon_{M,t}] \\ \max[0, -\varepsilon_{H,t}] \end{bmatrix}$ in equation (5). ρ_{MH} and ϕ_{MH} are scalar parameters and the other parameters can be written in matrix forms:

(7)
$$W = C'C = \begin{bmatrix} \omega_{MM} & \omega_{MH} \\ \omega_{MH} & \omega_{HH} \end{bmatrix}, \quad A = \{a_M, a_H\} = \begin{bmatrix} a_{MM} & a_{MH} \\ a_{HM} & a_{HH} \end{bmatrix}$$
$$B = \{b_M, b_H\} = \begin{bmatrix} b_{MM} & b_{MH} \\ b_{MH} & b_{HH} \end{bmatrix}, \quad G = \{g_M, g_H\} = \begin{bmatrix} g_{MM} & g_{MH} \\ g_{HM} & g_{HH} \end{bmatrix},$$

where W is positive definite and C is a 2 × 2 symmetric matrix. Our notations in equation (7) reflect the fact that matrixes W and B are symmetric but matrixes A and G are not.

Kroner and Ng (1998) show that, if matrixes A and B are diagonal and ϕ_{MH} is equal to 0, the ADC model becomes the asymmetric version of the constant conditional correlation model, as used by Scruggs (1998), for example. Also, if ρ_{MH} is equal to 0 and ϕ_{MH} is equal to 1, then the ADC model reduces to the asymmetric version of the popular BEKK model proposed by Engle and Kroner (1995), which, as we show below, seems to apply in this study.

We estimate the GARCH model using the quasi-maximum likelihood (QML) method. Bollerslev and Woodridge (1992) show that QML parameter estimates can be consistent, even though the conditional log-likelihood function assumes normality while stock returns are known to be skewed and leptokurtic. Nevertheless, we find qualitatively the same results using the maximum likelihood estimation (MLE) method by assuming a t distribution or a normal distribution. Given a sample of T observations of the return vector, the parameters of the bivariate GARCH model are estimated by maximizing the conditional log-likelihood function:

(8)
$$L = \sum_{t=1}^{T} l_t(P) = \sum_{t=1}^{T} (-\log(2\pi) - 0.5\log|H_t| - 0.5\varepsilon_t' H_t^{-1} \varepsilon_t),$$

where P denotes the vector of all the parameters to be estimated. Nonlinear optimization techniques are used to calculate the maximum likelihood estimates based on the Broyden, Fletcher, Goldfarb, and Shanno (BFGS) algorithm.

The ADC model should be estimated under some parameter restrictions to ensure the positive definite covariance matrix. It is possible to impose the constraint $|\rho_{mv}| + |\phi_{mv}| < 1$ in the model. To serve a similar purpose, Scruggs and Glabadanidis (2003) propose to penalize the likelihood function whenever the covariance matrix is not positive definite, which we followed in this study. While such treatment might lose the continuity of the likelihood function, it gains the ability to impose a less restrictive constraint and avoid the possibility of a non-positive definite covariance matrix. Also, imposing a penalty in the likelihood function might result in a function with multiple local optima. In this case, it is important to restart the optimization routine at several different starting points to ensure that the estimated parameters correspond to the global maximum of the likelihood function. All our results are tested for robustness using different starting values in the maximization of the likelihood function.

We focus mainly on the modern period January 1963 to December 2005 because, as mentioned in footnote 2 and confirmed in this study, the value premium is a poor proxy for investment opportunities in the pre-1963 sample. Table 6 provides summary statistics of the excess stock market return and the value premium (in percentages) for the modern sample. Consistent with quarterly data in Table 1, the two variables are negatively correlated, with a correlation coefficient of –0.32. The Ljung-Box test indicates that the value premium is serially correlated.

3.2. Model Selection Tests

Kroner and Ng (1998), among others, argue that choosing a parsimonious GARCH specification is important for the asset pricing tests because they critically depend on the covariance matrix estimates. In fact, their ADC model was originally proposed to facilitate the model selection (Kroner and Ng, 1998, p. 833). A parsimonious data-determined model is desirable also because the number of observations is limited, while a large amount of the data is required to yield precise estimates of GARCH models. Hence, it is important in this study to impose statistically acceptable constraints and reduce the redundant parameters.

The model selection test follows the general-to-specific approach. Similar to Scruggs (1998) and Scruggs and Glabadanidis (2003), we first look at the second-moment modeling. The results, which are reported in Table 7, can be easily summarized as follows. Using the full-fledged bivariate ADC model as the alternative hypothesis, we overwhelmingly reject the null model of the pooling of two univariate GARCH specifications (panel A). By contrast, we fail to reject the more restrictive, and yet quite general, ABEKK model at the 10% level (panel B). Also, for the BEKK model, panel C shows that the null hypothesis of symmetry is strongly rejected. Because the ADC model involves more parameters and thus has poorer convergence properties, we hereafter focus on the ABEKK model in the remaining discussion, although we find qualitatively the same results using the ADC model.

We then turn to the model selection test on the first-moment modeling for the ABEKK model. We first test the null hypothesis that the slope parameters are jointly zero in equation (4) or $\gamma_{MM} = \gamma_{MH} = \gamma_{HM} = \gamma_{HH} = 0$. Panel D of Table 7 shows that these restrictions are rejected at the 1% significance level, indicating that conditional variance and covariance terms are significant determinants of the excess stock market return and the value premium. However, consistent with the results obtained from the realized variance model, panels E and F show that we fail to reject the ICAPM restrictions at the conventional significance level.

3.3. Estimation Results

Table 8 presents the estimation results of the mean equations. We use the percentage return in the estimation; to make them comparable with the results in Table 2, we scale the constant terms by 1/100 and the slope parameters by 100.

For comparison with early studies, we first report in panel A of Table 8 the estimation results of the pooling univariate asymmetric GARCH model—i.e., we restrict the interaction terms between the stock market return and the value premium to be zero in equations (4) and (5). For the excess stock market return equation, the conditional return is positively related to the conditional variance with a point estimate of 0.87; however, the relation is statistically insignificant at the 10% level. Similarly, we find a positive but insignificant risk-return relation for the value premium. Nevertheless, such a result should be interpreted with caution because the specification potentially suffers from an omitted variable problem, which we discuss next.

Panel B of Table 8 presents the estimation results using the ABEKK model. In the unrestricted specification (row 2), only the slope parameters in the value premium equation are significant at the 10% level. Because the slope parameters are jointly significant (panel D of Table 7), this result suggests that our estimation is not efficient. One way to address this issue, as we have learned from the realized variance model reported in Table 2, is to impose the restrictions dictated by Merton's (1973) ICAPM. As expected, row 4 shows that the slope parameters in the mean equations are statistically significant at the 1% level after we impose the ICAPM restrictions of zero constant terms and the same risk prices across assets.

