The Value Uncertainty Premium
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Abstract

We investigate whether the time-series volatility of book-to-market (BM), called value uncertainty (UNC), is priced in the cross-section of equity returns.

A size-adjusted value-weighted factor with a long (short) position in high-UNC (low-UNC) stocks generates an annualized alpha of 6-8%.

UNC premium is not explained by established risk factors or firm characteristics.

At the aggregate level, UNC is correlated with macroeconomic fundamentals and predicts future market returns and market volatility.

Findings are explained within a rational asset-pricing framework.

Motivation & Intuition

We show that UNC is more informative than the expected value of the BM ratio concerning the risk associated with profitability and the quality of available accounting information.

If BM captures some form of fundamental risk, UNC is partly driven by difficulties in generating clear expectations about the sources of this risk.

The aggregate measure of UNC is positively associated with the interaction between ΔC and ΔP, implying higher productivity and consumption risk for stocks with high-UNC.

Thus, risk-averse investors demand extra compensation when holding high-UNC stocks.

Findings & Contributions

1. Volatility of “value” matters and is priced!

2. A significant premium is required by investors to hold high-UNC firms that is not explained by common risk factors.

3. We provide rational asset pricing explanation for this premium.

4. A value uncertainty index (UNCavg) is strongly associated with standard uncertainty indices.

5. UNCavg can be viewed as proxy for sources of fundamental economic uncertainty reflecting ambiguity about the true current value of the underlying investment in operating productive assets.

6. ΔUNCavg can be a state variable candidate of the ICAPM satisfying Maio and Santa-Clara’s (2012) restrictions.

Data & Variables

US stocks: CRSP, COMPSTAT, and I/B/E/S.
January 1985 to December 2016.

References