Firm Risk and Market Valuation: A Reexamination Using Quantile Regression

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Abstract

Relationship between firm risk and market value of firms has been examined for long but is poorly understood. Traditional asset pricing theory suggests only market risks are rewarded, and firm risks are priced out, but behavioral literature (Barberis & Huang, 2001) suggests firm-risks are priced. Others (Merton, 1987) also suggest higher risks should be associated with higher rewards. Empirical results examining relationship between firm risk or level of volatility and its stock market valuation is mixed. Some of the prior research have found a positive relationship (Barberis & Huang, 2001), some have found a negative relationship (Ang, Hodrick, Xing, & Zhang, 2006; Rountree, Weston, & Allayannis, 2008), while some others have found no relationship. Considering the inconsistency of these findings, in this research, we reexamine this relationship using quantile regression. We argue that the nature of relationship is fundamentally different for leading firms and laggard firms; for leading firms, the upside aspect of risks more central, and the relationship between risk and return is likely to be positive, but for laggard firms the downward aspect of risk becomes more central, the relationship is likely to be negative. We examine these relationships using a sample of Compustat firms (1977-2006) and find preliminary support for our core expectations. We believe further research using this approach could shed new lights on the relationship between risk and return.

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