Common Idiosyncratic Quantile Risk*

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November 1, 2024

Abstract

We identify a new type of risk that is characterised by commonalities in the quantiles of the cross-sectional distribution of asset returns. Our newly proposed quantile risk factors are associated with a quantile-specific risk premia and provide new insights into how upside and downside risks are priced by investors. In contrast to the previous literature, we recover the common structure in cross-sectional quantiles without making confounding assumptions or aggregating potentially non-linear information. We discuss how the new quantile-based risk factors differ from popular volatility and downside risk factors, and we identify heterogeneous implications of quantile-dependent risks for asset prices. Quantile factors also have predictive power for aggregate market returns. We explore potential mechanisms that give rise to these asset pricing facts.

Keywords: Cross-section of asset returns, factor structure of asset returns, idiosyncratic risk, quantiles, asymmetric risk

JEL: C21; C58; G12

*We are grateful to the editor, Jun Pan, and an anonymous associate editor as well as referee for their useful comments and suggestions, which have greatly improved the paper. We appreciate numerous comments from participants at STAT of ML (Prague), Financial Econometrics Conference (Lancaster), 16th Annual Society for Financial Econometrics Conference (Rio de Janeiro) and seminars at Charles University (Prague) and University of Sussex (Brighton). Support from the Czech Science Foundation under the 19-28231X (EXPRO) project is gratefully acknowledged. The Common Idiosyncratic Quantile (CIQ) factors we use are available for download and use at https://github.com/matejnevrla/Common-Idiosyncratic-Quantile-Risk

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1 Introduction

The question of how relevant the information contained in different parts of the return distribution is to an investor has received considerable attention in the recent empirical asset pricing literature (Ang et al., 2006; Van Oordt and Zhou, 2016; Chabi-Yo et al., 2018; Lu and Murray, 2019), with number of studies focusing on the tails or extremes in the cross-section of returns (Kelly and Jiang, 2014; Chabi-Yo et al., 2022). These studies typically rely on assumptions about moment conditions or existence of a model that generates returns. In contrast, our aim is to use conditional quantiles of observed returns to capture set of nonlinear factors that provide finer characterization of risk.

In particular, by moving away from volatility as the usual proxy for risk to other parts of the idiosyncratic return distribution, we provide a much richer understanding of the behaviour of idiosyncratic risk and its implications for asset prices. We identify a common structure in the cross-section of quantiles of idiosyncratic returns that is distinct from the common structure found in volatility. In doing so, we remain agnostic about the data generation process. We also document the relationship between quantile risk and quantile-specific risk premia, and identify where quantile-dependent risks merit greater compensation. Both volatility and downside risk measures hide such details while aggregating information about risk.

Importantly, we identify potential channels through which our measure may have cross-sectional price implications. First, we show that the newly identified risk contains additional information that cannot be explained by the choice of popular linear factor models. Second, we associate the common idiosyncratic quantile risk to heterogeneous household income and firm fundamental risks. This is an important observation because the consumption function may differ across households for a variety of reasons, such as changes in income components with different degrees of persistence, persistent idiosyncratic cash flow shocks from firms, heterogeneity in preferences or discounting, household-specific returns on assets, or heterogeneous access to other sources of insurance. Arellano et al. (2024) find substantial heterogeneity in consumption responses to asymmetrically persistent and non-linear income shocks, revealing latent types of households with different life-cycle consumption behaviour. For example, they find that older and wealthier households adjust their consumption less in response to an income shock than younger and less wealthy households.

Since households' consumption risk inherits the factor structure of firms' idiosyncratic cash flow risk, the common factor in idiosyncratic quantiles can be used as a priced state variable in the household price kernel. While Herskovic et al. (2016) studies such relation for volatility, economic agents engaged in a wide range of activities have much more complex preferences that require distributional information beyond the first two moments.

The information captured by quantile-dependent factors can be related to the behaviour of investors with quantile preferences (de Castro and Galvao, 2019), and utility-free representation of risk. Quantiles contain rich information because they capture heterogeneity in risk and allow the separation of risk aversion and elasticity of intertemporal substitution. Our main interest is to show that there are strong common factors across quantiles of the cross-sectional distribution of asset returns that are more informative about investors' compensation requirements. We argue that such risk is distinct from other types of risk associated with the distribution of returns, such as downside risk or volatility risk. The quantile-dependent risk premia associated with such factors are then used to generalise notion of upside risk and downside risk.

Just as quantile regression extends classical linear regression, our quantile factor model of asset returns extends the approximate factor models used in the empirical asset pricing literature. In the spirit of the popular Principal Component Analysis, which recovers the conditional mean, we work with more general quantile factor models (QFMs). These are flexible enough to capture quantile-dependent objects that cannot be captured by standard tools. Unlike standard principal component analysis, quantile factor models are able to capture hidden factors that shift distributional properties such as moments or quantiles. Importantly, such factors differ from the usual mean and volatility factors when we abandon the traditional location and scale shift model structure and allow for more general, possibly unknown, data generating processes. In effect, quantile-dependent risk is treated as constant in factor models based on such assumptions. Downside risk models then aggregate the quantiles, usually under some distributional assumption.

Our main contribution is to investigate the pricing implications of newly identified common non-linear factors that are quantile specific for the predictability of aggregate market returns and the cross-section of stock returns. We are interested in factors that identify the risk premium associated with different quantiles of the return distribution in terms of both downside (or tail) risk and upside potential. Our approach will identify new information about risk beyond the usual moments associated with tail risks. To this end, we use the quantile factor model of Chen et al. (2021) and investigate the pricing implications of quantile-dependent factors while controlling for various linear factors and exposures to them. Our objective is also motivated by the increasing evidence of non-linearities in equity markets.[1] We aim to show that the common quantile risk present in the stock return data

[1]E.g., Amengual and Sentana (2020) report a non-linear dependence structure in short-term reversals and momentum. Ma et al. (2021) show that many firm-level characteristics have a complex relationship with returns in terms of quantiles.

carries different information from the common volatility and downside risks. Our quantile dependent factors also carry strong information for both the cross-section of asset returns and the time series predictability of the equity premium.

We begin by identifying common factor structures in the idiosyncratic quantiles of stocks in the Center for Research in Security Prices (CRSP) over a sample spanning 1960 to 2018. We show that the newly identified risk contains additional information that cannot be explained by the choice of popular linear factor models. Then, we associate the common idiosyncratic quantile risk to heterogeneous household income and firm fundamental risks. We discuss the relationship with volatility and downside risk factors and show that quantile factors have predictive power for aggregate market returns. Predictive regressions show that a one standard deviation increase in quantile risk predicts a statistically significant increase in annualised excess market returns of up to 7.05% in the case of the left tail. These results hold out-of-sample, are stronger for the left tail, and are robust to controlling for a wide range of popular predictors studied by Welch and Goyal (2007), as well as tail risk (Kelly and Jiang, 2014) and common volatility risk (Herskovic et al., 2016). We also document the predictive power of the upper tail factor with a smaller effect of up to 3.50% increase in annualised returns, hence the effect is asymmetric. Moreover, the predictive power of the upper tail factors disappears when looking at the out-of-sample performance.

We also find that idiosyncratic quantile risk has significant predictive power for the cross-section of average returns. We show that stocks with high loadings of past quantile risk in the left tail earn up to an annual six-factor alpha of 8.57% higher than stocks with low tail risk loadings for 0.2 quantiles. This risk premium is not subsumed by other commonly priced factors such as common volatility, tail and downside risk, and other popular risk factors. Investors thus have a strong aversion to tail risk with respect to the common movements in idiosyncratic returns. On the other hand, the absence of the risk premium associated with the factors for the upper quantiles suggests that investors are not upside potential seekers. Both results are consistent with the literature on the impact of asymmetric dependencies on asset prices.

Our work is related to several strands of the literature. The first relates to the factor-based asset pricing models that are very popular in the empirical pricing literature (Ross, 1976; Fama and French, 1993; Kelly et al., 2019). In sharp contrast to this literature, our approach remains agnostic about the nature of the true data generating process and uses the conditional quantiles of observed returns without imposing moment conditions.

The second strand to which we contribute is the study of idiosyncratic risk that comoves across assets, thus exploring common trends that are not captured by first moment factors. The bulk of this research is motivated by the introduction of the idiosyncratic volatility puzzle proposed by Ang et al. (2006a). Unfortunately, all existing explanations of the anomaly based on lottery preferences, market frictions or other factors account only for 29-54% of the puzzle using individual stocks (Hou and Loh, 2016).[2]

The third line of thought that we take into account deals with asymmetric properties of systematic risk and how they are incorporated into asset prices. Interest in this type of model was reignited by Ang et al. (2006) and their introduction of downside beta, which captures the covariance between asset and market returns conditional on the market being below some threshold. Bollerslev et al. (2021) further decompose traditional market beta into semibetas, which are characterised by the signed covariation between market and asset returns. They show that only the semibetas associated with negative market and asset returns predict significantly higher future returns. More recently, Bollerslev et al. (2022) argue that betas are granular and associated with a risk premium that depends on the relevant part of the return distributions.

From a theoretical point of view, there are many justifications for moving from classical common factor pricing theory to the asymmetric forms of the utility function. Probably the most relevant for our work is the dynamic quantile decision maker of de Castro and Galvao (2019), who decides on the basis of quantile-dependent preferences. In addition, Barro (2006), building on Rietz (1988), introduced the rare disaster model and showed that tail events can have a significant ability to explain various asset pricing puzzles, such as the equity premium puzzle. The other popular model that takes into account asymmetric features of risk is the generalised disappointment aversion model of Routledge and Zin (2010), which inherently assumes that investors are downside averse. Based on these preferences, Farago and Tédongap (2018) introduce an intertemporal equilibrium asset pricing model and show that disappointment-related factors should be priced in the cross-section. Moreover, they prove that their model performs well empirically by jointly pricing different asset classes with significant prices for the risk associated with the disappointment factors.

There are also attempts to combine the two or three of these research agendas. Herskovic et al. (2016) introduced a risk factor based on the common volatility of firm-level idiosyncratic returns, and showed its pricing capabilities for the cross section of different asset classes. For example, Kelly and Jiang (2014); Allen et al. (2012); Jondeau et al. (2019); Baruník and Čech (2021) explore the factor risks associated with skewness, tails and extremes. Giglio et al. (2016) estimate quantile-specific latent factors using systemic risk and financial market

[2]For a comprehensive list of references belonging to each of these categories, see Hou and Loh (2016). The only exception to this observation is the lottery-based explanation using the highest realised return from the previous month, proposed by Bali et al. (2011) and confirmed in European markets by Annaert et al. (2013). However, Hou and Loh (2016) argue that this explanation is not valid as it is an almost perfect collinear range-based measure of idiosyncratic volatility.

distress variables to predict macroeconomic activity. Much of the research investigating common tail risk and its implications for asset pricing relies on options data. They argue that the tail factor identifies additional information beyond the volatility factor. Andersen et al. (2020) show strong predictive power for future equity risk premia in US and European equity index derivatives. Bollerslev and Todorov (2011) combine high-frequency and options data and use a non-parametric approach to conclude that a large part of the equity and variance risk premia is related to jump tail risk.

The remainder of the paper is structured as follows. Section 2 proposes the quantile factor model for idiosyncratic returns, discusses its estimation and relates it to common idiosyncratic volatility. Section 3 examines the common idiosyncratic quantile factors, their robustness to the linear model specification and their links to the real economy. Section 4 presents the results of market predictability using the common idiosyncratic quantile factors. Section 5 examines the cross-sectional asset pricing implications of exposure to the proposed factors. Section 6 concludes.

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2 Common Idiosyncratic Quantile (CIQ) Factors

Time variation in equity returns is usually captured in the literature by relatively small number of common factors with following structure[3]

$$r_{i,t} = \alpha_i + \beta_i^\top f_t + \epsilon_{i,t} \tag{1}$$

where $r_{i,t}$ is excess return of an asset $i = 1, \ldots, N$ at time $t = 1, \ldots, T$, f_t is a $k \times 1$ vector of common factors and β_i is a $k \times 1$ vector of the asset's i exposures to the common factors. Such time-series regressions as the one in (1) yielding high R^2 are used to identify factors serving as good proxies for aggregate risks present in the economy. Exposures to the relevant factors captured by β_i coefficients should be compensated in the equilibrium and explain the

[3]Recently, Lettau and Pelger (2020) introduce Risk-Premium Principal Component Analysis, which allows for systematic time-series factors that incorporate information from the first and second moments.

risk premium of the assets

$$\mathbb{E}_t[r_{i,t+1}] = \beta_i^\top \lambda_t \tag{2}$$

where the λ_t is a $k \times 1$ vector of prices of risk associated with factor exposures. Importantly, while the arbitrage pricing theory (APT) of Ross (1976) suggests that any common return factors f_t are valid candidate asset pricing factors, the idiosyncratic return residuals $\epsilon_{i,t}$ are assumed not to be priced. This implication is due to many simplifying assumptions, such that an average investor can perfectly diversify her portfolio or that the linear model (1) is correctly specified.

In these models, only common return factors are valid candidate pricing factors, and sensitivities to those factors determine the risk premium associated with an asset (Ross, 1976). This strand of literature yields highly successful and popular results focusing on the parsimonious models (Fama and French, 1993), as well as exploration of statistically motivated latent factors.[4] Recently, Kelly et al. (2019) introduced instrumented principal component analysis, which enables to flexibly model the latent factors with time-varying loadings using the observable characteristics.[5] In addition, Ma et al. (2021) introduced a semi-parametric quantile factor panel model that considers stock-specific characteristics, which may non-linearly affect stock returns in a time-varying manner. They find that many characteristics possess a non-linear effect on stock returns. In contrast to these authors, the approach used in our paper is more general since it allows not only loadings but also factors to be quantile-dependent. Moreover, our approach does not require the loadings to depend on observables and has direct relation of the approximate factor models that are ubiquitous in the finance literature.

While large literature have focused mainly on the diversification assumption, we aim to question linear nature of the factor model, and our focus is on exposure to parts of idiosyncratic return's distribution instead. Recently, Herskovic et al. (2016) documents strong comovement in idiosyncratic volatility that does not arise from omitted factors, and even after saturating the factor regression with up to ten principal components, residuals that are virtually uncorrelated display same co-movement seen in raw returns.

[4]This approach dates back to Chamberlain and Rothschild (1983) and Connor and Korajczyk (1986). For a comprehensive overview of machine learning methods applied to asset pricing problems such as measuring expected returns, estimating factors, risk premia, or stochastic discount factor, model selection, and corresponding asymptotic theory, see Giglio et al. (2022).

[5]Other notable recent contributions to the factor literature are, e.g., Kozak et al. (2018) and Giglio et al. (2021). The recent availability of high-frequency return data also motivated the development of continuous-time factor models. Aït-Sahalia et al. (2020) proposed a generalisation of the classical two-pass Fama-MacBeth regression from the classical discrete-time factor setting to a continuous-time factor model and enables uncovering complex dynamics such as jump risk and its role in the expected returns.

While the exposure to common movements in volatility seems to carry strong pricing implications, we ask if there exists additional structure insufficiently captured by volatilities especially in a nonlinear and heavy-tailed financial data. In other words, we ask if various parts of the return distributions may have pricing implications for the cross-section of stock returns.[6]

In parallel to the simple factor structure in the idiosyncratic volatility of a panel of returns commonly recovered by researchers (Ang et al., 2006b; Herskovic et al., 2016), we aim to recover the true unobserved structure in the idiosyncratic quantiles. These quantities will be more informative for investors in the case of heavy-tailed nonlinear data, where the second moment is not a sufficient quantity to capture risk. We will show the relationship of the quantile factors to volatility under some specific model assumptions, relate the proposed factor model to existing approaches that recover different factor structures from the data, and also provide a first look at the quantile factor structures in the cross section of US stocks. Importantly, we show that our quantile-dependent factors carry different information than the structure recovered using volatility or some popular downside risk measures that require certain moment conditions to be satisfied.

2.1 Quantile Factor Model

To formalise the discussion, we assume that the panel of returns of length T and width N, after eliminating the common mean factors from the time series regression

$$r_{i,t} = \alpha_i + \beta_i^\top f_t + \epsilon_{i,t}, \tag{3}$$

to have a τ-dependent structure, captured by $f_t(\tau)$, in idiosyncratic errors that we coin common idiosyncratic quantile – CIQ(τ) – factors, $f_t(\tau)$

$$Q_{\epsilon_{i,t}}\Big[\tau | f_t(\tau)\Big] = \gamma_i^\top(\tau) f_t(\tau), \tag{4}$$

which implies

$$\epsilon_{i,t} = \gamma_i^\top(\tau) f_t(\tau) + u_{i,t}(\tau), \tag{5}$$

where $f_t(\tau)$ is an $r(\tau) \times 1$ vector of random common factors, and $\gamma_i(\tau)$ is $r(\tau) \times 1$ vector of non-random factor loadings with $r(\tau) \ll N$ and the quantile-dependent idiosyncratic error $u_{i,t}(\tau)$ satisfies the quantile restriction $P[u_{i,t}(\tau) < 0 | f_t(\tau)] = \tau$ almost surely for all $\tau \in (0,1)$.

[6] Ando and Bai (2020) document that the common factor structures explaining the upper and lower tails of the asset return distributions in global financial markets have become different since the subprime crisis.