The price of stock market risk, γ_M, has a point estimate of 4.74 and a standard error of 1.21. It appears to be quite reasonable because Mehra and Prescott (1985), for example, suggest a plausible range 1 to 10. Interestingly, it is also strikingly similar to the point estimate of 4.93 reported by Guo and Whitelaw (2006), who use CAY_t as a proxy for investment opportunities. This is mainly because, as shown in row 2 of Table 3, $v_{MH,t}$ and CAY_t appear to capture the common variations of stock market returns.

Figure 5 plots the fitted values of conditional stock market variance (dashed line) and covariance between the stock market return and the value premium (solid line) from the benchmark estimation reported in row 4 of Table 8. The pattern is very similar to that presented in Figure 1. The patterns documented in Figures 6 and 7 are qualitatively the same as those in Figures 2 and 3, respectively. Also, Figure 8 shows that there is substantial variation in the coefficient of conditional correlation between the stock market return and the value premium. This result confirms the finding of Scruggs and Glabadanidis (2003) that it is important to allow for a time-varying correlation coefficient in the ICAPM estimation.

Table 9 presents the parameter estimates of the benchmark ABEKK model. Panels A and B report the estimates of the mean equations, which are the same as those in row 4 of Table 8. Panels C, D, and E show that most parameters in the matrices *W*, *A*, *B*, and *G* are statistically significant. This result highlights the importance of allowing for a time-varying variance-covariance matrix.

3.4. Robustness Checks

Panel C of Table 6 reports the mean of fitted values of conditional variances and covariance based on the estimation results of the benchmark specification reported in Table 9.

They are very similar to the unconditional variance-covariance matrix of the excess stock market return and the value premium, as reported in panel B of Table 6.

Row 5 of Table 8 reports the estimation results of the ABEKK model for the early period July 1926 to December 1962. The risk price associated with the value premium has a negligible point estimate of -0.002, which is statistically insignificant at any conventional level. The price of stock market risk is again statistically significant; nevertheless, its point estimate of 2.20 is substantially smaller than the point estimate of 4.74 obtained from the modern period, as reported in row 4 of Table 8. These results confirm that in the early period the value premium is a poor proxy for investment opportunities and can be explained by the CAPM. Row 6 shows that in the full sample spanning the period July 1927 to December 2005, the value premium risk is not priced but the price of the market risk is significantly positive. However, because of the likely structural break in the value premium, we should interpret this result with caution.

Although we concentrate on a restricted ABEKK specification in the previous discussion, it is worth noting that we find similar results using the ADC model, as shown in panel C of Table 8. In the unrestricted model (row 7), we find that the risk prices are all positive, although most of them are statistically insignificant. By contrast, row 8 shows that the risk prices again become significant at the 1% level after imposing the ICAPM restrictions, which cannot be rejected at the conventional significance level. Moreover, the point estimates are very similar to those obtained using the benchmark ABEKK model, as shown in row 4 of Table 8.

We also estimate the restricted ABEKK model using the MLE method by assuming a *t* distribution and a normal distribution for the modern sample and report the main results in rows 9 and 10, respectively, of Table 8. For the *t* distribution, the degree of freedom of the distribution has a point estimate of 9.14 and a standard error of 1.91. This result is consistent with the general belief that the distribution of stock returns is characterized by fat tails. Nevertheless, the other results are essentially the same as the benchmark ABEKK model. We reach the same conclusion for the normal distribution as well.

Lastly, we repeat the above analysis using daily and weekly data. Again, our main finding that the loadings on the stock market return and the value premium carry a positive and significant risk premium holds well in the modern period. For brevity, these results are not reported here but are available on request.

3.5. *Diagnostics Tests*

To evaluate the adequacy of the benchmark ABEKK model reported in Table 9, we conduct several specification tests on the standardized residuals ($\hat{\varepsilon}_{i,t} = \varepsilon_{i,t} / \sqrt{h_{ii,t}}, \quad i = M, H$) and standardized products of residuals ($\hat{\varepsilon}_{i,t}\hat{\varepsilon}_{j,t} = \varepsilon_{i,t}\varepsilon_{j,t} / h_{ij,t}, \quad i = M, H$). Specifically, we examine some moment conditions required for the consistency of QML estimates. Panel A of Table 10 shows that the two mean standardized residuals are not significantly different from zero. However, the evidence is somewhat mixed for testing the null hypothesis that the mean of the products of the residuals is 1. The null cannot be rejected for $\hat{\varepsilon}_{M,t}\hat{\varepsilon}_{M,t}$ and $\hat{\varepsilon}_{H,t}\hat{\varepsilon}_{H,t}$ but can be rejected for the cross-product, $\hat{\varepsilon}_{M,t}\hat{\varepsilon}_{H,t}$. We also note that the skewness and kurtosis for the standardized residuals is much lower than the skweness and kurtosis for the value premium but not for the stock market return. Panel B of Table 10 summarizes the Ljung-Box test for autocorrelation in the estimated residual series. The autocorrelation is still present in the residuals of the HML equation. (Recall that the original HML series contains autocorrelation.)

Overall, these results indicate that, while the model provides a reasonable description of the data, there is still room for improvement.

4. International Evidence

To address the question of data snooping, Fama and French (1998) investigate the value premium for major international equity markets constructed from MSCI (the Morgan Stanley Capital International) data. They have two main findings. First, the value premium is pervasive in major international equity markets. Second, the value premium appears to be a priced risk factor omitted from the CAPM. In this section we estimate the bivariate GARCH model using the Fama and French international data for the period January 1975 to December 2005.

Without the loss of generality, we focus on the world market as well as the other G7 countries, namely, Canada, France, Germany, Italy, Japan, and the U.K. The world market portfolios are especially relevant because they represent the most diversified portfolios: For example, Fama and French (1998) use the world stock market return and value premium as risk factors in their international ICAPM. We also expect to uncover qualitatively similar patterns for each of the other G7 countries because Fama and French (1998) find that the country-specific stock market return and value premium move closely to their world market's counterparts.

For brevity, we consider only the ABEKK model because, consistent with U.S. evidence, it also provides a good description for all the international markets that we considered. In the estimation we also impose the ICAPM restrictions: $\gamma_{MM} = \gamma_{MH}$, $\gamma_{HM} = \gamma_{HH}$, and $\alpha_R = \alpha_H = 0$, which we fail to reject using the log likelihood ratio test. Table 11 shows that international evidence is quite consistent with that documented in U.S. data. For the world market, the price of market risk, γ_M, is significantly positive, with a point estimate of 3.16. Similarly, the risk price for the value premium, γ_H, is significantly positive, with a point estimate of 8.18. We also find qualitatively the same results for the individual markets. Except for Italy, the parameter γ_H is positive and statistically significant at least at the 10% level for all the other G7 countries. Similarly, the parameter γ_M is always positive, and it is significant at least at the 10% level for France, Germany, Japan, and the U.K. Thus, the international evidence provides further support for the conjecture that the value premium is a proxy for investment opportunities.

