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Xingguo Luo, Jin E. Zhang

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Expected stock returns and forward variance

Xingguo Luo†
College of Economics and Academy of Financial Research
Zhejiang University, Hangzhou 310027, PR China
Email: xingguoluo@gmail.com

Jin E. Zhang†
Department of Accountancy and Finance
Otago Business School, University of Otago
Dunedin 9054, New Zealand
Email: jin.zhang@otago.ac.nz

Abstract

Bakshi, Panayotov, and Skoulakis (2011) show that forward variances are predictive of real economic activity and asset returns. In this paper, we study this relation by using CBOE VIX term structure data between January 1992 and August 2009. We find that certain combinations of the 3-, 6-, and 9-month forward variances (single forward variance factor) are predictive of stock market returns at 1-, 3-, and 6-month horizons. Forward variances constructed from seven out of nine sectors are also predictive of stock market returns and real economic activity. Out-of-sample analysis confirms the prediction power of the single forward variance factor.

Keywords: Stock returns; Forward variance; Predictability

JEL classification: C5; G12; G13

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†Both Xingguo Luo and Jin E. Zhang are corresponding authors, with contact details as follows: Luo, Tel: +86-571-87953210, Fax: +86-571-87953937; Zhang, Tel: +64 3 479 8575, Fax: +64 3 479 8171.
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