To estimate the common factors that capture co-movement of quantile-specific features of distributions of the idiosyncratic parts of the stock returns, we use Quantile Factor Analysis (QFA) introduced by Chen et al. (2021). In contrast to the principal component analysis (PCA), QFA allows to capture hidden factors that may shift more general characteristics such as moments or quantiles of the distribution of returns other than mean. The methodology is also suitable for large panels and requires less strict assumptions about the data generating process as we will discuss in detail here.

The quantile-dependent factors and its loadings can be estimated as

$$\underset{(\gamma_1,\ldots,\gamma_N,f_1,\ldots,f_T)}{\operatorname{argmin}} \frac{1}{NT}\sum_{i=1}^{N}\sum_{t=1}^{T}\rho_\tau\left(\epsilon_{it}-\gamma_i^\top f_t\right) \tag{6}$$

where $\rho_\tau(u)=(\tau-\mathbf{1}\{u\leq 0\})u$ is the check function while imposing the following normalizations $\frac{1}{T}\sum_{t=1}^{T} f_t f_t^\top=\mathbb{I}_r$, and $\frac{1}{N}\sum_{i=1}^{N}\gamma_i\gamma_i^\top$ is diagonal with non-increasing diagonal elements. A potential problem that may arise in small samples is the so-called quantile crossing, that is, the estimated quantiles are not guaranteed to be monotonic in τ. If this occurs, the approach due to Chernozhukov et al. (2010) can be employed to establish monotonicity of the estimated quantiles. In our empirical applications reported later, quantile crossing never arises.

As discussed in Chen et al. (2021), this estimator is related to the principal component analysis (PCA) estimator studied in Bai and Ng (2002) and Bai (2003) similarly as quantile regression is related to classical least squares regression. Unlike the PCA estimator of Bai (2003), this estimator does not yield an analytical closed-form solution. To solve for the stationary points of the objective function, Chen et al. (2021) propose a computational algorithm called iterative quantile regression. They also show that the estimator possess same convergence rate as the PCA estimators for the approximate factor model. We follow their approach when estimating the quantile factors.[7]

It is important here to make relation to the recent literature that attempts to recover possibly nonlinear commonalities and dependence structures in cross-section of returns. For example Pelger and Xiong (2022) allowed factors to be state-dependent, Chen et al. (2009) provided theory for nonlinear factors and Gorodnichenko and Ng (2017) estimated joint level and volatility factors simultaneously. Important strand of the literature is using copulas and documents nonlinear tail dependence, co-skewness, and co-kurtosis in cross-sectional dependence among monthly returns on individual U.S. stocks (Amengual and Sentana, 2020) or provides flexible copula factor model (Oh and Patton, 2017) .

[7]We employ the authors' Matlab codes provided on the Econometrica webpage.

Unlike these studies, our model remains agnostic about the nature of the true data generating process and uses the conditional quantiles of the observed data to capture nonlinearities in factor models. Also, unlike the literature, we do not require the idiosyncratic errors to satisfy specific moment conditions. Thus, our approach is more flexible as it estimates factors that shift relevant parts of the return distributions without restrictive assumptions by relying on density properties. The approach also differs from the existing factor literature in that it does not require the loadings to depend on observables and considers the factors as quantile-dependent objects.

2.2 Relation to Common Factors in Volatility

Quantiles of stock returns can be related to variety of quantities as well as distributional characteristics in specific cases. A specifically important quantity in finance that can relate to quantiles of the return distribution for a typically assumed location-scale model is volatility. As discussed by ample literature started by Ang et al. (2006b), there exists genuine factor structure in the idiosyncratic volatility of panel of asset returns. Applying PCA (or cross-sectional averages) to squared residuals, once mean factors have been removed from the returns (a procedure labeled PCA-SQ hereafter) will recover that structure. We will use this approach to study the relation to quantile specific factors on data, but before we do so, let's discuss the relation theoretically.

It is important to note that the volatility structure will be recovered only if the data-generating process were to be known, and well characterised by the first two moments of the distribution. Yet in case of more general, or even unknown data generating processes that will not be well characterised by the first two moments, such approaches will fail to characterise the risks precisely, and quantile factor models will estimate more useful information.

To illustrate the discussion and provide the link between volatility and quantiles in such restrictive models, let's consider the data generating process to be a typical location-scale model with two unrelated factors in the first and second moments. Idiosyncratic returns $\epsilon_{i,t}$ of such model will be zero mean i.i.d. process independent of both factors with cumulative distribution function $F_{\epsilon_{i,t}}$. Further let $Q_{\epsilon_{i,t}}(\tau) = F^{-1}_{\epsilon_{i,t}}(\tau) = \inf\{s : F_{\epsilon_{i,t}}(s) \leq \tau\}$ be a quantile function of $\epsilon_{i,t}$ and assume the median is zero. Then the following model that is typical for finance

$$r_{i,t} = \beta_i f_{1,t} + (\sigma_{i,t}^\top f_{2,t})\epsilon_{i,t}, \tag{7}$$

where $\sigma_{i,t}$ is time-varying volatility of an ith stock and $\sigma_{i,t} f_{2,t} > 0$ can be assumed to generate returns. When $f_{1,t}$ and $f_{2,t}$ do not share common elements, then

$$Q_{r_{i,t}}\Big[\tau|f_t(\tau)\Big] = \beta_i f_{1,t} + \sigma_{i,t}^{\top} f_{2,t} Q_{\epsilon_{i,t}}(\tau) \tag{8}$$

for $\tau \neq 0.5$ and $Q_{r_{i,t}}\Big[\tau|f_t(\tau)\Big] = \beta_i f_{1,t}$ for $\tau = 0.5$. Note that here loadings on the factor are the only quantile-dependent objects and structure in the mean and volatility describes well the structure in quantiles. While this is already restrictive example that operates with the assumption on first two moments, even in such case standard PCA will not provide consistent estimates if the distribution of $\epsilon_{i,t}$ is heavy-tailed (Chen et al., 2021).

But what if the data follows more complicated models than the one implied by location-shift models? Consider adding asymmetric dependence such as

$$r_{i,t} = \beta_i f_{1,t} + f_{2,t}\epsilon_{i,t} + f_{3,t}\epsilon_{i,t}^3, \tag{9}$$

where $\epsilon_{i,t}$ is standard normal random variable with cumulative distribution function $\Phi(.)$. The quantiles of the returns will then follow

$$Q_{r_{i,t}}\Big[\tau|f_t(\tau)\Big] = \beta_i f_{1,t} + \Phi^{-1}(\tau)\big[f_{2,t} + f_{3,t}\Phi^{-1}(\tau)^2\big], \tag{10}$$

for $\tau \neq 0.5$ and we can clearly see that second factor in $f(\tau) = [f_{1,t}, f_{2,t} + f_{3,t}\Phi^{-1}(\tau)^2]^{\top}$ is quantile dependent.

The main benefit of the model proposed is that being agnostic about data generating process and moment conditions, we use conditional quantiles of the observed returns to capture nonlinearities in factor models. In case these factors are different from those obtained on first and second moments, they will also be more informative for investors. In the next section we estimate these quantities and compare them to volatility as well as other downside risk factors to find support that data show such a rich structures.

3 CIQ Factors and the US firms

To estimate the common idiosyncratic quantile – CIQ(τ) – factors, we use stock returns from the Center for Research in Securities Prices (CRSP) database sampled between January 1960 and December 2018. We include all stocks with codes 10 and 11 in the estimation. We adjust the returns for delisting as described in Bali et al. (2016). We follow the standard practice in the literature and exclude all "penny stocks" with prices below one dollar to avoid biases related to these stocks.[8] We performed the analysis using all stocks, and the results did not qualitatively change. We use monthly data for both factor and beta estimations.

In the process of the factor estimation, we proceed in a few steps. First, we use a moving window of 60 months of monthly sampled observations. We select the stocks that have all the observations in this window. For all these stocks, we run time-series regression to eliminate the influence of the common (linear) factors

$$\forall i : r_{i,t} = \alpha_i + \beta_i^\top f_t + e_{i,t}, \quad t = 1, \ldots, T \tag{11}$$

and save the residuals $e_{i,t}$. For the common factors f_t, which we eliminate from the stock returns, we resort to the three factors of Fama and French (1993) (hence FF3). We use this as the baseline model and, unless otherwise stated, the CIQ factors are estimated with respect to this linear specification. As discussed in Herskovic et al. (2016), there is a little difference between the results obtained using the factors of Fama and French (1993) and the purely statistically motivated ones estimated using the PCA framework. Later in the text, we also perform robustness checks with respect to extensions of the FF3 model.

Second, we use the residuals from the first step and, for every τ, estimate common idiosyncratic quantile factors, $f_t(\tau)$

$$\forall \tau : e_{i,t} = \gamma_i(\tau) f_t(\tau) + u_{i,t}(\tau) \tag{12}$$

where the quantile-dependent idiosyncratic error $u_{i,t}(\tau)$ satisfies the quantile restriction following the methodology discussed in the previous subsection. We use only the first – the most informative – estimated factor for our purposes. In the overwhelming majority of the cases, the algorithms proposed in Chen et al. (2021) select exactly one factor to be the correct number of factors that explain the panels of idiosyncratic returns.

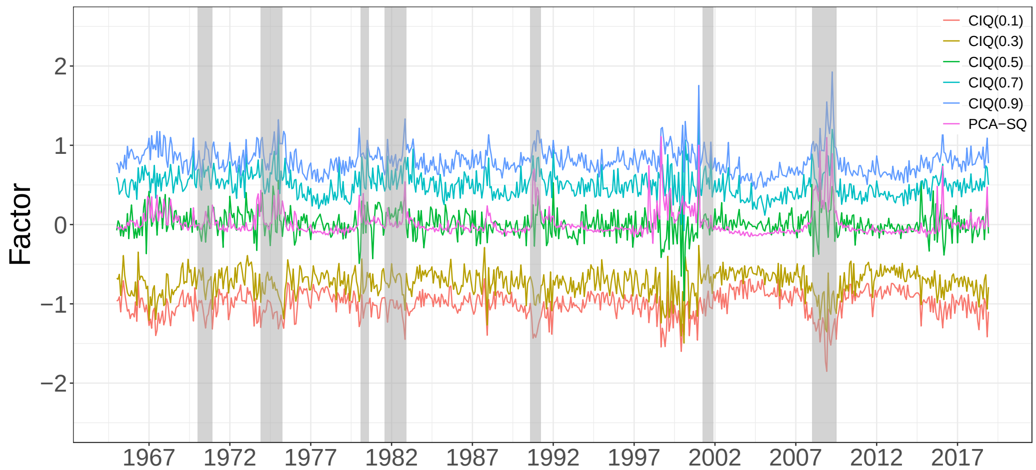
Since we are interested in how the quantile dependent factors relate to volatility, we also estimate an approximate factor model on the squared residuals that captures the common volatility factor. Specifically, we use the residuals from 11, square them and estimate the first principal component using PCA. Such a factor, denoted as PCA- SQ, will not capture the full factor structure if the distribution of idiosyncratic returns has non-normal characteristics (Chen et al., 2021). Figure 1 shows some of the estimated CIQ factors and the PCA-SQ factor.

To illustrate the importance of examining quantile-specific risks above and beyond common volatility, we run the following simple exercise. In Table 1, we report time-series correlations between cross-sectional quantiles of stock returns estimated from raw and idiosyncratic

[8] See, e.g., Amihud (2002).

Figure 1: CIQ factors

The figure captures CIQ(τ) and PCA-SQ factors estimated using idiosyncratic returns relative to the FF3 model. Factors are estimated using 60-month rolling window. The data cover the period from January 1965 to December 2018. The shaded areas represent NBER recessions.



returns . More specifically, each month, we compute a set of cross-sectional quantiles of raw and idiosyncratic returns and report the correlations over the whole investigated period. The idiosyncratic returns are estimated using FF3, the five-factor model of Fama and French (2015) (hence FF5), and a model that extends the FF5 model with the momentum factor (hence FF6). We find that there is a strong dependence between raw and idiosyncratic quantiles, especially in the tails, regardless of the model. We also report these correlations using quantiles of idiosyncratic returns that are standardized by the cross-sectional volatility. The main observation is that volatility erases correlations in the upper tail, while correlations in the left tail of the distribution are not affected as the correlations are virtually unchanged. These results show that neither linear factors nor cross-sectional volatility adequately capture the dispersion of the cross-sectional return distribution of stock returns, and factors that aim to explain this information may provide additional important pricing information.

While one of our main questions is whether there is quantile-dependent risk in the markets that is not subsumed by volatility and downside risk, we first look at the correlations between these risks. In line with the mainstream volatility factor literature, we also focus on changes in CIQ(τ) and work with ΔCIQ(τ) factors.[9] Intuitively, we will be looking at how investors price the innovations of these risks rather than the levels.[10]

[9] Unless otherwise stated, in the rest of the paper we perform all analyses using ΔCIQ(τ) factors.

[10] The notion that the volatility-like risk measures are related to asset prices is based on the ICAPM model of Merton (1973). The idea is that changes in the investment opportunity set should be related to asset prices. This approach is fairly standard and is used, for example, in Ang et al. (2006b) or Herskovic et al. (2016).

Table 1: Correlations between raw and idiosyncratic return quantiles

The table reports correlations between quantiles of monthly cross-sectional monthly excess returns and idiosyncratic returns with respect to the FF3, FF5 and FF6 models. Idiosyncratic returns are either non-standardized or standardized by the cross-sectional volatility of idiosyncratic returns computed with respect to the corresponding models. The data cover the period from January 1965 to December 2018.

	Non-standardized			Standardized		
τ	FF3	FF5	FF6	FF3	FF5	FF6
0.1	0.35	0.34	0.34	0.31	0.30	0.30
0.15	0.25	0.23	0.23	0.28	0.27	0.27
0.2	0.16	0.15	0.15	0.25	0.24	0.25
0.3	-0.02	-0.03	-0.03	0.15	0.14	0.15
0.4	-0.18	-0.18	-0.20	-0.02	-0.03	-0.01
0.5	-0.22	-0.22	-0.26	-0.20	-0.21	-0.20
0.6	-0.05	-0.03	-0.09	-0.28	-0.28	-0.30
0.7	0.25	0.25	0.22	-0.22	-0.23	-0.25
0.8	0.51	0.50	0.48	-0.13	-0.13	-0.14
0.85	0.62	0.61	0.59	-0.06	-0.07	-0.08
0.9	0.73	0.72	0.70	0.02	0.01	-0.00

Table 2: Correlations between CIQ(τ) and non-linear factors

The table reports correlations between CIQ(τ) factors and factors related to the asymmetric and variance risk. The data cover the period from January 1965 to December 2018.

variable / τ	0.1	0.15	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.85	0.9
Panel A: *Levels of factors*											
PCA-SQ	-0.76	-0.73	-0.69	-0.56	-0.24	0.15	0.23	0.53	0.70	0.75	0.78
CIV	-0.45	-0.43	-0.39	-0.31	-0.06	-0.05	0.15	0.27	0.36	0.39	0.40
TR	0.13	0.12	0.12	0.07	0.01	-0.11	-0.11	-0.26	-0.27	-0.24	-0.23
VRP	-0.05	-0.04	-0.05	-0.02	0.04	-0.09	-0.03	0.07	0.08	0.08	0.09
VIX	-0.37	-0.34	-0.30	-0.20	0.12	0.11	0.20	0.36	0.40	0.39	0.39
Panel B: *Differences of factors*											
PCA-SQ	-0.53	-0.47	-0.43	-0.30	-0.09	0.21	0.22	0.37	0.53	0.59	0.65
CIV	-0.21	-0.20	-0.18	-0.15	-0.09	0.04	0.07	0.09	0.10	0.11	0.08
TR	0.04	0.03	0.03	-0.01	-0.08	-0.10	-0.15	-0.26	-0.29	-0.27	-0.25
VRP	0.12	0.11	0.11	0.06	0.08	-0.02	-0.04	-0.06	-0.08	-0.09	-0.10
VIX	0.24	0.25	0.27	0.27	0.26	0.04	0.07	0.10	0.02	-0.04	-0.11

Table 2 reports correlations between CIQ(τ) factors and factors related to the variance and asymmetric risk. In Panel A, we work with levels of CIQ(τ) factors and other factors, in Panel B, we focus on differences of the factors. First, we look at the dependence between CIQ(τ) factors and PCA-SQ factor. We can see that the correlation is the strongest if we move to the tails with the correlation for CIQ(0.1) and PCA-SQ being equal to -0.76 for the level of the factors but it decreases substantially if we look at the differences with the correlation being equal to -0.53. Moreover, the correlation is stronger for the CIQ(τ) factors with τ above the median.

Next, we look at the correlations with the common idiosyncratic variance factor of Herskovic et al. (2016). In this case, the correlations are slightly higher for τs below the median, with the peak correlation at $\tau = 0.1$ equal to -0.45 for the levels of the factors. On the other

Table 3: Correlations between the CIQ(τ) factors

The table presents unconditional correlations between CIQ(τ) factors in levels (above diagonal) and differences (below diagonal). We estimate the factors using FF3 residuals of the monthly CRSP stocks' returns. The data cover the period from January 1965 to December 2018.