5. Some Discussions

In the post-1963 sample, the CAPM fails to explain the value premium. Lakonishok, Shleifer, and Vishny (1994) argue that the value premium reflects mispricing: Investors tend to overestimate future earnings of growth stocks but underestimate future earnings of value stocks. MacKinlay (1995) attributes the value premium to data snooping. By contrast, Fama and French (1996, 1998) advocate for a systematic risk explanation for the value premium because it is a pervasive phenomenon in both the U.S. and international stock markets.

One well-known rational-pricing explanation is that, as pointed out by Fama and French (1996), the value premium reflects a distress risk. Fama and French explain the point as follows: "Why is relative distress a state variable of special hedging concern to investors? One possible explanation is linked to human capital, an important asset for most investors. Consider an investor with specialized human capital tied to a growth firm (or industry or technology). A negative shock to the firm's prospects probably does not reduce the value of the investor's human capital; it may just mean that employment in the firm will grow less rapidly. In contrast, a negative shock to a distressed firm more likely implies a negative shock to the value of human capital since employment in the firm is more likely to contract. Thus, workers with specialized human capital in distressed firms have an incentive to avoid holding their firms' stocks. If variation in distress is correlated across firms, workers in distressed firms have an incentive to avoid the stocks of all distressed firms. The result can be a state-variable risk premium in the expected returns of distressed stocks." (p.77).

Fama and French (1995) and Liew and Vassalou (2000) find that the effect of the distress risk is more pronounced during business recessions than during business expansions. Thus the distress risk hypothesis helps explain the evidence that the value premium has a positive mean, although its unconditional market beta is negative, as reported in Table 1. Consistent with this conjecture, Lettau and Ludvigson (2001a) estimate a conditional consumption-based CAPM, and find that value stocks are substantially riskier than growth stocks during economic recessions, when the conditional risk premium is high. Zhang (2005) develops a partial equilibrium model, in which the market beta of the value premium moves countercyclically; and Petkova and Zhang (2005) find some empirical support for this prediction, especially in the early period 1927 to 1962. Note that these explanations also predict countercyclical movement in the conditional value premium, as we document in Figure 4.

Alternatively and complementarily, Campbell (1993) emphasizes that the hedging demand associated with the time-varying cost of capital has important effects on expected stock returns. In his model, there are two types of shocks—the cash-flow shock and the discount-rate shock. The cash-flow shock has a permanent effect on stock prices, while the effect of the discount-rate shock is only temporary. Therefore, the cash-flow shock is riskier than the discount-rate shock, and carries a higher risk price. Campbell and Vuolteenaho (2004) find that in the post-1963 sample, the value premium has a negative market beta because of its large *positive* loadings on the discount-rate shock.[10] However, the sample average of the value premium is positive because of its positive loadings on the cash-flow shock, which carries a much higher risk price than does the discount-rate shock.

In Campbell's (1993) ICAPM, the discount-rate shock is negatively correlated with stock market returns. The value premium is a potentially good proxy for the discount-rate shock because Figures 1 and 6 show that the covariance between the value premium and stock market returns is almost always negative. This interpretation is also consistent with recent empirical studies by Cornell (1999) and Dechow, Sloan, and Soliman (2004), who find that growth stocks are more vulnerable to the discount-rate shock because they have a higher duration.

Campbell's (1993) ICAPM also appears to provide a coherent explanation for our main empirical findings.[11] For example, the discount-rate shock is overpriced in the CAPM because investors require a higher risk price for the cash-flow shock than the discount-rate shock. The second right-hand-size term in equation (2) serve as a correction for the mispricing of the CAPM for the value premium. Overall, Figure 4 shows that the expected value premium is mostly positive mainly because of its positive loading on economic fundamentals, e.g., cash flows. As mentioned above, this result is in general consistent with intuition of Fama and French's (1996) distress risk hypothesis. It is also consistent with the recent studies by Bansal, Dittmar, and Lundblad (2005), Cohen, Polk, and Vuolteenaho (2003), and Hansen, Heaton, and Li (2004), who show that the cash flows of value stocks covary more with aggregate cash flows than do those of growth stocks. Therefore, the CAPM fails to explain the cross-section of stock returns

[10] The discount-rate shock is negatively related to stock market returns because an increase in the discount rate leads to an immediate fall in stock prices.
[11] Lettau and Wachter (2006) propose a parsimonious model to explain the stylized fact that the value premium has a positive mean but a negative market beta. Their main economic intuition is similar to that of Campbell (1993).

(e.g., Petkova and Zhang [2005], Lewellen and Nagel [2005] and Fama and French [2005]) possibly because it provides a poor measure of systematic risk.

However, Fama (1998) has pointed out that the empirical ICAPM is also vulnerable to the criticism of data snooping. In particular, the empirical ICAPM studied by Campbell and Vuolteenaho (2004), for example, is potentially sensitive to two types of misspecifications (e.g., Chen [2003] and Chen and Zhao [2005]). First, Campbell (1993) suggests that we should use variables that forecast stock market returns as proxies for investment opportunities; however, he provides little guidance for the choice of the stock return predictors. Second, innovations in the state variables are not directly observable and Campbell and Vuolteenaho, for example, must rely on some ad hoc assumptions to identify them. In this paper we avoid these two identification issues by directly using the value premium as a proxy for investment opportunities and then investigating its asset pricing implications. We cannot rule out the data mining; nevertheless, it is unlikely to be the only explanation of our main findings because they hold up well in both the U.S. and international markets and are consistent with numerous cross-sectional studies.

6. Conclusion

This paper estimates a variant of Merton's (1973) ICAPM using the value premium as a proxy for time-varying investment opportunities. In contrast with many early authors, we uncover a positive and significant risk-return tradeoff after controlling for covariance of the stock market return with the value premium. We also document a new finding on a significantly positive relation between the value premium and its conditional variance. These results suggest that we cannot fully attribute the value premium to irrational pricing or data mining.

Our results also shed light on time-series stock market return predictability. We find that it cannot by fully attributed to irrational pricing or data mining for three reasons. First, existing economic theories have provided guidance for identifying predictive variables, i.e., conditional variances and covariances of the risk factors in Merton's (1973) ICAPM. Second, despite its simplicity, our analysis shows that the theoretically motivated variables forecast stock market returns in sample and out of sample. Third, many financial variables forecast stock returns mainly because of their close correlation with conditional variances and covariances of stock market returns and other risk factors.

With few notable exceptions, e.g., Campbell and Cochrane (1999) and Bansal and Yaron (2004), the existing literature provides little guidance for the fundamental economic sources of variation in the risk premium. A further investigation of the link between macroeconomy and financial markets should improve our understanding of risk-return tradeoff, and we leave it for future research.

