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Regime Switches in the Risk-Return Trade-off*

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Abstract

This paper deals with the estimation of the risk-return trade-off. We use a MIDAS model for the conditional variance and allow for possible switches in the risk-return relation through a Markov-switching specification. We find strong evidence for regime changes in the risk-return relation. This finding is robust to a large range of specifications. In the first regime characterized by low ex-post returns and high volatility, the risk-return relation is reversed, whereas the intuitive positive risk-return trade-off holds in the second regime. The first regime is interpreted as a "flight-to-quality" regime.

Keywords: Risk-return trade-off; Markov-switching; MIDAS; conditional variance.

JEL Classification Code: G12, G10.

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