τ	0.1	0.15	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.85	0.9
0.1	.	0.98	0.95	0.86	0.55	-0.03	-0.05	-0.32	-0.56	-0.63	-0.69
0.15	0.97	.	0.98	0.91	0.63	0.00	0.01	-0.24	-0.50	-0.58	-0.65
0.2	0.93	0.97	.	0.95	0.71	0.05	0.05	-0.16	-0.42	-0.52	-0.60
0.3	0.85	0.91	0.95	.	0.82	0.13	0.15	0.06	-0.22	-0.33	-0.43
0.4	0.68	0.77	0.83	0.93	.	0.23	0.28	0.36	0.12	0.02	-0.08
0.5	0.07	0.12	0.17	0.25	0.34	.	0.75	0.41	0.34	0.30	0.26
0.6	0.12	0.17	0.21	0.29	0.40	0.78	.	0.47	0.40	0.37	0.32
0.7	0.14	0.24	0.31	0.49	0.66	0.47	0.54	.	0.93	0.87	0.79
0.8	-0.10	-0.01	0.07	0.25	0.46	0.41	0.48	0.92	.	0.98	0.94
0.85	-0.21	-0.13	-0.05	0.13	0.35	0.39	0.46	0.85	0.96	.	0.97
0.9	-0.32	-0.25	-0.18	-0.01	0.22	0.33	0.39	0.75	0.90	0.95	.

hand, when we move to the differences, the correlation drops to -0.21. The correlations with the tail risk factor (TR) are relatively low, peaking at $\tau = 0.8$ with a correlation of -0.29. The correlations between the TR factor and the CIQ(τ) factors are particularly low for the lower values of τ. The correlations with the Variance Risk Premium (VRP) factor of Bollerslev et al. (2009) are also very low, with absolute values not exceeding 0.12 for both levels and differences of the factors. Finally, the correlations with the VIX index are symmetrical around the median τ with a peak of 0.39 at $\tau = 0.9$, while there is a stronger correlation between the downside τ and the VIX with values around 0.26 in differences.

This preliminary analysis suggests that the behaviour of idiosyncratic quantile shocks differs to a non-negligible extent from shocks to volatility and downside risk measures, and we will explore whether this additional information captures risks that are important to investors.

In addition, Table 3 provides correlations between CIQ(τ) factors at different quantiles. The correlations between CIQ(τ) at levels for the upper and lower parts of the distribution are far from perfect, e.g. the correlation between the lower tail factor CIQ(0.1) and the upper tail factor CIQ(0.9) is -0.69. This observation suggests that the factors do not simply duplicate information and are therefore unlikely to rescale the information contained in a common volatility factor (e.g. captured by PCA-SQ). Moreover, this dependence decreases significantly when we look at the increments of the CIQ(τ) factors – the dependence between the lower and upper tail factors decreases to -0.32. These results suggest that there is a potential for heterogeneous pricing information across quantiles and that this information does not simply reflect the information contained in the common volatility.

Overall, we can see that the correlations between CIQ(τ) factors and other related factors are far from perfect. Not surprisingly, the highest degree of co-movement is seen for the levels of the CIQ(τ) factors and the PCA-SQ factor, which is significantly reduced when we look at the correlations between differences of these factors. Furthermore, a strong asymmetry in the correlations across τ suggests that the information contained in the downside and upside CIQ factors is different.

3.1 CIQ Factors under Different Linear Model Specifications

Next, we show that the choice of the linear model specification has a little effect on the nature of the CIQ factors. In doing so, we further show that the CIQ factors contain additional information compared to the linear factor models. In Table 4, we report the correlations between the CIQ factors estimated relative to different linear factor models. In Panel A, we report the correlations between the CIQ factors estimated from idiosyncratic returns using the FF5 model and our baseline specification using the FF3 model. Panel B reports the same, but extends the FF5 model to include the momentum factor (FF6). We see that the correlations remain very high, especially outside the median, even after including three more linear factors. This observation supports our claim that the risks of common quantile-specific events are not well captured by simple linear factors.

We also look at the correlations between the increments of the CIQ factors and the individual linear factors. The results are shown in Table 5. We include six factors from the FF6 model and also three factors estimated using principal component analysis (PC1-3). We report the results for the CIQ factors estimated using the FF3 model in Panel A and the FF6 model in Panel B. We see that the correlations are quite small for all factors, suggesting that they do not duplicate the information from these linear factors.

Further, we examine whether usual subsets of these factors can span the CIQ factors. We regress the increments of the CIQ factors on these sets and present the resulting R^2s, and report these results in Table 6. We find that none of the specifications explain the CIQ factors particularly well. This observation further show that the information contained in the CIQ factors is distinct from the information captured by the linear factors.

3.2 CIQ Risk Shocks and the Real Economy

The risks faced by individual firms can be linked to individual households through a variety of channels. A large strand of the theoretical literature (Harris and Holmstrom, 1982; Berk et al., 2010; Heathcote et al., 2014) shows that employee compensation is exposed to firm-level shocks due to incomplete insurance against productivity shocks. The empirical findings of Brown and Medoff (1989) provide a mechanism through which shocks to employee earnings are correlated with shocks to the firm. Since Brown and Medoff (1989) primarily

Table 4: Correlations between the CIQ factors under different linear models

The table presents unconditional correlations between CIQ(τ) factors in levels and differences estimated using linear model specifications FF3, FF5, and FF6. The data cover the period from January 1965 to December 2018.

τ	0.1	0.15	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.85	0.9
						Panel A: CIQ w.r.t. FF5 vs. FF3					
						Levels					
0.1	0.94	0.93	0.91	0.82	0.54	0.02	0.02	-0.31	-0.54	-0.61	-0.66
0.15	0.93	0.94	0.93	0.86	0.61	0.04	0.05	-0.25	-0.48	-0.56	-0.62
0.2	0.91	0.93	0.94	0.90	0.66	0.08	0.10	-0.17	-0.42	-0.50	-0.57
0.3	0.81	0.85	0.89	0.92	0.77	0.15	0.18	0.05	-0.21	-0.31	-0.39
0.4	0.55	0.61	0.67	0.78	0.79	0.24	0.28	0.32	0.10	0.01	-0.07
0.5	-0.05	-0.01	0.04	0.11	0.22	0.68	0.60	0.39	0.34	0.32	0.28
0.6	-0.04	0.01	0.05	0.15	0.26	0.58	0.64	0.49	0.43	0.40	0.36
0.7	-0.34	-0.27	-0.19	0.03	0.32	0.38	0.44	0.94	0.91	0.86	0.79
0.8	-0.55	-0.49	-0.42	-0.22	0.12	0.30	0.34	0.89	0.96	0.95	0.92
0.85	-0.62	-0.57	-0.51	-0.32	0.02	0.28	0.31	0.84	0.95	0.96	0.95
0.9	-0.67	-0.63	-0.58	-0.41	-0.07	0.23	0.27	0.77	0.91	0.95	0.96
						Increments					
0.1	0.89	0.87	0.84	0.76	0.62	0.10	0.16	0.13	-0.09	-0.19	-0.29
0.15	0.89	0.90	0.88	0.83	0.70	0.14	0.20	0.22	-0.01	-0.12	-0.22
0.2	0.87	0.90	0.90	0.87	0.76	0.18	0.25	0.30	0.06	-0.05	-0.16
0.3	0.79	0.84	0.87	0.90	0.85	0.27	0.33	0.48	0.25	0.14	0.03
0.4	0.62	0.69	0.74	0.84	0.89	0.36	0.40	0.64	0.46	0.36	0.26
0.5	0.10	0.15	0.19	0.26	0.35	0.68	0.59	0.45	0.41	0.39	0.35
0.6	0.17	0.21	0.25	0.33	0.42	0.64	0.65	0.54	0.49	0.45	0.41
0.7	0.10	0.20	0.27	0.45	0.61	0.46	0.53	0.92	0.88	0.82	0.74
0.8	-0.11	-0.02	0.06	0.24	0.44	0.41	0.46	0.86	0.93	0.91	0.87
0.85	-0.21	-0.13	-0.05	0.13	0.33	0.38	0.42	0.79	0.91	0.92	0.91
0.9	-0.29	-0.22	-0.15	0.01	0.22	0.32	0.35	0.69	0.85	0.89	0.91
						Panel B: CIQ w.r.t. FF6 vs. FF3					
						Levels					
0.1	0.89	0.88	0.85	0.76	0.50	-0.03	-0.03	-0.35	-0.55	-0.61	-0.65
0.15	0.87	0.88	0.87	0.80	0.55	-0.01	0.00	-0.30	-0.51	-0.58	-0.63
0.2	0.85	0.87	0.87	0.82	0.60	0.01	0.03	-0.23	-0.45	-0.53	-0.59
0.3	0.75	0.80	0.82	0.84	0.68	0.06	0.11	-0.05	-0.29	-0.37	-0.45
0.4	0.43	0.48	0.53	0.62	0.65	0.16	0.22	0.24	0.08	0.02	-0.04
0.5	0.05	0.08	0.10	0.13	0.11	0.39	0.36	0.16	0.11	0.10	0.07
0.6	-0.03	0.01	0.04	0.09	0.14	0.31	0.40	0.22	0.17	0.14	0.11
0.7	-0.40	-0.33	-0.25	-0.06	0.22	0.27	0.34	0.81	0.79	0.75	0.70
0.8	-0.59	-0.54	-0.48	-0.30	-0.00	0.22	0.27	0.76	0.84	0.84	0.81
0.85	-0.66	-0.61	-0.56	-0.40	-0.10	0.20	0.23	0.72	0.83	0.85	0.84
0.9	-0.69	-0.66	-0.61	-0.48	-0.19	0.16	0.20	0.65	0.79	0.83	0.84
						Increments					
0.1	0.79	0.78	0.74	0.66	0.54	0.06	0.10	0.06	-0.14	-0.22	-0.29
0.15	0.80	0.80	0.78	0.71	0.60	0.09	0.13	0.11	-0.10	-0.19	-0.27
0.2	0.79	0.80	0.79	0.74	0.64	0.12	0.16	0.16	-0.04	-0.14	-0.23
0.3	0.73	0.77	0.79	0.79	0.73	0.18	0.22	0.31	0.10	-0.01	-0.11
0.4	0.52	0.57	0.59	0.65	0.69	0.27	0.31	0.42	0.29	0.21	0.14
0.5	0.12	0.15	0.18	0.22	0.25	0.43	0.39	0.28	0.24	0.23	0.20
0.6	0.07	0.12	0.15	0.17	0.19	0.35	0.38	0.27	0.22	0.18	0.14
0.7	0.03	0.12	0.18	0.32	0.44	0.34	0.40	0.71	0.67	0.61	0.52
0.8	-0.18	-0.10	-0.03	0.11	0.25	0.30	0.34	0.64	0.70	0.68	0.62
0.85	-0.29	-0.21	-0.15	-0.02	0.13	0.25	0.29	0.56	0.67	0.67	0.65
0.9	-0.37	-0.31	-0.25	-0.13	0.01	0.20	0.24	0.47	0.61	0.64	0.65

covers constituents of the S&P500 index, it is natural to assume that the common firm-level quantiles in our paper proxy for household income risks. Herskovic et al. (2016) further argue that persistent, idiosyncratic cash flow shocks hitting firms are an important source

Table 5: Correlations between ΔCIQ(τ) and linear factors

The table reports correlations between the ΔCIQ(τ) factors estimated using either FF3 or FF6 models, and six tradable factors of the FF6 model and three latent factors estimated using PCA (PC1-3). The data cover the period from January 1965 to December 2018.

Factor	0.1	0.15	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.85	0.9
					Panel A: $CIQ(\tau)^{FF3}$						
Mkt	-0.26	-0.28	-0.30	-0.29	-0.26	-0.02	-0.04	-0.01	0.11	0.18	0.25
SMB	-0.19	-0.21	-0.25	-0.25	-0.24	-0.00	-0.09	-0.11	-0.02	0.02	0.09
HML	0.11	0.13	0.14	0.12	0.08	0.05	0.07	0.04	0.01	-0.02	-0.05
RMW	0.11	0.11	0.13	0.13	0.13	0.02	0.06	-0.00	-0.08	-0.11	-0.13
CMA	0.15	0.15	0.15	0.12	0.07	-0.02	-0.03	-0.04	-0.07	-0.10	-0.13
MOM	-0.22	-0.22	-0.22	-0.25	-0.26	-0.18	-0.18	-0.30	-0.28	-0.27	-0.25
PC1	-0.22	-0.23	-0.25	-0.24	-0.23	0.04	-0.01	0.02	0.14	0.21	0.27
PC2	0.01	0.03	0.03	0.05	0.03	0.11	0.11	0.03	0.02	0.01	0.01
PC3	-0.02	-0.00	0.02	0.01	0.04	-0.05	-0.04	-0.04	-0.05	-0.06	-0.07
					Panel B: $CIQ(\tau)^{FF6}$						
Mkt	-0.20	-0.22	-0.23	-0.25	-0.12	0.01	-0.08	-0.05	0.07	0.13	0.17
SMB	-0.04	-0.07	-0.07	-0.11	-0.05	0.02	-0.04	-0.08	-0.06	-0.04	-0.01
HML	0.10	0.09	0.10	0.12	0.12	0.08	0.05	0.12	0.09	0.05	0.05
RMW	0.06	0.07	0.09	0.11	0.10	-0.05	-0.01	0.03	0.00	-0.01	-0.03
CMA	0.14	0.14	0.14	0.14	0.08	0.03	0.09	0.04	0.01	-0.01	-0.02
MOM	-0.06	-0.05	-0.04	-0.03	-0.17	-0.10	0.10	0.01	0.01	0.02	0.02
PC1	-0.16	-0.19	-0.20	-0.22	-0.08	0.04	-0.08	-0.02	0.09	0.15	0.20
PC2	-0.04	-0.04	-0.04	-0.02	-0.03	-0.04	-0.01	0.09	0.10	0.11	0.11
PC3	0.02	0.01	0.01	-0.01	-0.10	-0.10	-0.01	-0.06	-0.09	-0.09	-0.09

Table 6: R^2s from regressing ΔCIQ(τ) factors on factor models

The table reports coefficients of determination from regressing ΔCIQ(τ) factors on various sets of factors. ΔCIQ(τ) factors are estimated using idiosyncratic returns of either FF3 or FF6 model. The data cover the period from January 1965 to December 2018.

Model	0.1	0.15	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.85	0.9
					Panel A: $CIQ(\tau)^{FF3}$						
FF3	0.08	0.10	0.12	0.11	0.10	0.00	0.01	0.01	0.02	0.03	0.06
FF5	0.08	0.10	0.11	0.11	0.10	0.01	0.03	0.03	0.03	0.05	0.08
FF6	0.15	0.16	0.18	0.19	0.19	0.04	0.06	0.11	0.10	0.10	0.12
PCA3	0.05	0.06	0.06	0.06	0.05	0.02	0.01	0.00	0.02	0.04	0.08
					Panel B: $CIQ(\tau)^{FF6}$						
FF3	0.04	0.05	0.05	0.07	0.02	0.01	0.01	0.02	0.02	0.03	0.04
FF5	0.04	0.05	0.06	0.07	0.03	0.01	0.01	0.02	0.02	0.03	0.04
FF6	0.05	0.06	0.06	0.07	0.06	0.02	0.02	0.02	0.03	0.03	0.05
PCA3	0.03	0.04	0.04	0.05	0.02	0.01	0.01	0.01	0.02	0.04	0.05

of non-diversifiable risk for households. In addition, the shape of the consumption function may differ across households for a variety of reasons, such as heterogeneity in preferences or discounting, household-specific returns on assets, or heterogeneous access to other sources of insurance.

Here we present evidence that the CIQ factor proxies for the idiosyncratic risk faced by households, and that this risk is different from that captured by common volatility. In particular, we document that a common structure in the quantiles of idiosyncratic returns is asymmetrically related to the distributional characteristics of the cross-section of firm fundamentals.

We first download Compustat data on the annual number of employees for US firms to proxy for employment risk. We then download annual earnings by place of work from the National Income and Product Accounts (NIPA) to measure income risk. For household wealth, Herskovic et al. (2016) note that a large fraction of household wealth is invested in residential real estate. Thus, shocks to the value of housing transmit fluctuations in individual wealth. For this reason, we use seasonally adjusted house price data from the Federal Housing Financing Agency as a proxy for household wealth risk. Specifically, we download monthly house price indices for nine regions in the US and more granular quarterly data on house prices in the 100 largest metropolitan areas.

We construct (monthly, quarterly or annual) employment, earnings and house price growth rates and compute the cross-sectional measures of dispersion (an interquartile range, a difference between the maximum and minimum values and a standard deviation), selected percentiles ($20\%, 40\%, 60\%, 80\%$) and the cross-sectional average.

Shocks to cash flow, household income growth, employment growth, and wage and house price growth affect the entire distribution of households, but they can create different risks for different households in the distribution. The commonality in the variance of returns of idiosyncratic firms suggests a common risk across households, as noted by Herskovic et al. (2016) and captured by their CIV risk. In contrast, our CIQ measure can capture possible heterogeneous responses of households to this type of shocks. We show a significant association between shocks to common quantile factors in the cross-section of firm returns and household income risk, implying that it is heterogeneous responses and risks that we should be concerned with.

More specifically, Table 7 shows correlations between innovations in common quantiles[11] and changes in cross-sectional measures of employment, earnings and house price growth rates. Innovations in common quantiles have the strongest and most statistically significant correlations with earnings growth and sales growth. The comovement in the left part of the distribution is positive, while the comovement in the right part is negative, similar to innovations in common volatility (confirming the findings of Herskovic et al. (2016)). The most important information we see is that the correlations are different in magnitude, and therefore the association with these types of household risk is heterogeneous. In other words, the table documents that the common quantile risk captures the heterogeneous response of households to shocks to income growth and sales growth.

The association with employment growth and house price growth is less strong, but the

[11] We computed correlations for CIQ return risk for 49 industry portfolios and 100 size-value portfolios. As the results do not change significantly, we do not report them here.