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Table 1 Summary Statistics of Quarterly Return Data

Note: We report summary statistics for the excess stock market return, R_t; the value premium, HML_t; realized stock market variance, $v_{M,t}^2$; realized variance of the value premium, $v_{H,t}^2$; and realized covariance between the stock market return and the value premium, $v_{MH,t}$. The sample spans the period 1963:Q4 to 2005:Q4.

	R_t	HML_t	$v_{M,t}^2$	$v_{H,t}^2$	$v_{MH,t}$
Panel A Correlation Matrix					
R_t	1.000				
HML_t	-0.461	1.000			
$v_{M,t}^2$	-0.370	0.081	1.000		
$v_{H,t}^2$	-0.273	0.291	0.675	1.000	
$v_{MH,t}$	0.358	-0.190	-0.818	-0.931	1.000
Panel B Univariate Statistics					
Mean	0.015	0.014	0.005	0.001	-0.001
Standard Deviation	0.085	0.059	0.005	0.002	0.002
Autocorrelation	0.022	0.135	0.531	0.721	0.565

Table 2 Merton's (1973) ICAPM: Realized Variance Model

Note: We report the estimation results of Merton's (1973) ICAPM using the GMM:

$$(3)\quad \begin{aligned} R_{t+1} &= \alpha_M + \gamma_{MM} v_{M,t}^2 + \gamma_{HM} v_{MH,t} + \varepsilon_{M,t+1} \\ HML_{t+1} &= \alpha_H + \gamma_{MH} v_{MH,t} + \gamma_{HH} v_{H,t}^2 + \varepsilon_{H,t+1} \end{aligned},$$

where R_{t+1} is the excess stock market return; HML_{t+1} is the value premium; $v_{M,t}^2$ is realized stock market variance; $v_{MH,t}$ is realized covariance between the stock market return and the value premium; $v_{H,t}^2$ is realized variance of the value premium; and $\varepsilon_{M,t+1}$ and $\varepsilon_{H,t+1}$ are shocks to the stock market return and the value premium, respectively. Unless otherwise indicated, we use the quarterly sample spanning the period 1963:Q4 to 2005:Q4. The heteroskadesticity-corrected standard errors are in parentheses. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively. In the column under $\overline{R}^2$, the adjusted R-squared is reported in rows 1 and 2 and the R-squared is reported in the other rows. The two equations are estimated separately in rows 1 and 2 and jointly in the other rows. The system is just identified in row 3: We use a constant, $v_{M,t}^2$, and $v_{MH,t}$ as instrumental variables for the stock market return equation and use a constant, $v_{H,t}^2$, and $v_{MH,t}$ for the value premium equation. We impose the restriction of zero intercept in row 4, the restriction of the same risk prices in row 5, and both restrictions in rows 6 to 8. We use the same instrumental variables in rows 4 to 6 as in row 3. We also include the default premium, the term premium, the stochastically detrended risk-free rate, and the dividend yield as instrumental variables in row 7. Row 8 also includes the consumption-wealth ratio by Lettau and Ludvigson (2001b) as an instrumental variable. We report Hansen's (1982) J-test in the column under J-Test. Rows 9 and 10 have the same specifications as rows 7 and 8, respectively, but are estimated for the sample period 1963:Q4 to 1997:Q4.

	Panel A Stock Market Returns				Panel B the Value Premium				J-Test
	α_R	γ_{MM}	γ_{HM}	$\overline{R}^2$	α_H	γ_{MH}	γ_{HH}	$\overline{R}^2$	
1	0.002	2.713*		0.016	0.007		4.860	0.017	
	(0.008)	(1.475)			(0.005)		(3.459)		
2	-0.004	7.725***	12.386**	0.048	0.007	11.508	18.246*	0.039	
	(0.008)	(2.559)	(5.461)		(0.005)	(7.428)	(9.988)		
3	-0.004	7.725***	12.386**	0.059	0.007	11.508	18.246*	0.051	
	(0.008)	(2.559)	(5.461)		(0.005)	(7.428)	(9.988)		
4		7.725***	12.386**	0.059		11.508	18.246**	0.051	X(2)=0.00
		(2.018)	(4.948)			(7.155)	(8.908)		(1.00)
5	-0.004	8.160***	13.544***	0.059	0.008	8.160***	13.544***	0.050	X(2)=0.37
	(0.008)	(2.500)	(5.050)		(0.005)	(2.500)	(5.050)		(0.83)
6		8.162***	13.547***	0.059		8.162***	13.547***	0.050	X(4)=0.37
		(1.750)	(3.806)			(1.750)	(3.806)		(0.99)
7		7.748***	12.792***	0.059		7.748***	12.792***	0.050	X(12)=15.74
		(1.693)	(3.723)			(1.693)	(3.723)		(0.20)
8		7.859***	13.358***	0.059		7.859***	13.358***	0.050	X(14)=23.39
		(1.696)	(3.712)			(1.696)	(3.712)		(0.05)
9		10.303***	13.852***	0.043		10.303***	13.852***	0.006	X(12)=17.09
		(2.074)	(4.976)			(2.074)	(4.976)		(0.15)
10		10.988***	13.748***	0.045		10.988***	13.748***	0.005	X(14)=23.56
		(2.093)	(4.908)			(2.093)	(4.908)		(0.05)

Table 3 Forecasting Quarterly Excess Stock Market Returns

Note: We report the OLS regression results of forecasting one-quarter-ahead excess stock market returns using some predetermined variables over the period 1963:Q4 to 2005:Q4. The heteroskadesticity-corrected standard errors are in parentheses. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively. $v_{M,t}^2$ is realized stock market variance; $v_{H,t}^2$ is realized variance of the value premium; $v_{MH,t}$ is realized covariance between the stock market return and the value premium; $RREL_t$ is the stochastically detrended risk-free rate; CAY_t is the consumption-wealth ratio proposed by Lettau and Ludvigson (2001b); and IV_t is a measure of idiosyncratic variance used in Guo and Savickas (2006).

