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Ming Gu, Wenjin Kang, Bu Xu

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Limits of Arbitrage and Idiosyncratic Volatility: Evidence from China Stock Market

Ming Gu *
Renmin University of China
Wenjin Kang
Renmin University of China
Bu Xu
Renmin University of China

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ABSTRACT

This study examines how limits of arbitrage can affect the pricing of idiosyncratic volatility. Using both unique trading constraints in the Chinese stock market and other commonly-used limits-of-arbitrage measures, we construct a comprehensive limits-of-arbitrage index. Based on this index, we find that the negative idiosyncratic volatility return premium is much stronger and more persistent in stocks with high limits of arbitrage. Furthermore, the existing explanations about the idiosyncratic volatility return premium cannot fully explain what we find about the role of limits of arbitrage in the pricing of idiosyncratic volatility in the Chinese stock market. Our study suggests that the trading constraints introduced in the name of protecting individual investors can actually hurt them, since these additional limits of arbitrage will increase the inefficiency of the security market.

JEL classification: G12 G15

Keywords: Limits of Arbitrage, Idiosyncratic Volatility

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✩ * Corresponding author. Tel: +86-10-82504614. Email address: minggu@ruc.edu.cn (Ming Gu); kangwenjin@ruc.edu.cn (Wenjin Kang); buxu@ruc.edu.cn (Bu Xu).