Table 7: Employment, earnings, and wealth

This table presents the correlations between innovations in CIQ risk premiums and changes in cross-sectional measures of employment (Panel A), earnings (Panel B), house price (Panels C and D) growth, and sales growth (Panel E). The statistics include the cross-sectional measures of dispersion (an interquartile range, a difference between the maximal and minimal values, a standard deviation), selected percentiles (20%, 40%, 60%, 80%), and the cross-sectional average.

	0.1	0.15	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.85	0.9	**CIV**
Panel A: Annual employment growth												
75% − 25%	0.19	0.24	0.29	0.41 *	0.73 ***	0.83 ***	0.45 **	0.32	0.2	0.12	0.09	-0.1
max − min	-0.11	-0.06	-0.02	0.12	0.18	0.54 ***	0.24	0.39 *	0.32	0.26	0.25	-0.01
std	0.13	0.19	0.24	0.35	0.63 ***	0.82 ***	0.47 **	0.33	0.21	0.11	0.08	-0.09
20%	0.14	0.11	0.05	-0.07	-0.53 ***	-0.77 ***	-0.57 ***	-0.58 ***	-0.51 ***	-0.48 **	-0.47 **	-0.27
40%	0.19	0.19	0.14	0.04	-0.21	-0.28	-0.14	-0.4 *	-0.37	-0.43 **	-0.43 **	-0.25
60%	0.42 *	0.44 **	0.45 **	0.46 **	0.23	-0.04	-0.26	-0.4 *	-0.47 **	-0.53 ***	-0.56 ***	-0.52 ***
80%	0.46 **	0.5 ***	0.53 ***	0.59 ***	0.58 ***	0.49 ***	0.1	-0.14	-0.26	-0.36	-0.4 *	-0.47 **
Avg.	0.38 *	0.37	0.33	0.26	-0.14	-0.37	-0.42 *	-0.59 ***	-0.6 ***	-0.63 ***	-0.64 ***	-0.51 ***
Panel B: Annual earnings growth												
75% − 25%	-0.09	-0.11	-0.12	-0.14	-0.31	0.06	-0.02	-0.08	-0.08	-0.02	-0.01	0.02
max − min	-0.06	-0.09	-0.13	-0.19	-0.52 ***	0.26	0.1	-0.06	-0.05	-0.04	-0.06	-0.0
std	0.06	0.05	0.03	0.0	-0.18	0.13	-0.08	-0.17	-0.19	-0.15	-0.16	-0.15
20%	0.53 ***	0.54 ***	0.52 ***	0.43 *	0.19	-0.4 *	-0.33	-0.56 ***	-0.58 ***	-0.65 ***	-0.67 ***	-0.48 **
40%	0.56 ***	0.57 ***	0.55 ***	0.46 **	0.16	-0.33	-0.36	-0.61 ***	-0.65 ***	-0.72 ***	-0.74 ***	-0.54 ***
60%	0.55 ***	0.55 ***	0.52 ***	0.43 *	0.06	-0.33	-0.36	-0.65 ***	-0.68 ***	-0.73 ***	-0.76 ***	-0.54 ***
80%	0.49 **	0.49 **	0.46 **	0.35	-0.02	-0.36	-0.33	-0.64 ***	-0.66 ***	-0.69 ***	-0.71 ***	-0.47 **
Avg.	0.54 ***	0.54 ***	0.51 ***	0.41 *	0.06	-0.45 **	-0.39 *	-0.62 ***	-0.63 ***	-0.68 ***	-0.69 ***	-0.51 ***
Panel C: Monthly house price growth (nine areas, seasonally adjusted series)												
75% − 25%	-0.01	0.0	0.02	0.01	-0.02	-0.1 *	-0.03	-0.04	-0.05	-0.04	-0.04	0.03
max − min	0.02	0.03	0.05	0.03	0.06	-0.06	-0.04	0.02	-0.02	-0.03	-0.03	-0.04
std	0.01	0.02	0.04	0.03	0.05	-0.08	-0.05	0.01	-0.02	-0.02	-0.02	-0.02
20%	0.13 ***	0.13 ***	0.1 *	0.13 ***	0.04	0.1 *	0.07	0.07	0.05	0.04	0.04	-0.12 **
40%	0.08	0.05	0.02	0.04	-0.07	0.08	0.02	0.04	0.04	0.04	0.04	-0.12 **
60%	0.09	0.08	0.06	0.09 *	-0.03	0.05	0.04	0.05	0.04	0.04	0.04	-0.06
80%	0.13 ***	0.14 ***	0.12 **	0.15 ***	0.07	0.02	0.03	0.07	0.04	0.03	0.04	-0.12 **
Avg.	0.12 **	0.12 **	0.09	0.12 **	-0.01	0.08	0.06	0.07	0.05	0.04	0.05	-0.13 ***
Panel D: Quarterly house price growth (100 largest Metropolitan areas, seasonally adjusted series)												
75% − 25%	0.06	0.03	0.04	0.07	0.06	-0.03	0.09	0.13	0.1	0.1	0.08	-0.08
max − min	-0.12	-0.12	-0.09	-0.11	-0.05	-0.05	0.02	0.01	0.01	0.03	0.07	0.12
std	-0.04	-0.05	-0.03	-0.03	-0.03	-0.02	0.09	0.08	0.05	0.07	0.08	-0.01
20%	0.15	0.14	0.12	0.09	-0.05	-0.05	-0.13	-0.19 **	-0.24 ***	-0.21 **	-0.19 **	-0.11
40%	0.14	0.13	0.12	0.11	-0.01	0.02	0.03	-0.04	-0.09	-0.06	-0.06	-0.1
60%	0.11	0.1	0.09	0.08	-0.05	-0.09	-0.01	-0.09	-0.14	-0.12	-0.11	-0.08
80%	0.18 *	0.16 *	0.16 *	0.14	0.01	-0.05	-0.02	-0.06	-0.12	-0.1	-0.09	-0.14
Avg.	0.17 *	0.16 *	0.16 *	0.14	0.01	-0.05	-0.04	-0.11	-0.17 *	-0.15	-0.14	-0.12
Panel E: Sales growth												
75% − 25%	-0.23 **	-0.23 **	-0.21 *	-0.19 *	0.23 **	0.37 ***	0.21 *	0.22 *	0.25 **	0.24 **	0.26 **	0.28 ***
max − min	0.09	0.08	0.1	0.09	0.13	0.18	-0.1	0.03	-0.01	-0.03	-0.05	-0.23 **
std	-0.09	-0.09	-0.07	-0.06	0.19	0.34 ***	0.1	0.21 *	0.19 *	0.17	0.17	-0.03
20%	0.37 ***	0.35 ***	0.33 ***	0.29 ***	-0.28 ***	-0.34 ***	-0.29 ***	-0.42 ***	-0.45 ***	-0.43 ***	-0.45 ***	-0.43 ***
40%	0.38 ***	0.37 ***	0.35 ***	0.31 ***	-0.25 **	-0.28 ***	-0.25 **	-0.43 ***	-0.46 ***	-0.45 ***	-0.47 ***	-0.45 ***
60%	0.32 ***	0.31 ***	0.29 ***	0.24 **	-0.2 *	-0.19 *	-0.22 **	-0.43 ***	-0.44 ***	-0.43 ***	-0.43 ***	-0.39 ***
80%	0.28 ***	0.27 ***	0.25 **	0.22 *	-0.13	-0.04	-0.16	-0.35 ***	-0.36 ***	-0.36 ***	-0.36 ***	-0.31 ***
Avg.	0.34 ***	0.32 ***	0.3 ***	0.26 ***	-0.28 ***	-0.27 ***	-0.29 ***	-0.41 ***	-0.43 ***	-0.42 ***	-0.43 ***	-0.41 ***

results document it to some extent, again with asymmetric correlations in the distribution, suggesting heterogeneity in risks not captured by dispersion. Interestingly, house prices are only associated with the left tail, i.e. house price risk is only associated with downside risk.

In summary, our empirical analysis suggests that the commonality in quantiles of individual firm returns is strongly associated with the commonality in earnings, wealth and sales growth, as well as employment and house price growth, while the strength of the association is heterogeneous across quantiles. The economic interpretation is that the quantile risk premium associated with negative or positive firm performance is a proxy for the underlying risk faced by firms and households. Since the correlations vary in magnitude, our results show that such risks are heterogeneous and that asset pricing should be concerned with quantile preferences, which express heterogeneity in risk much more accurately than variance (de Castro and Galvao, 2019).

Interestingly, the insignificant correlations with various measures of dispersion in employment, earnings and wealth growth (see the top row of each panel in Table 7) suggest that the idiosyncratic risk captured by the common quantile risk premium is distinct from idiosyncratic return volatility, which is strongly associated with cross-sectional dispersion in household income.

4 Time-series Predictability of Market Return

We continue examining the information content of the CIQ(τ) factors for subsequent short-term market returns. Here we aim to predict the monthly excess return of the market, which we approximate by the value-weighted return of all CRSP firms. In Section 4.1, in the regressions, we also control for popular predictive variables used in Welch and Goyal (2007) as well as three closely related factors – TR factor of Kelly and Jiang (2014), the innovations of common idiosyncratic volatility (ΔCIV) factor of Herskovic et al. (2016), and the lagged market return.[12] Moreover, we construct the PCA-SQ factor and use its increments to control for the effect of the common volatility. We also investigate the relationship with the stock return reversals.

In Section 4.2, on the other hand, we aim to combine the pricing information of the CIQ factors and present prediction results using sets of CIQ factors at the same time.

Because the CIQ(τ) factors are estimated using a rolling window, we use the last value of the factors estimated from each rolling window to construct a single series of the CIQ(τ) factors.

4.1 Predictions using Single CIQ Factor

First, we report the results from the univariate regressions of the market return on the differences of the CIQ(τ) factors at various τ quantile levels of the form

$$r_{m,t+1} = \gamma_0 + \gamma_1 \times \Delta f_t(\tau) + \epsilon_{t+1} \tag{13}$$

in Table 8. We report estimated scaled coefficients to capture the effect of one standard deviation increase of the independent variable on the subsequent annualized market return.

[12] We replicated tail risk factor construction of Kelly and Jiang (2014) by ourself and acquired data of Herskovic et al. (2016) from Bernard Herskovic's webpage.

The corresponding t-statistics are computed using Newey-West robust standard errors using six lags.

In Panel A of Table 8, we report the results with our baseline specification using FF3 model idiosyncratic returns. We document strong predictive power using the ΔCIQ(τ) factors for the left part of the distribution, with the peak for $\tau = 0.3$, where the increase (decrease) of one standard deviation in the factor predicts subsequent decrease (increase) of 7.05 percents in annualized market return.[13] There is also some predictive power for the upper tail factor in the case of CIQ(0.9), but the effect is much smaller with only 3.50 percent increase in annualized market return accompanied with only less than one-third of the R^2 from the lower tail. From a perspective of an investor, in times of high risk – captured by large negative increments of the left-tail CIQ(τ) factor, she requires a premium for investing. And thus, these risky periods correlate with the high marginal utility states of the investors.

Together with in-sample (IS) R^2, we also report the out-of-sample (OOS) R^2 from expanding window scheme. We use data up to time t to estimate the prediction model and then forecast the $t+1$ return (the first window contains 120 monthly periods to obtain sufficiently reasonable estimates). Then, the window is extended by one observation, the prediction model is re-estimated and a new forecast is obtained. We repeat this procedure until the whole sample is exhausted. The corresponding R^2 is computed by comparing conditional forecast and historical mean computed using the available data up to time t, i.e., $1 - \sum_t (r_{m,t+1} - \widehat{r}_{m,t+1|t})^2 / \sum_t (r_{m,t+1} - \bar{r}_{m,t})^2$ where $\widehat{r}_{m,t+1|t}$ is out-of-sample forecast of the $t+1$ return using data up to time t, and $\bar{r}_{m,t}$ is the historical mean of the market return computed up to date t. Unlike the case of the IS R^2, the OOS R^2 can attain negative values if the conditional forecasts perform worse than the historical mean forecast. The positive values of the OOS R^2 for τ between 0.1 and 0.4 provide strong evidence for the benefits of the ΔCIQ(τ) factors for predicting the market return in the real-world setting. On the other hand, the predictability vanishes for the higher values of τ.

To assess the economic usefulness for the investors, we further follow suggestions from Campbell and Thompson (2007) (hence CT). They propose to truncate the predictions from the estimated model at 0, as the investor would not have used a model to predict a negative premium. This non-linear modification of the model should introduce caution into the models. Based on this modification, we report both IS and OOS R^2s. Naturally, using this transformation, the IS R^2 does not improve for any of the models, but the performance rises for the OOS analysis. Results suggest that the common fluctuations in the lower part of the excess returns distributions robustly predict the subsequent market movement.

[13] Note that the lower tail factors are on average negative. Increase (decrease) of these factors corresponds to the decrease (increase) of risk, which leads to a decrease (increase) of the required risk premium.

Table 8: Predictive power

The table reports results from the univariate predictive regressions of the value-weighted return of all CRSP firms on the ΔCIQ(τ) factors for various $\tau \in (0,1)$. Idiosyncratic returns are estimated with respect to FF3, FF5 or FF6 models. Coefficients are scaled to capture the effect of one standard deviation increase in the factor on the annualized market return in percent. The corresponding t-statistics are computed using the Newey-West robust standard errors using six lags. We report both in-sample (IS) and out-of-sample (OOS) R^2s. We also truncate the predictions at zero following Campbell and Thompson (2007) (CT) and report corresponding IS and OOS R^2s. The data cover the period from January 1965 to December 2018.

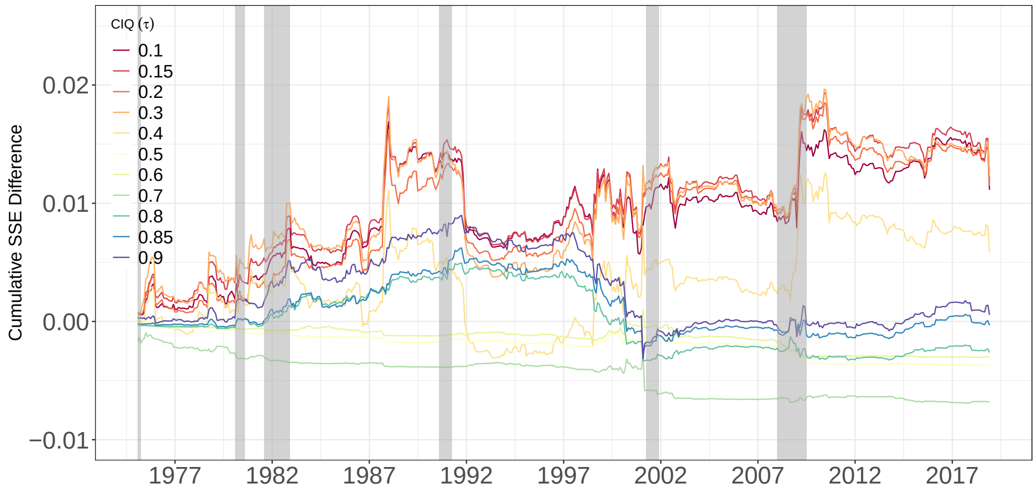
τ	Coeff.	t-stat	R^2 IS	R^2 OOS	R^2 IS CT	R^2 OOS CT
			Panel A: $CIQ(\tau)^{FF3}$			
0.1	-6.31	-2.77	1.40	1.09	1.21	1.42
0.15	-6.49	-2.74	1.48	1.17	1.20	1.45
0.2	-6.38	-2.63	1.43	1.13	1.14	1.33
0.3	-7.05	-2.98	1.75	1.21	1.21	1.41
0.4	-6.59	-2.92	1.53	0.58	0.83	0.76
0.5	0.15	0.07	0.00	-0.37	0.00	-0.19
0.6	0.29	0.13	0.00	-0.30	0.00	-0.23
0.7	-0.88	-0.48	0.03	-0.67	0.03	-0.37
0.8	2.09	1.13	0.15	-0.26	0.10	-0.08
0.85	3.05	1.67	0.33	-0.03	0.21	0.31
0.9	3.50	1.88	0.43	0.06	0.29	0.31
			Panel B: $CIQ(\tau)^{FF5}$			
0.1	-4.95	-2.30	0.84	0.39	0.62	0.74
0.15	-5.53	-2.48	1.05	0.60	0.79	1.00
0.2	-5.76	-2.47	1.14	0.66	0.80	0.99
0.3	-6.04	-2.67	1.25	0.65	0.65	0.85
0.4	-5.69	-2.45	1.11	0.52	0.50	0.68
0.5	2.22	0.91	0.17	-0.20	0.17	-0.03
0.6	1.21	0.50	0.05	-0.46	0.05	-0.22
0.7	-0.59	-0.31	0.01	-0.46	0.01	-0.42
0.8	1.47	0.73	0.07	-0.43	0.06	-0.32
0.85	2.24	1.07	0.17	-0.37	0.15	-0.19
0.9	3.13	1.48	0.34	-0.35	0.28	-0.24
			Panel C: $CIQ(\tau)^{FF6}$			
0.1	-6.29	-2.90	1.35	0.64	1.25	1.52
0.15	-5.88	-2.55	1.18	0.50	1.15	1.44
0.2	-5.83	-2.56	1.16	0.72	1.08	1.44
0.3	-5.86	-2.52	1.18	0.62	1.03	1.42
0.4	-4.65	-1.74	0.74	-0.65	1.03	1.57
0.5	3.24	1.35	0.36	-0.55	0.35	-0.08
0.6	1.51	0.62	0.08	-0.74	0.09	-0.26
0.7	0.21	0.11	0.00	-0.33	0.00	-0.15
0.8	2.76	1.37	0.26	-0.32	0.30	0.03
0.85	4.06	1.82	0.57	-0.05	0.55	0.43
0.9	3.90	1.78	0.52	-0.01	0.42	0.38

To visually assess the OOS forecasting performance of the CIQ factors, we plot the cumulative difference of the sums of squared errors of the historical mean model and the models based on the ΔCIQ(τ) factors in Figure 2. A positive value corresponds to a better predictive power of a CIQ factor compared to the historical mean model. As suggested by the previous results, the downside CIQ factors consistently outperform the historical mean model. On the other hand, the median and upside factors perform worse than the historical mean.