	$v_{M,t}^2$	$v_{MH,t}$	$v_{H,t}^2$	$RREL_t$	CAY_t	IV_t	$\overline{R}^2$
1	7.119***	11.478**		-3.653*			0.060
	(2.514)	(5.441)		(2.124)			
2	6.849***	8.814			1.449***		0.098
	(2.597)	(5.596)			(0.384)		
3	8.721***	1.797				-2.690***	0.088
	(2.435)	(6.735)				(0.819)	
4	6.995***		-16.019***				0.077
	(1.858)		(4.834)				
5	6.629***		-15.590***	-3.843*			0.091
	(1.815)		(4.768)	(2.072)			
6	6.507***		-12.257**		1.312***		0.116
	(1.915)		(4.998)		(0.394)		
7	8.439***		-5.105			-2.221*	0.091
	(1.950)		(8.625)			(1.155)	

Table 4 Forecasting Quarterly Value Premium

Note: We report the OLS regression results of forecasting the one-quarter-ahead value premium using some predetermined variables over the period 1963:Q4 to 2005:Q4. The heteroskadesticity-corrected standard errors are in parentheses. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively. $v_{M,t}^2$ is realized stock market variance; $v_{H,t}^2$ is realized variance of the value premium; $v_{MH,t}$ is realized covariance between the stock market return and the value premium; $RREL_t$ is the stochastically detrended risk-free rate; CAY_t is the consumption-wealth ratio proposed by Lettau and Ludvigson (2001b); and IV_t is a measure of idiosyncratic variance used in Guo and Savickas (2006).

	$v_{M,t}^2$	$v_{MH,t}$	$v_{H,t}^2$	$RREL_t$	CAY_t	IV_t	$\overline{R}^2$
1		11.758	18.683*	2.847**			0.056
		(7.367)	(9.827)	(1.392)			
2		11.008	16.843*		-0.352		0.040
		(7.464)	(9.951)		(0.315)		
3		11.619	16.985			0.231	0.034
		(7.444)	(10.548)			(0.919)	
4	-3.275**		10.455**				0.049
	(1.429)		(4.726)				
5	-3.045**		10.186**	2.407*			0.059
	(1.422)		(4.615)	(1.393)			
6	-3.166**		9.476**		-0.341		0.049
	(1.431)		(4.623)		(0.315)		
7	-3.945**		5.391			1.031	0.052
	(1.707)		(6.179)			(1.079)	

Table 5 Realized Variance of Alternatively Measured Value Premia

Note: We report the OLS regression results of forecasting one-quarter-ahead returns using some predetermined variables over the period 1963:Q4 to 2005:Q4. The heteroskadesticity-corrected standard errors are in parentheses and ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively. $v^2_{M,t}$ is realized stock market variance; $v^2_{H,t}$ is realized variance of the value premium; $v^2_{HB,t}$ is realized variance of the value premium based on big stocks; and $v^2_{HS,t}$ is realized variance of the value premium based on small stocks.

	$v^2_{M,t}$	$v^2_{H,t}$	$v^2_{HS,t}$	$v^2_{HB,t}$	$\overline{R}^2$
Panel A Stock Market Returns					
1	6.995***	-16.019***			0.077
	(1.858)	(4.834)			
2	6.754***		-12.881***		0.059
	(1.875)		(4.554)		
3	7.612***			-14.362***	0.094
	(1.979)			(5.132)	
Panel B The Value Premium					
4	-3.275**	10.455**			0.049
	(1.429)	(4.726)			
5	-3.599**		9.940***		0.051
	(1.517)		(3.710)		
6	-3.071*			7.595	0.038
	(1.623)			(4.703)	

Table 6 Summary Statistics of Monthly Return Data

Note: The table reports summary statistics of the excess stock market return, R_t, and the value premium, HML_t, in percentages. Panel B reports the unconditional variance-covariance matrix in the upper triangle and the correlation coefficient in the lower triangle. Panel C reports the conditional variances and covariance, which are based on estimation of the benchmark ABEKK model reported in Table 9. $\sigma^2_{M,t}$ is stock market variance, $\sigma^2_{H,t}$ is variance of the value premium, and $\sigma_{MH,t}$ is covariance of the stock market return with the value premium. The sample spans the period January 1963 to December 2005. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.

Panel A Summary Statistics

	Mean	Standard Deviation	Skewness	Kurtosis	Ljung-Box statistics		
					Q1	Q6	Q12
R_t	0.481	4.409	–0.505	5.065	1.427	5.587	8.878
HML_t	0.457	2.911	0.005	5.505	8.930***	14.405**	17.422

Panel B Unconditional Covariance Matrix

	R_t	HML_t
R_t	19.435	–5.232
HML_t	–0.408	8.472

Panel C Mean of Conditional Variances and Covariance

$\sigma^2_{M,t}$	$\sigma_{MH,t}$	$\sigma^2_{H,t}$
19.103	–5.177	8.259

Table 7 Specification Tests for GARCH Model

Note: The table reports the specification tests of the GARCH model described in equations (4) through (7). The sample spans the period January 1963 to December 2005.

Null hypothesis	DF	LR	P-Value
Panel A Pooling Univariate GARCH Model vs. ADC Model			
H_0: No Interaction Term	10	129.40	0.00
Panel B ABEKK model vs. ADC Model			
H_0: $\rho_{MH} = 0$ and $\phi_{MH} = 1$	2	4.30	0.12
Panel C BEKK Model vs. ABEKK Model			
H_0: $g_{MM} = g_{MH} = g_{HM} = g_{HH} = 0$	4	28.28	0.00
Panel D Constant Equity Premium and Value Premium in ABEKK Model			
H_0: $\gamma_{MM} = \gamma_{MH} = \gamma_{HM} = \gamma_{HH} = 0$	4	18.88	0.00
Panel E No Constant Terms in ABEKK Model			
H_0: $\alpha_{ER} = \alpha_{HML} = 0$	2	0.12	0.94
Panel F Equal Risk Prices Across Assets in ABEKK Model			
H_0: $\gamma_{MM} = \gamma_{MH}$, $\gamma_{HM} = \gamma_{HH}$ $\alpha_{ER} = \alpha_{HML} = 0$	4	4.79	0.31

Table 8 Merton's (1973) ICAPM: Bivariate GARCH Model

Note: The table reports the estimation results of Merton's (1973) ICAPM using various bivariate GARCH models described in equations (4) through (7). Unless otherwise indicated, we use the QML method and the monthly sample spanning the period January 1963 to December 2005. We use the sample period July 1926 to December 1962 in row 5 and the sample period July 1926 to December 2005 in row 6. The specifications in rows 9 and 10 are the same as those in row 4 except that we assume a *t* distribution in row 9 and a normal distribution in row 10. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively. We report the log likelihood in the column under LL.