We also include these sets of results for the CIQ factors estimated with respect to the FF5 and FF6 models. We present them in Panel B and C of Table 8. We observe similar

Figure 2: Out-of-sample predictive performance

The figure depicts cumulative sum of differences between squared prediction error computed using either historical mean model or model based on a ΔCIQ(τ) factor. Positive values correspond to out-performance of the CIQ model relative to the historical mean model. The data cover the period from January 1965 to December 2018. The shaded areas represent NBER recessions.



conclusions as in the case of our baseline specification. In particular, only the downside factors have robust in-sample and out-of-sample predictive power.

Next, we run bivariate regressions to assess whether the proposed quantile factors contain additional information not included in the relevant previously proposed variables

$$r_{m,t+1} = \gamma_0 + \gamma_1 \times \Delta f_t(\tau) + \gamma_2 \times f_t^{Control} + \epsilon_{t+1} \tag{14}$$

where we separately control for variables that may contain duplicate information. First, in Panel A of Table 9, we report coefficients and their t-statistics while controlling for differences of the PCA-SQ factor, the ΔCIV of Herskovic et al. (2016), the TR factor of Kelly and Jiang (2014), and the lagged market return, respectively. In the case of PCA-SQ factor, we can see that neither the significance nor the magnitude of the predictive power of the downside CIQ factors is diminished. Moreover, the borderline significance of the upside CIQ factors vanishes. This suggests that the common volatility element is not the driving force of the predictive performance of the quantile factors.

In the second case, while controlling for the ΔCIV, the results regarding the ΔCIQ(τ) factors remain the same, and ΔCIV proves not to predict future market returns. In the case of the TR factor, the ΔCIQ(τ) factors mirror the results from the univariate regressions in terms of coefficients and their significance. TR factor is significant across all the specifications, although its effect is smaller and less significant than in the case of ΔCIQ(τ) for the lower tail values of τ. Finally, we use lagged market return as the control. This predictor may

Table 9: Predictive regressions

The table reports results from the bivariate and multivariate predictive regressions of the value-weighted return of all CRSP firms on ΔCIQ(τ) factors for various $\tau \in (0, 1)$ and other control variables. We employ the PCA-SQ factor, innovations of CIV factor of Herskovic et al. (2016), TR factor of Kelly and Jiang (2014), and lagged market return, respectively. Coefficients are scaled to capture the effect of one-standard-deviation increase in the factor on the annualized market return in percent. The corresponding t-statistics are computed using the Newey-West robust standard errors using six lags. The data cover the period from January 1965 to December 2018.

control / τ	0.1	0.15	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.85	0.9
						Panel A: Bivariate regressions					
CIQ	-6.05	-6.12	-5.89	-6.54	-6.33	-0.62	-0.52	-2.56	0.22	1.35	1.93
	(-2.45)	(-2.43)	(-2.35)	(-2.83)	(-2.83)	(-0.31)	(-0.24)	(-1.21)	(0.10)	(0.56)	(0.78)
PCA-SQ	0.48	0.77	1.14	1.74	3.14	3.79	3.77	4.59	3.54	2.86	2.40
	(0.22)	(0.36)	(0.56)	(0.91)	(1.59)	(1.96)	(1.90)	(2.00)	(1.40)	(1.05)	(0.86)
R^2	1.40	1.50	1.47	1.85	1.87	0.48	0.48	0.67	0.47	0.51	0.55
CIQ	-6.72	-6.89	-6.71	-7.29	-6.71	0.18	0.33	-0.84	2.17	3.15	3.56
	(-2.82)	(-2.77)	(-2.66)	(-2.98)	(-2.87)	(0.08)	(0.15)	(-0.47)	(1.14)	(1.68)	(1.87)
ΔCIV	-1.96	-1.96	-1.78	-1.61	-1.19	-0.57	-0.58	-0.49	-0.77	-0.92	-0.84
	(-0.59)	(-0.59)	(-0.54)	(-0.49)	(-0.36)	(-0.16)	(-0.17)	(-0.14)	(-0.22)	(-0.26)	(-0.24)
R^2	1.53	1.61	1.54	1.84	1.58	0.01	0.01	0.04	0.17	0.36	0.45
CIQ	-6.28	-6.44	-6.36	-6.99	-6.52	0.31	0.35	-0.76	2.27	3.12	3.58
	(-2.76)	(-2.72)	(-2.63)	(-2.96)	(-2.88)	(0.15)	(0.16)	(-0.41)	(1.22)	(1.72)	(1.93)
TR	4.67	4.64	4.69	4.62	4.60	4.72	4.71	4.69	4.80	4.76	4.77
	(2.33)	(2.32)	(2.35)	(2.31)	(2.31)	(2.33)	(2.33)	(2.32)	(2.35)	(2.34)	(2.34)
R^2	2.17	2.24	2.20	2.50	2.27	0.78	0.78	0.80	0.96	1.12	1.23
CIQ	-6.76	-6.91	-6.72	-7.37	-6.60	0.14	0.27	-0.97	1.86	2.82	3.27
	(-2.80)	(-2.73)	(-2.61)	(-3.00)	(-2.94)	(0.07)	(0.12)	(-0.53)	(0.99)	(1.51)	(1.71)
Mkt_{t-1}	1.10	1.06	0.87	0.90	0.04	-1.72	-1.72	-1.77	-1.43	-1.17	-0.96
	(0.56)	(0.53)	(0.44)	(0.46)	(0.02)	(-0.88)	(-0.88)	(-0.90)	(-0.71)	(-0.58)	(-0.48)
R^2	1.43	1.51	1.46	1.77	1.53	0.11	0.11	0.14	0.22	0.37	0.46
						Panel B: Multivariate regressions					
CIQ	-6.54	-6.58	-6.29	-6.90	-6.55	-0.39	-0.35	-2.34	0.48	1.45	1.92
	(-2.55)	(-2.46)	(-2.39)	(-2.83)	(-2.82)	(-0.19)	(-0.16)	(-1.11)	(0.21)	(0.61)	(0.77)
PCA-SQ	0.80	1.14	1.52	2.26	3.65	3.66	3.66	4.48	3.32	2.72	2.34
	(0.35)	(0.51)	(0.70)	(1.10)	(1.68)	(1.69)	(1.66)	(1.79)	(1.22)	(0.94)	(0.78)
ΔCIV	-2.00	-2.01	-1.88	-1.78	-1.62	-1.26	-1.25	-1.15	-1.28	-1.32	-1.25
	(-0.60)	(-0.60)	(-0.56)	(-0.54)	(-0.49)	(-0.36)	(-0.35)	(-0.33)	(-0.36)	(-0.37)	(-0.35)
TR	4.67	4.65	4.71	4.63	4.66	4.87	4.87	4.82	4.89	4.88	4.88
	(2.35)	(2.34)	(2.37)	(2.34)	(2.35)	(2.37)	(2.38)	(2.36)	(2.37)	(2.38)	(2.37)
Mkt_{t-1}	0.63	0.67	0.59	0.89	0.66	-1.04	-1.04	-0.85	-1.08	-1.07	-1.03
	(0.31)	(0.32)	(0.29)	(0.42)	(0.32)	(-0.48)	(-0.48)	(-0.40)	(-0.50)	(-0.49)	(-0.47)
R^2	2.33	2.42	2.39	2.75	2.75	1.36	1.36	1.52	1.36	1.41	1.43

potentially capture the reversal or continuation effect of the market return. We observe that it does not alter the results regarding the CIQ factors and the lagged return does not significantly improves the prediction fit, either.

In Panel B of Table 9, we report multivariate regression results including all the previously mentioned variables. As it is obvious from the results, this set of variables does not drive out the predictive power of the CIQ factors.

Next, we focus on a relationship between CIQ factors and reversals. More specifically, we want to see if the predictive ability of the CIQ factors can be captured by the return reversal of p% worst performing stocks. We construct factors, $Rev(p)$, as the average return of p%

worst performing stocks in a given month and use them to predict the future market returns. We report the results in Table 10. In Panel A, we use differences of these worst returns, and in Panel B, we use levels. We can clearly see that these variables do not subsume the predictive ability of the CIQ factors. These results suggest that the predictive information of the CIQ factors do not simply mirror reversal tendencies of the stock returns.

As a next step, we control for variables discussed in Welch and Goyal (2007).[14] Instead of a large table of coefficients and t-statistics through all variables and quantiles, we summarize the bivariate results in Panel A of Table 11, in which we include t-statistics of the $\Delta\text{CIQ}(\tau)$ factors from the bivariate regressions of the form 14 while controlling for said variables. We observe that none of the variables drives out the significance of the $\Delta\text{CIQ}(\tau)$ factors. Moreover, the magnitude of the significance remains very close to the ones from the univariate regressions. In Panel B, we provide full estimation results from multivariate regressions that include all the control variables along with the $\Delta\text{CIQ}(\tau)$ factors. The results hold the same independent of the setting.

4.2 Prediction using many CIQ(τ) Factors

Because it is *ex-ante* not clear on which quantile the investor should base her investment strategy on, we perform an out-of-sample prediction exercise which utilizes information from more than one $\Delta\text{CIQ}(\tau)$ factor when constructing a forecast. The results are summarized in Table 12. We use either all of the factors when predicting the market return or we use two disjunct subsets of them. Using the first subset, we employ a prior assumption that only the downside factors ($\tau < 0.5$) are significant predictors of the market return. Second subset imposes the premise that the upside factors ($\tau > 0.5$) possess the forecasting power for the aggregate return. To do that, we use various models to exploit the information from the $\Delta\text{CIQ}(\tau)$ factors. We train the models on the first 120 monthly observations and then expand the estimation window as discussed before. We report both simple OOS R^2 and OOS R^2 CT to asses the fit. When performing regularization in the coefficient estimation, one has to choose so called tuning parameters. We choose the tuning parameters based on the in-sample leave-one-out full cross-validation procedure. We chose the forecast construction methods following Dong et al. (2022).

The first model that we employ is an OLS model which uses an OLS fitted multivariate regression model (estimated in-sample) to predict one-month-ahead return of the market. We can see that using all the $\Delta\text{CIQ}(\tau)$ factors to predict OOS return yields a negative R^2. This is caused by the overfitting problem when we use many correlated variables and do

[14] For the information regarding the specification of the variables, see Welch and Goyal (2007). We obtained the data from the Iwo Welch's webpage.

Table 10: Controlled predictive regressions with reversals

The table reports the results of the controlled bivariate predictive regressions of the value-weighted return of all CRSP firms on the ΔCIQ(τ) factors for various $\tau \in (0,1)$. We construct new variables, $Rev(p)$ as the average return of p% worst performing stocks. We use either differences of this variable in Panel A, or levels in Panel B. Coefficients are scaled to capture the effect of one-standard-deviation increase in the factor on the annualized market return in percent. The corresponding t-statistics are computed using the Newey-West robust standard errors using six lags. The data cover the period from January 1965 to December 2018.

	0.1	0.15	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.85	0.9
					Panel A: Reversal differences						
CIQ	-5.71	-5.90	-5.78	-6.52	-6.06	0.14	0.34	-1.22	1.28	2.08	2.43
	(-2.51)	(-2.50)	(-2.40)	(-2.78)	(-2.72)	(0.07)	(0.16)	(-0.66)	(0.65)	(1.05)	(1.18)
Rev(0.1)	2.14	2.03	2.00	1.83	2.35	3.73	3.74	3.84	3.43	3.08	2.81
	(1.04)	(1.00)	(1.00)	(0.90)	(1.15)	(1.79)	(1.79)	(1.81)	(1.54)	(1.34)	(1.20)
R^2	1.55	1.61	1.56	1.86	1.71	0.49	0.49	0.54	0.54	0.63	0.67
CIQ	-5.60	-5.79	-5.67	-6.42	-5.96	0.13	0.36	-1.23	1.19	1.96	2.27
	(-2.45)	(-2.45)	(-2.35)	(-2.73)	(-2.68)	(0.06)	(0.16)	(-0.66)	(0.60)	(0.98)	(1.10)
Rev(0.15)	2.30	2.19	2.17	1.99	2.54	4.03	4.03	4.13	3.74	3.40	3.14
	(1.10)	(1.07)	(1.06)	(0.96)	(1.23)	(1.91)	(1.91)	(1.92)	(1.67)	(1.47)	(1.33)
R^2	1.57	1.63	1.58	1.88	1.74	0.57	0.57	0.62	0.62	0.69	0.72
CIQ	-5.46	-5.66	-5.54	-6.30	-5.85	0.11	0.35	-1.27	1.09	1.82	2.09
	(-2.39)	(-2.39)	(-2.29)	(-2.68)	(-2.63)	(0.05)	(0.16)	(-0.68)	(0.55)	(0.91)	(1.01)
Rev(0.2)	2.53	2.43	2.42	2.23	2.80	4.35	4.35	4.46	4.08	3.75	3.51
	(1.22)	(1.19)	(1.19)	(1.09)	(1.36)	(2.08)	(2.07)	(2.08)	(1.82)	(1.62)	(1.49)
R^2	1.60	1.66	1.61	1.91	1.79	0.67	0.67	0.72	0.70	0.77	0.79
CIQ	-5.37	-5.58	-5.45	-6.23	-5.78	0.11	0.37	-1.28	1.02	1.73	1.98
	(-2.33)	(-2.35)	(-2.25)	(-2.64)	(-2.60)	(0.05)	(0.17)	(-0.69)	(0.51)	(0.86)	(0.95)
Rev(0.25)	2.63	2.52	2.53	2.33	2.92	4.53	4.54	4.64	4.28	3.96	3.73
	(1.25)	(1.22)	(1.23)	(1.13)	(1.41)	(2.15)	(2.15)	(2.16)	(1.90)	(1.70)	(1.57)
R^2	1.61	1.67	1.63	1.92	1.81	0.72	0.73	0.78	0.76	0.82	0.84
					Panel B: Reversal levels						
CIQ	-6.31	-6.48	-6.35	-7.01	-6.52	0.10	0.33	-0.91	2.00	2.92	3.36
	(-2.75)	(-2.72)	(-2.61)	(-2.96)	(-2.91)	(0.05)	(0.15)	(-0.50)	(1.07)	(1.59)	(1.78)
Rev(0.1)	1.69	1.64	1.54	1.43	1.28	1.66	1.67	1.68	1.54	1.40	1.29
	(0.69)	(0.67)	(0.64)	(0.59)	(0.55)	(0.71)	(0.70)	(0.71)	(0.65)	(0.58)	(0.53)
R^2	1.50	1.57	1.52	1.82	1.59	0.10	0.10	0.13	0.24	0.39	0.49
CIQ	-6.28	-6.44	-6.31	-6.96	-6.47	0.10	0.35	-0.92	1.96	2.86	3.28
	(-2.74)	(-2.71)	(-2.60)	(-2.95)	(-2.90)	(0.05)	(0.16)	(-0.50)	(1.05)	(1.56)	(1.73)
Rev(0.15)	2.05	1.99	1.88	1.77	1.65	2.13	2.14	2.15	2.00	1.85	1.71
	(0.86)	(0.84)	(0.80)	(0.75)	(0.72)	(0.93)	(0.92)	(0.93)	(0.86)	(0.78)	(0.72)
R^2	1.55	1.62	1.56	1.86	1.62	0.16	0.16	0.19	0.29	0.44	0.53
CIQ	-6.24	-6.40	-6.26	-6.92	-6.43	0.09	0.37	-0.93	1.92	2.81	3.21
	(-2.72)	(-2.70)	(-2.59)	(-2.94)	(-2.88)	(0.04)	(0.17)	(-0.50)	(1.03)	(1.53)	(1.69)
Rev(0.2)	2.30	2.23	2.13	2.02	1.92	2.48	2.50	2.50	2.35	2.17	2.03
	(0.98)	(0.96)	(0.93)	(0.87)	(0.86)	(1.11)	(1.10)	(1.11)	(1.03)	(0.94)	(0.87)
R^2	1.58	1.66	1.59	1.89	1.66	0.22	0.22	0.25	0.35	0.49	0.57
CIQ	-6.19	-6.35	-6.22	-6.87	-6.38	0.09	0.39	-0.92	1.90	2.76	3.15
	(-2.71)	(-2.69)	(-2.58)	(-2.93)	(-2.87)	(0.04)	(0.17)	(-0.50)	(1.01)	(1.50)	(1.66)
Rev(0.25)	2.43	2.36	2.26	2.14	2.07	2.72	2.73	2.73	2.58	2.39	2.23
	(1.05)	(1.02)	(0.99)	(0.94)	(0.94)	(1.23)	(1.21)	(1.23)	(1.14)	(1.05)	(0.97)
R^2	1.61	1.68	1.61	1.91	1.68	0.26	0.27	0.29	0.39	0.52	0.60

not impose any parameter regularization. Using only either downside or upside factors and truncating the prediction at zero, yield some marginal gains for the investor.

The LASSO (least absolute shrinkage and selection operator, Tibshirani, 1996) model

Table 11: Controlled predictive regressions with Welch and Goyal (2007) variables

Panel A of the table summarizes t-statistics associated with the ΔCIQ(τ) factors from the bivariate regressions when controlling for the macroeconomic variables discussed in Welch and Goyal (2007). Panel B reports the regression results from the multivariate regressions using all the control variables at the same time. The dependent variable is the value-weighted return of all CRSP firms. The t-statistics are computed using the Newey-West robust standard errors using six lags. The data cover the period from January 1965 to December 2018.

control/ τ	0.1	0.15	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.85	0.9
						Panel A: Bivariate regressions					
dp	-6.31	-6.49	-6.41	-7.10	-6.64	0.08	0.24	-0.94	2.04	2.98	3.47
	(-2.78)	(-2.75)	(-2.65)	(-3.01)	(-2.94)	(0.04)	(0.11)	(-0.51)	(1.11)	(1.65)	(1.88)
dy	-6.25	-6.43	-6.35	-7.04	-6.59	0.08	0.25	-0.95	2.00	2.93	3.41
	(-2.75)	(-2.72)	(-2.63)	(-2.98)	(-2.92)	(0.04)	(0.11)	(-0.52)	(1.09)	(1.61)	(1.84)
ep	-6.31	-6.49	-6.41	-7.08	-6.60	0.12	0.29	-0.95	2.04	2.99	3.47
	(-2.77)	(-2.74)	(-2.64)	(-2.99)	(-2.93)	(0.06)	(0.13)	(-0.52)	(1.11)	(1.66)	(1.87)
de	-6.30	-6.48	-6.37	-7.05	-6.62	0.14	0.26	-0.84	2.13	3.08	3.51
	(-2.77)	(-2.74)	(-2.63)	(-2.98)	(-2.91)	(0.07)	(0.12)	(-0.46)	(1.16)	(1.71)	(1.90)
svar	-6.56	-6.63	-6.42	-6.99	-6.21	0.22	0.47	-0.43	2.69	3.52	3.91
	(-2.81)	(-2.75)	(-2.64)	(-2.96)	(-2.87)	(0.10)	(0.21)	(-0.23)	(1.39)	(1.87)	(2.06)
bm	-6.31	-6.49	-6.39	-7.07	-6.60	0.14	0.28	-0.90	2.08	3.03	3.49
	(-2.77)	(-2.74)	(-2.63)	(-2.98)	(-2.92)	(0.07)	(0.13)	(-0.49)	(1.12)	(1.67)	(1.88)
ntis	-6.24	-6.42	-6.33	-7.00	-6.58	0.14	0.29	-0.86	2.08	3.04	3.46
	(-2.72)	(-2.69)	(-2.59)	(-2.93)	(-2.89)	(0.07)	(0.13)	(-0.47)	(1.12)	(1.67)	(1.87)
tbl	-6.28	-6.48	-6.34	-7.00	-6.59	0.16	0.35	-0.81	2.15	3.11	3.50
	(-2.75)	(-2.74)	(-2.62)	(-2.95)	(-2.89)	(0.08)	(0.16)	(-0.44)	(1.15)	(1.71)	(1.88)
lty	-6.27	-6.47	-6.35	-7.01	-6.57	0.15	0.32	-0.85	2.10	3.07	3.49
	(-2.75)	(-2.73)	(-2.61)	(-2.96)	(-2.89)	(0.07)	(0.15)	(-0.46)	(1.13)	(1.68)	(1.88)
ltr	-5.66	-5.86	-5.80	-6.51	-6.20	-0.06	0.17	-0.95	1.78	2.71	2.98
	(-2.52)	(-2.52)	(-2.44)	(-2.82)	(-2.79)	(-0.03)	(0.08)	(-0.50)	(0.94)	(1.47)	(1.63)
tms	-6.40	-6.59	-6.48	-7.14	-6.72	0.18	0.30	-0.85	2.21	3.10	3.54
	(-2.82)	(-2.79)	(-2.68)	(-3.03)	(-2.97)	(0.09)	(0.14)	(-0.46)	(1.19)	(1.71)	(1.91)
dfy	-6.21	-6.39	-6.30	-6.98	-6.68	0.19	0.29	-0.86	2.04	2.94	3.36
	(-2.72)	(-2.69)	(-2.59)	(-2.95)	(-2.92)	(0.09)	(0.13)	(-0.47)	(1.11)	(1.62)	(1.82)
infl	-6.06	-6.24	-6.15	-6.84	-6.53	0.30	0.38	-0.84	2.01	2.95	3.32
	(-2.63)	(-2.61)	(-2.50)	(-2.85)	(-2.84)	(0.14)	(0.17)	(-0.45)	(1.08)	(1.62)	(1.79)
						Panel B: Multivariate regressions					
CIQ	-6.30	-6.44	-6.21	-6.75	-6.24	0.01	0.56	-0.17	2.67	3.42	3.60
	(-2.83)	(-2.82)	(-2.74)	(-3.14)	(-3.09)	(0.01)	(0.25)	(-0.09)	(1.38)	(1.81)	(1.90)
dp	3.15	3.23	3.17	3.20	2.87	1.76	1.75	1.76	2.16	2.44	2.65
	(1.85)	(1.95)	(1.91)	(1.93)	(1.73)	(1.03)	(1.02)	(1.02)	(1.23)	(1.38)	(1.47)
dy	-2.18	-2.27	-2.21	-2.24	-1.87	-0.79	-0.78	-0.78	-1.19	-1.48	-1.68
	(-1.28)	(-1.35)	(-1.32)	(-1.33)	(-1.12)	(-0.46)	(-0.46)	(-0.45)	(-0.68)	(-0.84)	(-0.94)
ep	0.60	0.60	0.60	0.60	0.62	0.59	0.60	0.60	0.57	0.56	0.57
	(1.21)	(1.22)	(1.23)	(1.25)	(1.31)	(1.24)	(1.24)	(1.25)	(1.17)	(1.14)	(1.14)
svar	-0.80	-0.80	-0.78	-0.77	-0.73	-0.73	-0.73	-0.73	-0.78	-0.79	-0.79
	(-3.55)	(-3.50)	(-3.54)	(-3.47)	(-3.35)	(-3.40)	(-3.39)	(-3.34)	(-3.51)	(-3.60)	(-3.63)
bm	-1.09	-1.08	-1.07	-1.07	-1.11	-1.06	-1.06	-1.06	-1.05	-1.04	-1.05
	(-1.86)	(-1.86)	(-1.86)	(-1.86)	(-1.94)	(-1.83)	(-1.83)	(-1.83)	(-1.81)	(-1.79)	(-1.79)
ntis	0.13	0.14	0.13	0.13	0.14	0.12	0.12	0.12	0.12	0.11	0.11
	(0.57)	(0.58)	(0.55)	(0.55)	(0.59)	(0.52)	(0.53)	(0.53)	(0.50)	(0.48)	(0.49)
tbl	-0.72	-0.72	-0.73	-0.73	-0.69	-0.67	-0.67	-0.67	-0.68	-0.68	-0.69
	(-1.74)	(-1.76)	(-1.77)	(-1.78)	(-1.72)	(-1.65)	(-1.64)	(-1.65)	(-1.66)	(-1.65)	(-1.66)
lty	-0.07	-0.07	-0.06	-0.05	-0.10	-0.12	-0.13	-0.12	-0.11	-0.10	-0.09
	(-0.15)	(-0.16)	(-0.14)	(-0.12)	(-0.24)	(-0.28)	(-0.28)	(-0.28)	(-0.24)	(-0.23)	(-0.21)
ltr	0.42	0.42	0.43	0.43	0.43	0.46	0.46	0.46	0.46	0.46	0.45
	(2.43)	(2.43)	(2.45)	(2.44)	(2.47)	(2.62)	(2.59)	(2.59)	(2.59)	(2.59)	(2.55)
dfy	0.67	0.66	0.65	0.65	0.67	0.64	0.64	0.64	0.65	0.65	0.64
	(2.27)	(2.30)	(2.25)	(2.24)	(2.39)	(2.20)	(2.20)	(2.18)	(2.21)	(2.19)	(2.17)
infl	-0.14	-0.14	-0.14	-0.14	-0.16	-0.16	-0.17	-0.16	-0.16	-0.16	-0.16
	(-0.67)	(-0.67)	(-0.70)	(-0.72)	(-0.83)	(-0.85)	(-0.85)	(-0.84)	(-0.82)	(-0.82)	(-0.80)
R^2	6.82	6.87	6.78	7.02	6.84	5.55	5.56	5.55	5.78	5.93	5.96

(estimator) introduces a regularization in the estimation procedure of the predictive coefficients. In the case of LASSO, only a subset of the predictors is chosen to have non-zero coefficients. As we can see, the performances for all τ and downside τ models substantially improve. On the other hand, prediction based on the upside τs do not yield a good fit even after the introduction of a regularization.

Next, we generalize the previous LASSO model and report results based on the elastic net (ENET) estimator (Zou and Hastie, 2005). The estimator employs ℓ_1 (LASSO) and ℓ_2 (ridge regression, Hoerl and Kennard, 1970) penalty terms. For simplicity reasons, we chose the penalty weights to be both equal to 0.5 without any tuning procedure. As we can see, the results closely mirror the results from the LASSO estimation.

As a next model, we perform a simple combination forecast. We first obtain univariate forecasts for each ΔCIQ(τ) factor separately and then the final forecast is obtained as a simple average of the univariate forecasts. We can see that the model performs very well for selection of all τs and downside τs, with R^2 being up to 1.26% for downside τs and R^2 CT of 1.39%. On the other hand, upside τs do not lead to any valuable forecasts.

C-LASSO and C-NET follow the same idea as the Combination model but instead of averaging all the univariate forecasts, they run multivariate penalized regression (LASSO and ENET, respectively) of the future market return on the univariate forecasts to select the best combination of them. The resulting forecast is then obtained by plugging the last value of ΔCIQ(τ) from a window into the fitted models. Once again, all τ and downside τ subsets perform both very well, with R^2 of 0.93% and R^2 CT of 1.29% for downside τ C-LASSO. But the models using upside τ yield even negative R^2. This is the case for all the remaining models which use upside τ factors.

PCA model aggregates information and creates the first principal component from all the ΔCIQ(τ) factors and uses it as the prediction variable in the univariate prediction regression. We observe that the downside τ PCA model performs the best across all the specifications.

Finally, the OLS selection model fits univariate prediction models for each ΔCIQ(τ) factor and uses the univariate model 13 with the best in-sample fit to predict the future market return. This simple approach yields very solid performance of 0.87% for R^2 and 1.28% for R^2 CT.

To summarize this section, we observed that using the downside ΔCIQ(τ) factors in various multivariate models, we obtain significant positive performance. On the contrary, the upside ΔCIQ(τ) factors do not result into economic gains because they do not outperform the forecasts based on the historical mean. All the results thus suggest that the driving force behind the downside quantile factors' performance is not the common volatility component but the information contained in the left part of the common factor structure.

Table 12: Out-of-sample performance of the forecast combinations

The table reports performance of various specifications of multivariate predictive models using all ΔCIQ(τ) factors, τ below median ΔCIQ factors (downside), or above median ΔCIQ factors (upside). The data cover the period from January 1965 to December 2018.

	All τ		Downside τ		Upside τ	
model	R^2	R^2 CT	R^2	R^2 CT	R^2	R^2 CT
OLS	-1.53	-0.40	-0.44	0.53	-0.31	0.39
LASSO	0.94	0.95	0.21	0.80	-0.25	0.14
ENET	0.92	1.03	0.07	0.71	-0.11	0.27
Combination	1.10	1.06	1.26	1.39	-0.07	0.07
C-LASSO	0.79	0.92	0.93	1.29	-0.61	-0.23
C-NET	0.86	0.78	0.85	1.22	-0.65	-0.19
PCA	1.17	1.22	1.21	1.46	-0.31	-0.10
OLS selection	0.87	1.28	0.87	1.28	-0.73	-0.10

5 Pricing the CIQ(τ) Risks in the Cross-Section

In this section, we investigate the pricing implications of the presented common idiosyncratic quantile factors for the cross-section of stock returns. We hypothesize that the stochastic discount factor increases in the CIQ(τ) risk, as the risk-averse investor's marginal utility is high in the states of high CIQ(τ) risk. Based on that hypothesis, we assume that the assets that perform poorly in the states of high CIQ(τ) risk will require a higher risk premium for holding by the investors. On the other hand, assets that perform well during these states serve as a hedging tool and will be traded with higher prices and thus lower expected returns.

Moreover, we expect that there is a heterogeneity in the risk prices associated with the exposures to different parts of the joint cross-sectional distribution of stock returns. This notion is supported by the results in Section 3.2, which show significant variation in the relationships between CIQ factors and variables capturing real economic activity. Following the results of the market premium prediction, we hypothesise that the exposure to the common downside movements will be more important.

The stocks sensitivities to the factors capture betas estimated by the linear regression of stocks returns on the factors. To alleviate the concerns that the quantile factors simply mirror the dynamics of the idiosyncratic volatilities of the single-stock returns, in the case of pricing the cross-section, we perform the estimation of the factors using standardized idiosyncratic returns.[15] Specifically, we estimate time-varying volatility using exponentially weighted moving average model. Then, we use the $\Delta f_t(\tau)$ estimates as our risk factors. For

[15] In Appendix in Table 22, we report correlations between the CIQ(τ) factors estimated using standardized data and other non-linear factors. The correlations are generally smaller.

all available stocks and and for all τ, we estimate quantile-specific betas

$$r_{i,t} = \alpha_i + \beta_i(\tau)\Delta f_t(\tau) + v_{i,t}(\tau),$$

using the least-square estimator. These betas will be used in the following asset pricing tests as a measure of the exposure to the CIQ(τ) factors. Same as the factors, betas are also estimated using the 60-month rolling window. We include the stocks that possess at least 48 monthly observations. Betas computed up to time t are used to predict returns at time $t+1$ or further – no overlap between estimation and prediction periods. If not explicitly stated otherwise, we use as our predicted variable monthly out-of-sample returns following the estimation window. We also try to predict one-year returns using portfolios to assess the persistence of the CIQ(τ) betas and thus indirectly investigate the transaction costs related to the trading of these factors.

Later in the analysis, we also control for the effect of the increments of the PCA-SQ factor, ΔCIV factor and many other related variables to show that the effect of the newly proposed quantile factors is not subsumed by the effect of any related factor or stock-specific variable. The employed control variables are estimated using the same procedure as originally proposed. The data cover the usual cross-sectional asset pricing period between January 1963 and December 2018. We exclude "penny stocks" with prices less than one dollar to avoid related biases.

5.1 Cross-sectional Regressions

As a first step in the investigation of the cross-sectional implications of exposures to the common idiosyncratic quantile risks, we perform two-stage Fama and MacBeth (1973) predictive regressions. We explore the hypothesis that the exposures to the ΔCIQ(τ) factors align with the future excess returns of the stocks. This type of asset pricing test moreover conveniently allows for simultaneous estimation of many risk premiums associated with various risk measures. That means that we can estimate the risk premium associated with the CIQ(τ) risks while controlling for other risk measures previously proposed in the literature. More specifically, for each time $t = 1, \ldots, T-1$ using all of the stocks $i = 1, \ldots, N$ available at time t and $t+1$,[16] we cross-sectionally regress all the returns at time $t+1$ on the betas estimated using only the information available up to time t. This procedure yields estimates

[16] A stock is identified as available, if it possess at least 48 monthly return observations during the last 60-month window up to time t and also an observation at time $t+1$.

of prices of risk $\lambda_{t+1}(\tau)$ while controlling for the most widely used competing measure of risk

$$r_{i,t+1} = \alpha + \beta_{i,t}^{CIQ(\tau)}(\tau)\lambda_{t+1}^{CIQ(\tau)}(\tau) + \beta_{i,t}^{\top Control}\lambda_{t+1}^{Control} + e_{i,t+1} \tag{15}$$

where $\beta_{i,t}^{Control}$ is vector of control betas or other stock characteristics and $\lambda_{t+1}^{Control}$ is vector of corresponding prices of risk. Using $T-1$ cross-sectional estimates of the prices of risk, we compute the average price of risk associated with each $\lambda^{CIQ}(\tau)$ as

$$\widehat{\lambda}^{CIQ(\tau)}(\tau) = \frac{1}{T-1}\sum_{t=2}^{T}\widehat{\lambda}_t^{CIQ(\tau)}(\tau) \tag{16}$$

and report them along with their t-statistics based on the Newey-West robust standard errors.

We summarize the first set of results in Panel A of Table 13 where we report estimation outcomes of the univariate predictive regressions using the CIQ(τ) betas. We observe similar results to those obtained from the market predictions – the exposure to the common idiosyncratic downside events is significantly compensated in the cross-section of stock returns. For example, CIQ(τ) for $\tau = 0.2$ possess a coefficient of 1.11 (t-stat = 2.57), on the other hand, for $\tau = 0.8$, the estimated coefficient is equal to -0.14 (t-stat = -0.30). This suggests that the exposure to the common idiosyncratic downside events is significantly compensated in the cross-section. On the contrary, to hold assets with high exposure to the upside common movements the investors have to pay a small discount for those stock, although not statistically significant one.