	Stock Market Returns			Value Premium			LL
	α_R	γ_{MM}	γ_{HM}	α_H	γ_{MH}	γ_{HH}	
Panel A Pooling Univariate GARCH							
1	0.004	0.87		-0.001		6.71	-2681.59
	(0.004)	(2.29)		(0.003)		(4.12)	
Panel B ABEKK Model							
2	0.000	6.00	10.91	0.001	19.04*	16.56*	-2619.05
	(0.623)	(4.35)	(6.57)	(0.229)	(10.90)	(9.50)	
3		5.40***	11.84*		16.49**	16.01***	-2619.11
		(1.87)	(6.33)		(7.72)	(5.04)	
4		4.74***	7.46***		4.74***	7.46***	-2621.44
		(1.21)	(1.95)		(1.21)	(1.95)	
5		2.20***	-0.002		2.20***	-0.002	-2385.97
		(0.84)	(0.016)		(0.84)	(0.016)	
6		2.52***	1.63*		2.52***	1.63*	-5075.29
		(0.584)	(0.897)		(0.584)	(0.897)	
Panel C ADC Model							
7	-0.001	5.82	9.95	-0.002	17.22	19.20***	-2616.90
	(0.001)	(4.29)	(5.67)	(0.002)	(15.31)	(4.79)	
8		4.73***	8.22***		4.73***	8.22***	-2618.34
		(1.22)	(2.01)		(1.22)	(2.01)	
Panel D ABEKK Model Using MLE Method							
9		4.97***	7.54***		4.97***	7.54***	–2603.72
		(1.16)	(1.83)		(1.16)	(1.83)	
10		4.74***	7.46***		4.74***	7.46***	-2621.44
		(1.15)	(1.71)		(1.15)	(1.71)	

Table 9 Parameter Estimates of the Benchmark ABEKK Model

Note: The table reports the estimation results of the ABEKK specification of equations (4) through (7) by imposing the restrictions $\rho_{MH} = 0$ and $\phi_{MH} = 1$, the same specifications as those reported in row 4 of Table 8. We also impose the ICAPM restrictions $\gamma_{MM} = \gamma_{MH}$, $\gamma_{HM} = \gamma_{HH}$, and $\alpha_R = \alpha_H = 0$. The sample spans the period January 1963 to December 2005. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.

Parameter	Estimate	Standard Error	Parameter	Estimate	Standard Error
Panel A Mean Equation of Stock Return			Panel B Mean Equation of Value Premium		
γ_{MM}	4.74***	1.21	γ_{MH}	4.74***	1.21
γ_{HM}	7.46***	1.95	γ_{HH}	7.46***	1.95
Panel C Variance Equation of Stock Return			Panel D Variance Equation of Value Premium		
ω_{MM}	0.870***	0.218	ω_{HH}	0.367**	0.164
b_{MM}	0.950***	0.019	b_{HH}	0.926***	0.018
a_{MM}	0.149**	0.062	a_{HH}	0.248***	0.057
g_{MM}	-0.199***	0.058	g_{HH}	0.323***	0.055
Panel E Covariance Equation of Stock Return and Value Premium					
ω_{MH}	-0.177	0.212	b_{MH}	0.019*	0.011
a_{MH}	-0.137*	0.074	a_{HM}	-0.013	0.037
g_{MH}	-0.103	0.075	g_{HM}	0.119***	0.033

Table 10 Specification Tests

Note: The table reports the standardized residuals and their second moments obtained from the benchmark ABEKK model, as reported in Table 9. $\hat{\varepsilon}_M$ is the residual of the stock market return and $\hat{\varepsilon}_H$ is for the value premium. The calculation is based on the estimates of Table 9. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.

	$\hat{\varepsilon}_M$	$\hat{\varepsilon}_H$	$\hat{\varepsilon}_M \hat{\varepsilon}_M$	$\hat{\varepsilon}_M \hat{\varepsilon}_H$	$\hat{\varepsilon}_H \hat{\varepsilon}_H$
Panel A Sample statistics					
Mean	–0.012	0.031	1.021	–0.363	1.002
Standard Deviation	1.011	1.002	2.226	1.272	1.476
Skewness	–0.729	-0.028	8.930	–2.553	2.371
Kurtosis	5.709	3.170	119.348	22.175	9.322
t-statistic for mean = 0	–0.279	0.692			
t-statistic for mean = 1			0.215	–24.275***	0.035
Panel B Ljung-Box statistics					
Q_1	0.689	15.782***	0.386	0.226	0.472
Q_6	4.894	18.130***	0.825	4.147	7.150
Q_{12}	7.372	21.368*	5.983	11.702	14.036

Table 11: International Evidence

Note: The table reports the estimation results of the ABEKK specification of equations (4) through (7) by imposing the restrictions $\rho_{MH} = 0$ and $\phi_{MH} = 1$. We also impose the ICAPM restrictions $\gamma_{MM} = \gamma_{MH}$, $\gamma_{HM} = \gamma_{HH}$, and $\alpha_R = \alpha_H = 0$. The sample spans the period January 1975 to December 2005. The returns are denoted in local currencies for the G7 countries and in the U.S. dollar for the world market. ***, **, and * denote significance at the 1%, 5%, and 10% significance levels, respectively.

Country	γ_M	Standard Errors	γ_H	Standard Errors
Canada	1.509	1.354	2.009*	1.090
France	1.842*	0.964	2.112*	1.276
Germany	1.878**	0.823	2.702**	1.218
Italy	0.645	0.807	-0.704	1.065
Japan	1.897*	1.054	3.873***	1.207
UK	2.450**	1.241	2.658**	1.321
World	3.157***	1.184	8.179***	2.334

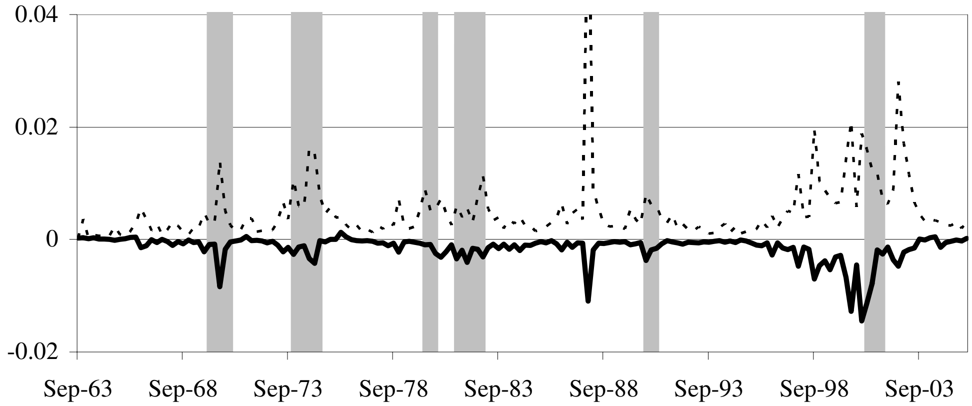

Fig. 1. Quarterly realized stock market variance (dashed line), $v^2_{M,t}$, and covariance of the stock market return with the value premium (solid line), $v_{MH,t}$, over the period 1963:Q3 to 2005:Q4. $v^2_{M,t}$ is the sum of squared daily excess stock market returns in quarter *t*. $v_{MH,t}$ is the sum of the cross-product of the daily excess stock market returns with the value premium in quarter *t*. The shaded areas indicate business recessions dated by NBER.

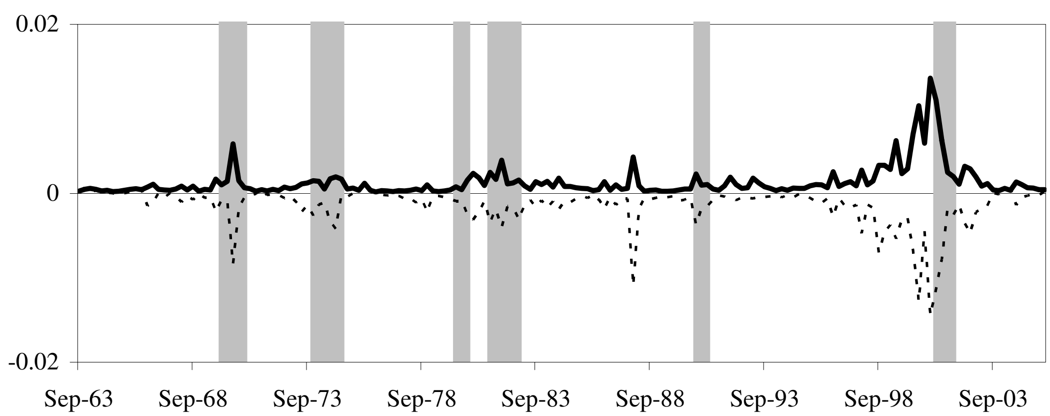

Fig. 2. Quarterly realized value premium variance (solid line), $v^2_{H,t}$, and covariance of the stock market return with the value premium (dashed line), $v_{MH,t}$, over the period 1963:Q3 to 2005:Q4. $v^2_{H,t}$ is the sum of squared daily value premia in quarter *t*. $v_{MH,t}$ is the sum of the cross-product of the daily excess stock market returns with the value premium in quarter *t*. The shaded areas indicate business recessions dated by NBER.

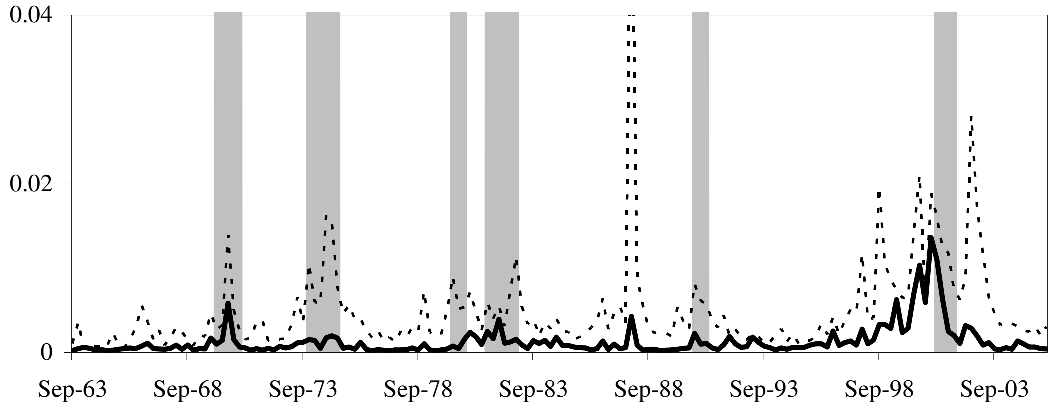

Fig. 3. Quarterly realized stock market variance (dashed line), $v_{M,t}^2$, and value premium variance (solid line), $v_{H,t}^2$, over the period 1963:Q3 to 2005:Q4. $v_{M,t}^2$ is the sum of squared daily value premia in quarter *t*. $v_{M,t}^2$ is the sum of squared daily excess stock market returns in quarter *t*. $v_{H,t}^2$ is the sum of squared daily value premia in quarter *t*. The shaded areas indicate business recessions dated by NBER.

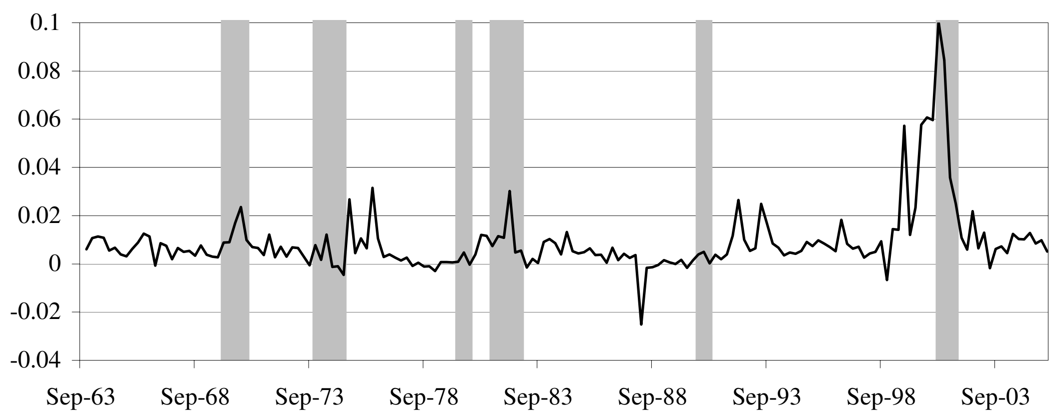

Fig. 4. Fitted value premium over the period 1963:Q4 to 2005:Q4. We estimate Merton's (1973) ICAPM

$$(3)\quad \begin{aligned} R_{t+1} &= \alpha_M + \gamma_{MM} v_{M,t}^2 + \gamma_{HM} v_{MH,t} + \varepsilon_{M,t+1} \\ HML_{t+1} &= \alpha_H + \gamma_{MH} v_{MH,t} + \gamma_{HH} v_{H,t}^2 + \varepsilon_{H,t+1} \end{aligned},$$

where R_{t+1} is the excess stock market return; HML_{t+1} is the value premium; $v_{M,t}^2$ is realized stock market variance; $v_{MH,t}$ is realized covariance between the stock market return and the value premium; $v_{H,t}^2$ is realized variance of the value premium; and $\varepsilon_{M,t+1}$ and $\varepsilon_{H,t+1}$ are shocks to the stock market return and the value premium, respectively. In the estimation we have imposed the ICAPM restrictions: $\alpha_M = \alpha_H = 0$, $\gamma_{MM} = \gamma_{MH} = \gamma_M$, and $\gamma_{HM} = \gamma_{HH} = \gamma_H$. The fitted value premium for quarter *t*+1 is equal to $\hat{\gamma}_{MH} v_{MH,t} + \hat{\gamma}_{HH} v_{H,t}^2$, where $\hat{\gamma}_{MH}$ and $\hat{\gamma}_{HH}$ are the estimated slope parameters. The shaded areas indicate business recessions dated by NBER.