Next, in Panel A, we also report regression results related to the betas estimated using idiosyncratic returns with respect to the FF5 and FF6 models. The results are very similar except for pricing implications related to the extreme τ values of 0.1 in the case of the FF6 model. We observe that the inclusion of the momentum factor into the linear model specification partially eliminates the pricing power of the extreme common idiosyncratic events. The observation that the momentum returns are associated with extreme negative events, so-called momentum crashes, is a well documented fact, see, for example, Daniel and Moskowitz (2016) or Barroso and Santa-Clara (2015).

This observation sheds further light on the drivers of the momentum risk premium. More specifically, the momentum factor captures extreme left-tail events in the cross-section of stock returns. At the same time, the remaining premia remain both economically and statistically significant, confirming two points we made earlier. First, there is important heterogeneity across common quantiles of stock returns. Although the momentum factor captures the common left-tail events, it does not explain the events above this quantile.

Table 13: Fama-MacBeth regressions

The table contains estimated prices of risk and t-statistics from the Fama-MacBeth predictive regressions. Each segment contains prices of risk of CIQ(τ) betas while controlling for various risk measures. The first panel contains results from univariate settings for CIQ factors estimated using FF3, FF5 or FF6 linear model specifications. The data cover the period from January 1963 to December 2018. Each month, we use all the CRSP stocks with at least 48 monthly observations over the last 60 months, and exclude penny stocks with prices below \$1. Note the coefficients are multiplied by 100 for clarity of presentation.

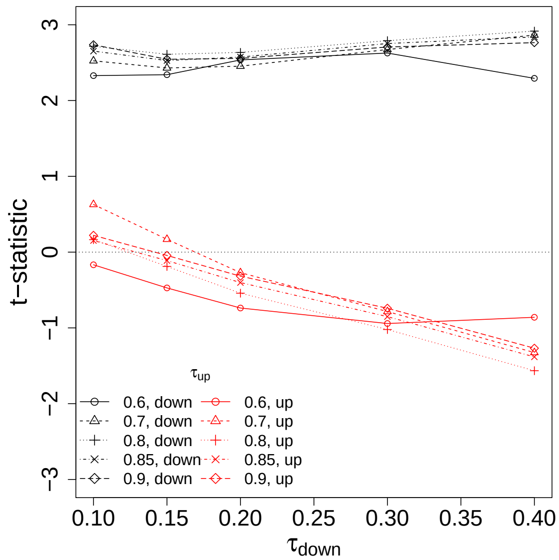
	0.1	0.15	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.85	0.9
	Panel A: Simple regressions										
CIQ(τ)	0.90	0.94	1.11	1.52	2.50	0.55	1.01	0.71	-0.14	-0.22	-0.27
	(2.52)	(2.42)	(2.57)	(2.88)	(2.80)	(0.20)	(0.41)	(1.13)	(-0.30)	(-0.49)	(-0.60)
CIQ(τ)^{FF5}	0.88	0.99	1.26	1.78	3.06	1.50	3.29	1.20	0.16	0.04	-0.20
	(2.71)	(2.90)	(3.35)	(3.52)	(3.29)	(0.54)	(1.38)	(1.97)	(0.36)	(0.10)	(-0.49)
CIQ(τ)^{FF6}	0.45	0.67	0.84	1.31	2.09	3.84	4.45	1.01	0.32	0.11	0.04
	(1.45)	(2.08)	(2.47)	(3.05)	(2.87)	(1.46)	(1.98)	(2.09)	(0.86)	(0.32)	(0.13)
	Panel B: General risk measures										
CIQ(τ)	0.68	0.72	0.83	1.15	1.96	-0.48	-1.12	0.46	-0.04	-0.08	-0.10
	(2.49)	(2.41)	(2.47)	(2.59)	(2.61)	(-0.22)	(-0.55)	(0.91)	(-0.11)	(-0.24)	(-0.32)
Idiosyncratic volatility	-14.57	-14.59	-14.58	-14.58	-14.78	-14.95	-15.00	-14.97	-14.95	-14.65	-14.29
	(-2.14)	(-2.14)	(-2.14)	(-2.15)	(-2.12)	(-2.15)	(-2.15)	(-2.14)	(-2.17)	(-2.14)	(-2.11)
Skewness	-0.10	-0.10	-0.10	-0.11	-0.10	-0.10	-0.10	-0.10	-0.11	-0.11	-0.12
	(-1.19)	(-1.22)	(-1.25)	(-1.30)	(-1.24)	(-1.17)	(-1.20)	(-1.21)	(-1.28)	(-1.32)	(-1.37)
Idiosyncratic skewness	0.12	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.14	0.14	0.14
	(1.55)	(1.59)	(1.61)	(1.66)	(1.60)	(1.55)	(1.59)	(1.60)	(1.66)	(1.70)	(1.74)
	Panel C: Stock characteristics										
CIQ(τ)	0.68	0.72	0.83	1.14	1.91	0.63	0.11	0.67	0.03	-0.04	-0.08
	(2.20)	(2.13)	(2.28)	(2.47)	(2.42)	(0.25)	(0.05)	(1.19)	(0.07)	(-0.11)	(-0.20)
Size	-0.02	-0.02	-0.02	-0.02	-0.02	-0.02	-0.02	-0.02	-0.02	-0.02	-0.02
	(-1.74)	(-1.75)	(-1.74)	(-1.76)	(-1.79)	(-1.89)	(-1.89)	(-1.73)	(-1.73)	(-1.76)	(-1.84)
Book-to-price	0.11	0.11	0.11	0.11	0.11	0.12	0.12	0.12	0.12	0.12	0.12
	(1.76)	(1.75)	(1.71)	(1.71)	(1.79)	(1.90)	(1.92)	(1.94)	(1.94)	(1.93)	(1.90)
Net payout yield	0.95	0.88	0.91	0.93	1.05	1.23	1.26	1.27	1.26	1.17	1.03
	(1.19)	(1.12)	(1.13)	(1.07)	(1.11)	(1.21)	(1.24)	(1.26)	(1.35)	(1.33)	(1.33)
Turnover	-0.10	-0.10	-0.10	-0.10	-0.11	-0.11	-0.11	-0.11	-0.10	-0.10	-0.10
	(-2.05)	(-2.13)	(-2.16)	(-2.21)	(-2.23)	(-2.07)	(-2.08)	(-2.13)	(-2.09)	(-2.13)	(-2.10)
Illiquidity	1.86	1.86	1.86	1.85	1.85	1.95	1.95	1.97	1.97	1.96	2.00
	(1.08)	(1.09)	(1.09)	(1.08)	(1.10)	(1.18)	(1.17)	(1.14)	(1.13)	(1.13)	(1.13)
Profit	0.47	0.46	0.47	0.47	0.47	0.47	0.47	0.48	0.48	0.48	0.48
	(3.60)	(3.59)	(3.61)	(3.61)	(3.56)	(3.56)	(3.57)	(3.68)	(3.71)	(3.71)	(3.68)
Investment	-0.39	-0.39	-0.38	-0.38	-0.39	-0.39	-0.39	-0.39	-0.39	-0.39	-0.39
	(-7.13)	(-7.09)	(-7.07)	(-7.16)	(-7.08)	(-7.20)	(-7.18)	(-7.22)	(-7.24)	(-7.26)	(-7.28)
	Panel D: Past returns										
CIQ(τ)	0.58	0.60	0.76	1.05	1.92	1.09	1.20	0.66	-0.11	-0.16	-0.19
	(1.67)	(1.62)	(2.00)	(2.20)	(2.39)	(0.44)	(0.53)	(1.14)	(-0.26)	(-0.38)	(-0.47)
Lagged return	-4.11	-4.12	-4.14	-4.13	-4.06	-4.04	-4.02	-4.00	-4.05	-4.07	-4.13
	(-9.91)	(-9.94)	(-9.96)	(-9.95)	(-9.79)	(-9.75)	(-9.61)	(-9.69)	(-9.79)	(-9.81)	(-9.92)
Intermediate return	0.24	0.24	0.23	0.23	0.25	0.27	0.27	0.27	0.26	0.26	0.26
	(1.29)	(1.28)	(1.22)	(1.23)	(1.33)	(1.49)	(1.49)	(1.43)	(1.39)	(1.39)	(1.40)
Momentum	0.59	0.59	0.60	0.60	0.58	0.57	0.57	0.58	0.58	0.58	0.58
	(2.97)	(2.96)	(2.99)	(2.98)	(2.87)	(3.04)	(2.89)	(2.90)	(2.94)	(2.97)	(2.87)

Second, the results provide further evidence that the common non-linear movements play an important role in the economy and that investors want to hedge against such movements.

Moreover, these results suggest there is a strong asymmetry in the pricing implications of the ΔCIQ(τ) factors. To further assess it, we perform the following set of bivariate

Figure 3: ΔCIQ(τ) betas – bivariate cross-sectional regressions

The figure reports t-statistics of prices of risks from bivariate regressions from the Equation 17 of CIQ(τ) betas for downside and upside τs. The data cover the period from January 1963 to December 2018. Each month, we use all the CRSP stocks with at least 48 monthly observations over the last 60 months, and exclude penny stocks with prices below \$1.



regressions

$$r_{i,t+1} = \alpha_{t+1} + \beta_{i,t}^{CIQ}(\tau_{down})\lambda_{t+1}(\tau_{down})^{CIQ} + \beta_{i,t}^{CIQ}(\tau_{up})\lambda_{t+1}(\tau_{up})^{CIQ} + e_{i,t+1}, \quad \tau_{down} = \{0.1, 0.15, 0.2, 0.3, 0.4\}, \tau_{up} = \{0.6, 0.7, 0.8, 0.85, 0.9\} \tag{17}$$

where we assess the joint effect of downside and upside CIQ(τ) factors. We report t-statistics for each pair of $\lambda(\tau_{down})^{CIQ}$ and $\lambda(\tau_{up})^{CIQ}$ in the Figure 3. We observe that the prices of risk associated with downside risk remain statistically significant using every combination of downside and upside CIQ factors. On the other hand, the risk prices for the upside potential are in agreement with the previous results – insignificant but negative when controlling for higher values of τ_{down}.

Next, in Panel B of Table 13, we present results from multivariate regressions when controlling for the effect of general risk measures. We control for the effect of the idiosyncratic volatility and skewness computed from the residuals of the 3-factor model of Fama and French (1993), and for the total skewness. The pricing implications of the CIQ exposures remain very close to the ones from the univariate regressions. Besides that, we confirm the presence of the idiosyncratic volatility puzzle.

In Panel C of Table 13, we also investigate whether the pricing information of the ΔCIQ(τ) factors is not subsumed by stock characteristics based on accounting and trading information.[17] To that end, we provide the results of the multivariate cross-sectional regressions, in which we simultaneously control stock-level characteristics such as size, book-to-price, net payout yield, turnover, illiquidity, profit, and investment. We can see that the additional variables do not erase the pricing effect of the CIQ(τ) risks. The downside factors are significant determinants of the risk premium peaking at $\tau = 0.3$ with t-statistics of 2.47. On the other hand, exposure to the upside factors do not carry any significant pricing information.

In Panel D of 13, we summarize the results of controlling for the effect of past returns on the cross-section. Same as in the case of previous set of variables, we report estimation results from multivariate regression including variables momentum, intermediate return, and lagged return. We observe that the additional variables slightly diminish the effect of the ΔCIQ(τ) factors for extreme left tail (τ between 0.1 and 0.2) but the effect for non-extreme downside risk remain strong. This result agrees with the effect of the inclusion of the momentum factor into the linear specification of the model. This observation suggests that the extreme idiosyncratic events are linked to the past returns. On the other hand, pricing effects of the CIQ betas remain significant for intermediate downside values of τ. The effect of upside quantile factors is still insignificant even in this setting.

Next, we focus on results from the bivariate[18] regressions in which we include as a control various risk measures based on common volatility or asymmetric non-linear dependence with some reference factor (usually market return). Those measures were previously proven to be significant predictors of expected returns. We summarize the estimation outcomes in Table 14.

To investigate whether the quantile factors provide different priced information beyond common volatility we control for the exposure to the PCA-SQ factor.[19] From the results, we can conclude that the quantile factors extract very different information regarding the expected returns, as the specification based on the factor extracted from the squared residuals turn out not to be a significant predictor in the cross-section of stock returns. One has to look deeper into the common distribution if he wants to identify priced information regarding the common distributional movements.

We also report the results of including CAPM betas from regressions of the returns on the market return (Mkt). Interestingly, the effect of the CAPM beta diminishes the pricing relationship for the extreme left τ CIQ factors but the price of risk related to the linear exposure to the market factor possess counterintuitive negative sign – consistent with

[17] We construct the variables in the same vein as in Langlois (2020).

[18] Except for the coskewness and cokurtosis, which we include both at the same time in the regression.

[19] Both the factor and the exposures are estimated using 60-month moving window similarly as in the case of the CIQ factors. Betas are estimated using the increments of the PCA-SQ factor.

Table 14: Fama-MacBeth regressions with asymmetric risk measures

The table contains estimated prices of risk and t-statistics from the Fama-MacBeth predictive regressions. Each segment contains prices of risk of ΔCIQ(τ) betas while controlling for various asymmetric risk measures. The data cover the period from January 1963 to December 2018. Each month, we use all the CRSP stocks with at least 48 monthly observations over the last 60 months, and exclude penny stocks with prices below $1. Note the coefficients are multiplied by 100 for clarity of presentation.

	0.1	0.15	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.85	0.9
CIQ(τ)	0.87	0.93	1.01	1.31	2.21	0.40	0.79	1.09	0.20	0.20	-0.12
	(2.45)	(2.52)	(2.53)	(2.69)	(2.42)	(0.14)	(0.30)	(1.55)	(0.43)	(0.43)	(-0.26)
PCA-SQ	8.56	8.97	2.57	-9.04	-22.35	-23.82	-26.22	-39.26	-29.58	-30.30	-14.48
	(0.35)	(0.37)	(0.11)	(-0.38)	(-0.92)	(-0.93)	(-1.01)	(-1.38)	(-1.04)	(-1.07)	(-0.54)
CIQ(τ)	0.41	0.46	0.59	0.95	1.78	0.55	0.91	1.02	0.39	0.30	0.22
	(1.43)	(1.53)	(1.76)	(2.18)	(2.25)	(0.21)	(0.39)	(1.74)	(0.97)	(0.80)	(0.59)
Mkt	-0.23	-0.23	-0.23	-0.22	-0.23	-0.25	-0.25	-0.24	-0.25	-0.25	-0.24
	(-1.70)	(-1.72)	(-1.71)	(-1.68)	(-1.69)	(-1.88)	(-1.87)	(-1.77)	(-1.83)	(-1.85)	(-1.84)
CIQ(τ)	0.77	0.81	0.99	1.38	2.34	1.26	2.14	0.89	-0.04	-0.13	-0.18
	(2.09)	(2.10)	(2.38)	(2.66)	(2.68)	(0.49)	(0.91)	(1.61)	(-0.10)	(-0.30)	(-0.41)
CIV	-0.39	-0.40	-0.43	-0.46	-0.50	-0.57	-0.55	-0.55	-0.53	-0.53	-0.51
	(-1.58)	(-1.64)	(-1.75)	(-1.91)	(-2.08)	(-2.46)	(-2.35)	(-2.34)	(-2.21)	(-2.23)	(-2.16)
CIQ(τ)	0.86	0.88	1.03	1.37	2.16	-0.77	-0.24	0.24	-0.43	-0.44	-0.44
	(2.45)	(2.28)	(2.42)	(2.64)	(2.53)	(-0.29)	(-0.10)	(0.41)	(-0.91)	(-1.00)	(-1.00)
TR	0.11	0.11	0.11	0.12	0.12	0.12	0.11	0.12	0.12	0.12	0.12
	(1.33)	(1.30)	(1.32)	(1.40)	(1.41)	(1.47)	(1.42)	(1.38)	(1.43)	(1.42)	(1.36)
CIQ(τ)	0.82	0.87	1.03	1.41	2.25	0.28	0.89	0.82	-0.03	-0.12	-0.18
	(2.40)	(2.39)	(2.47)	(2.83)	(2.76)	(0.11)	(0.39)	(1.38)	(-0.07)	(-0.27)	(-0.41)
Coskew	-0.12	-0.13	-0.14	-0.16	-0.16	-0.16	-0.15	-0.17	-0.17	-0.17	-0.17
	(-0.44)	(-0.46)	(-0.51)	(-0.57)	(-0.57)	(-0.58)	(-0.57)	(-0.61)	(-0.61)	(-0.62)	(-0.60)
Cokurt	-0.11	-0.11	-0.11	-0.11	-0.13	-0.16	-0.16	-0.15	-0.14	-0.14	-0.14
	(-1.50)	(-1.48)	(-1.45)	(-1.51)	(-1.72)	(-2.06)	(-2.07)	(-2.01)	(-1.90)	(-1.88)	(-1.78)
CIQ(τ)	0.68	0.73	0.89	1.30	2.26	0.55	0.88	0.87	0.13	0.03	-0.05
	(2.19)	(2.20)	(2.39)	(2.72)	(2.74)	(0.21)	(0.39)	(1.51)	(0.33)	(0.07)	(-0.13)
β^{DR}	-0.12	-0.12	-0.12	-0.11	-0.12	-0.14	-0.14	-0.13	-0.13	-0.13	-0.12
	(-1.17)	(-1.17)	(-1.15)	(-1.11)	(-1.18)	(-1.40)	(-1.41)	(-1.27)	(-1.29)	(-1.28)	(-1.25)
CIQ(τ)	0.96	1.01	1.18	1.63	2.69	0.51	0.69	0.68	-0.15	-0.24	-0.28
	(2.76)	(2.60)	(2.88)	(3.19)	(3.15)	(0.20)	(0.29)	(1.10)	(-0.34)	(-0.56)	(-0.64)
HTCR	119.53	118.76	118.64	119.47	118.91	111.84	113.06	118.60	118.29	116.58	114.63
	(3.00)	(2.98)	(2.97)	(2.97)	(2.91)	(2.75)	(2.77)	(2.88)	(2.92)	(2.96)	(2.94)
CIQ(τ)	0.80	0.80	0.84	1.06	1.68	-0.75	-0.73	0.15	-0.27	-0.32	-0.38
	(2.41)	(2.43)	(2.32)	(2.22)	(2.00)	(-0.28)	(-0.28)	(0.21)	(-0.55)	(-0.70)	(-0.80)
β^{-}	0.15	0.14	0.13	0.12	0.12	0.11	0.12	0.10	0.11	0.12	0.14
	(0.69)	(0.64)	(0.62)	(0.60)	(0.55)	(0.51)	(0.55)	(0.47)	(0.49)	(0.54)	(0.63)
CIQ(τ)	0.86	0.89	1.05	1.44	2.34	0.33	0.78	0.66	-0.15	-0.22	-0.27
	(2.45)	(2.26)	(2.46)	(2.73)	(2.61)	(0.12)	(0.32)	(1.09)	(-0.33)	(-0.51)	(-0.63)
DOWN ASY	-0.46	-0.46	-0.55	-0.56	-0.54	-0.58	-0.50	-0.43	-0.40	-0.27	-0.20
	(-0.23)	(-0.23)	(-0.26)	(-0.27)	(-0.26)	(-0.27)	(-0.24)	(-0.21)	(-0.19)	(-0.13)	(-0.10)
CIQ(τ)	1.07	1.10	1.26	1.58	2.65	1.26	1.03	1.13	0.13	-0.01	-0.15
	(2.70)	(2.56)	(2.68)	(2.61)	(2.54)	(0.40)	(0.37)	(1.55)	(0.25)	(-0.03)	(-0.32)
MCRASH	2.31	2.27	2.26	2.19	2.17	2.20	2.22	2.12	2.00	1.99	2.01
	(2.59)	(2.57)	(2.55)	(2.48)	(2.43)	(2.41)	(2.46)	(2.25)	(2.07)	(2.05)	(2.08)
CIQ(τ)	0.92	0.96	1.09	1.45	2.19	1.01	1.58	0.83	-0.12	-0.24	-0.33
	(2.70)	(2.62)	(2.66)	(2.72)	(2.40)	(0.39)	(0.66)	(1.40)	(-0.31)	(-0.64)	(-0.89)
COS PRED	-2.19	-2.26	-2.29	-2.40	-2.51	-2.53	-2.57	-2.50	-2.37	-2.40	-2.42
	(-1.30)	(-1.34)	(-1.34)	(-1.40)	(-1.47)	(-1.49)	(-1.52)	(-1.46)	(-1.39)	(-1.43)	(-1.44)