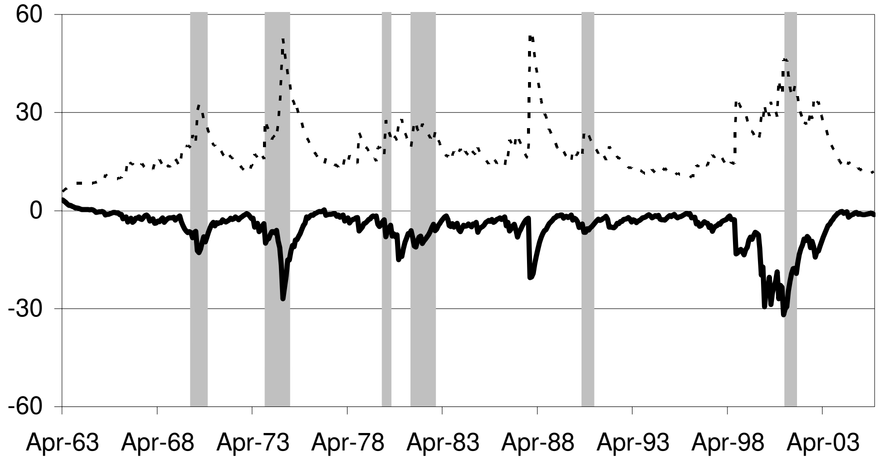

Fig. 5. Conditional stock market variance (dashed line), $\sigma^2_{M,t}$, and conditional covariance of the stock market return with the value premium (solid line), $\sigma_{MH,t}$, over the period January 1963 to December 2005. We estimate the conditional second moments using the benchmark ABEKK model, in which we impose all the ICAPM restrictions. The shaded areas indicate business recessions dated by NBER.

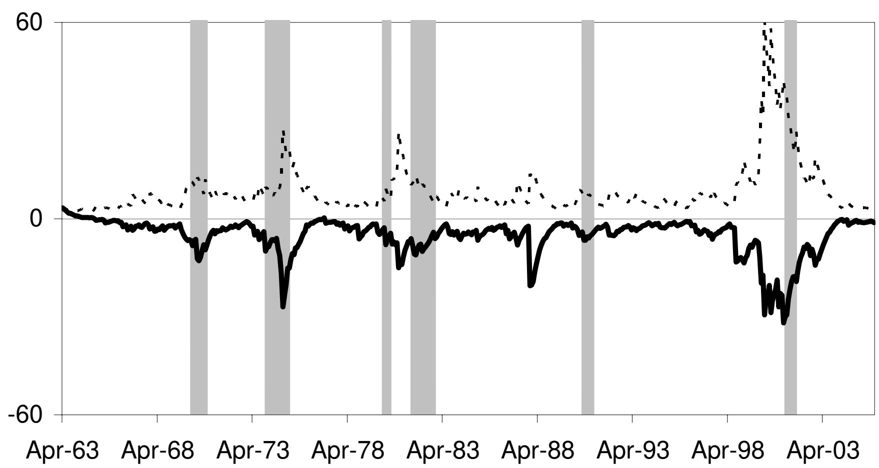

Fig. 6. Conditional value premium variance (dashed line), $\sigma^2_{H,t}$, and conditional covariance of the stock market return with the value premium (solid line), $\sigma_{MH,t}$, over the period January 1963 to December 2005. We estimate the conditional second moments using the benchmark ABEKK model, in which we impose all the ICAPM restrictions. The shaded areas indicate business recessions dated by NBER.

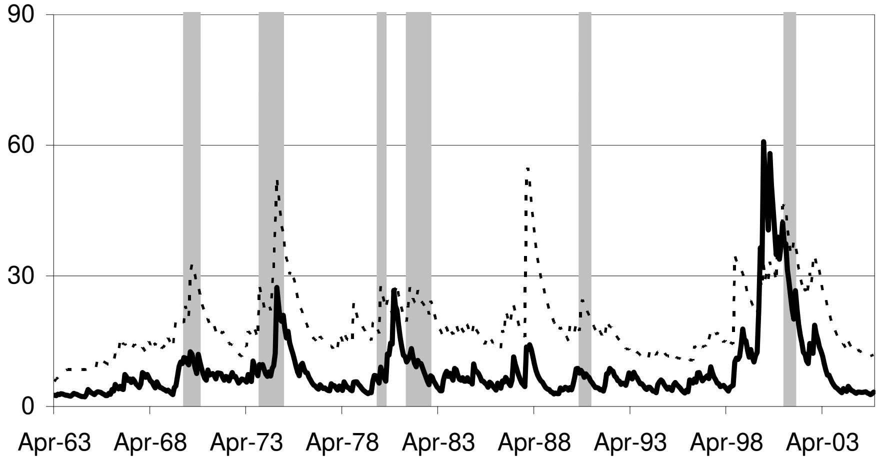

Fig. 7. Conditional stock market variance (dashed line), $\sigma^2_{M,t}$, and conditional value premium variance (solid line), $\sigma^2_{H,t}$, over the period January 1963 to December 2005. We estimate the conditional second moments using the benchmark ABEKK model, in which we impose all the ICAPM restrictions. The shaded areas indicate business recessions dated by NBER.

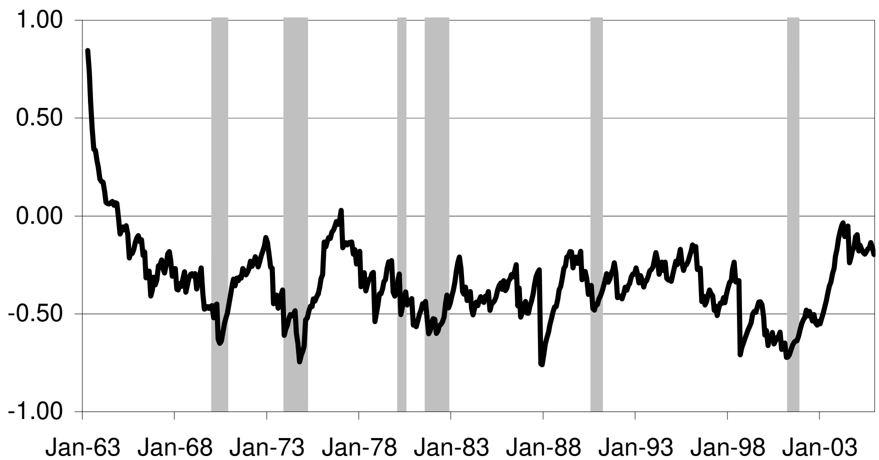

Fig. 8. Conditional coefficient of correlation between the stock market return and the value premium over the period January 1963 to December 2005, which is estimated with the benchmark ABEKK model, in which we impose all the ICAPM restrictions. The shaded areas indicate business recessions dated by NBER.ABEKK model with all the ICAPM restrictions.