previous empirical evidence.

Next, we employ volatility betas computed on differences of the CIV factor of Herskovic et al. (2016). We see that the results regarding CIQ(τ) betas still hold both qualitatively and quantitatively similar to the case of univariate regressions. Moreover, CIV risk is priced as well; especially strong is the relationship when we control for CIQ(τ) betas with τ from the right part of the distribution. These results suggest that both common idiosyncratic volatility and quantile risk are priced and do not convey the same pricing information.

As another related control, we use the tail risk (TR) factor of Kelly and Jiang (2014). As we can see, TR betas do not drive out the CIQ(τ) betas' effect, which remains significant, similarly to the univariate specification. Next, we control for related group of risk measures which consider the non-linear relationship between asset and market returns. By following the specifications of Harvey and Siddique (2000) and Ang et al. (2006), respectively, we control simultaneously for coskewness and cokurtosis. Once again, those measures do not drive out the significance of the CIQ(τ) betas. Coskewness possess the expected sign but it is not statistically significant. On the other hand, cokurtosis is borderline significant for $\tau \geq 0.5$ but with opposite sign than expected.

Another approach to capture non-linear dependence is via downside risk (DR) beta, which describes conditional covariance below some threshold level. We entertain the specification of Ang et al. (2006), which sets the threshold value equal to the average market return. As we can see, downside beta do not subsume the effect of the ΔCIQ(τ) factors, neither it is a significant predictor of future returns.

Another related left-tail risk measure is hybrid tail covariance risk (HTCR) measure proposed by Bali et al. (2014). Although, it is highly significant predictor of expected returns, it does not drive the effect of the CIQ(τ) risks out. Next, we include negative semibeta (β^{-}) of Bollerslev et al. (2021) in our bivariate regression. Similarly as in the previous cases, the exposure to the quantile factors yields a significant risk premium.

Then, to control for the effect of comovement asymmetry between left and right parts of the joint distribution of stock and market return, we include downside asymmetric comovement (DOWN ASY) measure of Jiang et al. (2018). This measure does not affect the relationship between expected returns and CIQ(τ) betas either.

To control for the effect of crashes in many risk factors, we control for multivariate crash risk (MCRASH) of Chabi-Yo et al. (2022).[20] MCRASH possess significant predictive power for the cross-section, which does not erase the effect of common idiosyncratic risk on the expected returns. Especially strong is the relationship between MCRASH and expected returns when controlling for CIQ(τ) risk in the left part of the joint distribution.

To control for the expectations of the coskewness, we also include stock-level predicted

[20]We employ the baseline seven-factor version of their measure.

systematic skewness (COS PRED) of Langlois (2020) in the regressions. We can see that neither this variable drive out the effect of CIQ(τ) factors.

To summarize this subsection, we have shown that the CIQ(τ) results from the Fama-MacBeth regressions suggest that the exposure to the idiosyncratic downside common events is significantly priced in the cross-section of stock returns, and that none of the discussed risks drives out the significance of these results. We also report that the extreme common idiosyncratic events are related to the stock characteristics based on past returns. At the same time, these characteristics do not subsume pricing ability of intermediate downside CIQ factors.

On the other hand, the exposure to the idiosyncratic upside potential captured by the quantile factors for $\tau \geq 0.5$ do not possess significant pricing implications for the cross-section of stock returns. This asymmetry further favors the hypothesis that the common volatility is not the reason behind the significant pricing consequences of the downside quantile factors.

5.2 Portfolio Sorts

Next, we asses the performance of the ΔCIQ(τ) factors in terms of investment opportunities. To this end, we look at the returns of the portfolios sorted on the CIQ(τ) betas. Every month, we estimate CIQ(τ) betas for all stocks that possess 48 return observations during the last 60 months using data up to time t. We sort the stocks into ten portfolios based on their betas for every τ separately. We then record the portfolios' performances at time $t + 1$ using either an equal-weighted or value-weighted scheme. Then we move one month ahead, re-estimate all the betas, and create new portfolios. We expect that, for $\tau < 0.5$, there will be an increasing pattern of returns from the low exposure to the high exposure portfolios, and vice versa for $\tau > 0.5$. The results for sorts based on ten portfolios summarizes Table 15. We observe an increasing return pattern for the portfolios with τ up to 0.4 for both equal-weighted and value-weighted schemes. This pattern practically disappears when we look at the portfolios formed on higher τ CIQ(τ) betas. This observation is in agreement with the results from the Fama-MacBeth regressions and suggests that only the exposure to the lower tail common movements is priced in the cross-section.

Moreover, to formally assess whether there is a compensation for bearing a risk of high exposure to the common movements in various parts of distributions of idiosyncratic returns, we present returns of high minus low portfolios. We obtain these returns as a difference between returns of portfolios with the highest CIQ(τ) betas and portfolios with the lowest CIQ(τ) betas. These portfolios are zero-cost portfolios and capture the risk premium associated with specific τ joint movements of idiosyncratic returns. As expected, we observe

Table 15: Portfolios sorted on the exposure to the ΔCIQ(τ) factors

The table contains annualized out-of-sample excess returns of ten portfolios sorted on the exposure to the ΔCIQ(τ) factors. We report returns of the high minus low (H - L) portfolios, their t-statistics, and annualized 6-factor alphas with respect to the four factors of Carhart (1997), CIV shocks of Herskovic et al. (2016), and BAB factor of Frazzini and Pedersen (2014). We also report t-statistics for these alphas. The data cover the period from January 1963 to December 2018. Each month, we use all the CRSP stocks with at least 48 monthly observations over the last 60 months, and exclude penny stocks with prices below $1.

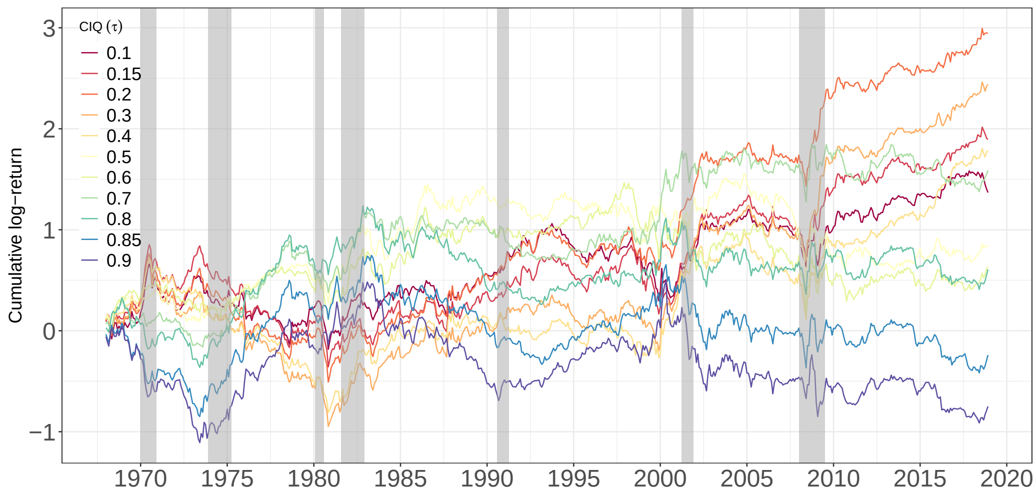
τ	Low	2	3	4	5	6	7	8	9	High	H - L	t-stat	α	t-stat
							Equal-weighted							
0.1	4.88	7.89	8.20	9.19	8.75	9.47	9.99	10.65	10.71	9.63	4.74	2.76	4.80	2.55
0.15	4.41	7.78	8.88	8.95	9.59	9.39	10.11	10.36	10.10	9.79	5.38	3.07	5.60	3.04
0.2	4.37	7.43	8.82	9.33	9.10	10.14	10.11	10.06	9.86	10.12	5.74	3.18	6.36	3.28
0.3	4.41	7.54	8.49	9.15	9.87	9.71	10.15	10.28	10.16	9.59	5.19	3.10	5.76	3.37
0.4	4.65	8.11	8.82	9.39	9.05	9.64	10.22	10.35	9.90	9.22	4.57	2.95	4.79	3.01
0.5	6.77	9.01	9.95	9.38	9.29	9.48	9.61	9.73	9.11	7.02	0.25	0.14	-0.84	-0.41
0.6	6.35	9.25	9.77	9.16	9.66	9.75	9.84	9.20	8.96	7.42	1.07	0.63	-0.80	-0.43
0.7	6.28	8.84	9.86	9.11	9.19	9.01	9.54	9.40	9.57	8.55	2.27	1.61	0.15	0.09
0.8	8.05	9.34	9.43	9.02	8.84	9.39	9.23	8.91	8.78	8.36	0.32	0.20	-1.67	-0.96
0.85	8.19	9.13	9.54	8.97	9.02	9.40	9.61	8.88	8.57	8.03	-0.16	-0.10	-1.83	-0.99
0.9	8.14	9.69	9.40	8.89	9.11	9.58	9.32	8.89	8.87	7.45	-0.69	-0.38	-2.17	-1.13
							Value-weighted							
0.1	4.08	5.07	5.98	6.17	6.47	7.02	6.83	8.60	9.46	8.18	4.10	1.75	3.28	1.41
0.15	3.77	4.63	6.82	5.60	7.36	6.15	7.69	7.18	9.17	8.99	5.22	2.05	5.47	2.20
0.2	2.87	6.31	6.63	5.65	6.48	7.12	7.15	7.40	8.91	10.14	7.27	2.78	8.57	3.13
0.3	3.17	6.40	5.73	6.15	6.67	7.35	6.92	6.97	7.78	9.39	6.22	2.33	7.53	2.67
0.4	3.41	6.43	5.44	6.78	6.47	7.24	6.76	6.74	7.28	8.27	4.86	2.03	7.17	3.02
0.5	3.89	5.44	5.37	5.45	6.36	7.28	7.65	6.36	4.89	7.08	3.19	1.42	3.72	1.42
0.6	3.32	6.45	5.28	4.68	7.43	6.09	8.63	6.79	6.14	6.09	2.77	1.21	1.47	0.61
0.7	3.90	5.65	7.58	7.48	6.94	6.47	6.29	6.20	5.94	8.40	4.51	1.92	3.50	1.34
0.8	4.29	7.17	6.46	5.84	6.88	6.77	6.39	6.18	5.17	6.96	2.68	1.09	2.31	0.93
0.85	5.09	6.80	6.19	6.61	6.54	6.77	6.75	6.14	5.54	6.33	1.24	0.50	1.41	0.57
0.9	4.62	6.71	6.47	5.90	6.42	7.27	6.19	5.69	6.07	5.05	0.43	0.16	0.49	0.18

a significant positive premium for the difference portfolios only for τ being less or equal to 0.4. These premiums are both economically and statistically significant. In the case of the equal-weighted portfolios, the premium for CIQ(0.2) factors is 5.74% on the annual basis with a t-statistic of 3.18. The premiums are very similar in the case of the value-weighted portfolios – e.g., for $\tau = 0.2$ the premium is 7.27 with t-statistic of 2.78. This slightly lower significance in the case of the value-weighted portfolios may be partially caused by the fact that the value-weighted portfolios possess a higher concentration, which leads to more volatile returns.

To make sure that the estimated premiums cannot be explained by exposure to other related risks previously proposed in the literature, we regress the returns of the high minus low portfolios on four factors of Carhart (1997) , the CIV shocks of Herskovic et al. (2016), and the BAB factor of Frazzini and Pedersen (2014) and report corresponding annualized 6-factor alphas. From the results, we can see that the proposed factors do not capture the positive premium associated with the zero-cost portfolios. For the equal-weighted portfolio with $\tau = 0.2$, the estimated annualized alpha is 6.36% with t-statistic of 3.28, for value-

Figure 4: Performance of the $\Delta CIQ(\tau)$ portfolios

The figure depicts cumulative log-return of high minus low portfolios obtained from sorting the stocks into decile portfolios based on their exposure to the CIQ(τ) factors and buying the portfolio with high exposure and selling the portfolio with low exposure. Returns of the portfolios are value-weighted. The data cover the period from January 1963 to December 2018. Each month, we use all the CRSP stocks with at least 48 monthly observations over the last 60 months, and exclude penny stocks with prices below \$1. The shaded areas represent NBER recessions.



weighted portfolios it is 8.57% premium with t-statistics being equal to 3.13.

We present the same set of portfolio results for the CIQ factors that are estimated using the idiosyncratic returns from the FF5 and FF6 models, respectively, in Table 27. We see that the FF5 model for the common linear structure does not affect the abnormal returns of the CIQ portfolios. On the other hand, the inclusion of the momentum factor in the linear specification affects the magnitude of the premiums associated with exposure to the extreme left-tail common events. In particular, the premiums associated with τ being equal to 0.1 and 0.15 lead to sizable economic and statistical reduction in significance. These observations are consistent with the results from the Fama-MacBeth regressions from the previous section.

To visually inspect the performance of the CIQ(τ) portfolios, we present in Figure 4 cumulative log-return of the value-weighted high minus low portfolios for every τ. Consistent with the numerical results, only the portfolios based on the CIQ factors for $\tau \leq 0.4$ provide strong performance during the sample period.

Next, in Panel A of Table 16, we look at the performance of the CIQ(τ) sorted portfolios as captured by the following twelve-month value-weighted returns. This exercise helps us to understand two things. First, whether the investment strategy based on the CIQ factors is feasible in terms of turnover by examining the returns of portfolios that are rebalanced only once a year. Second, we can infer whether the premium associated with exposure to the CIQ factors is a compensation for risk and not just a reversal effect. If risk is the driving force behind the abnormal returns, then the one-year returns should remain economically and statistically significant.[21]

We proceed as follows. Each month, we construct portfolios as in the previous case. Instead of saving the next one-month return of the sorted portfolios, we record the twelve-month return that follows after the formation period. Because of the passive approach, we focus on the value-weighted performance of the portfolios for the following 12-month period. We observe returns that are consistent with the results obtained using one-month returns, for example, the high minus low portfolio for $\tau = 0.2$ yields 4.98% p.a. ($t = 3.23$). These results show that the investor does not have to suffer high turnover costs associated with the strategy in order to exploit the associated risk premium.

To further mitigate the effect of return reversals, we also extend this analysis by storing the one-year return, but excluding the return immediately following the formation period. We report the results in Panel B of Table 16. The resulting returns are almost indistinguishable, both qualitatively and quantitatively, from the returns over the full one-year period. For example, the zero-cost portfolio associated with $\tau = 0.2$ yields a premium of 4.89% ($t = 3.06$).

We then examine whether the abnormal returns can be explained by the use of traditional linear factor models. In particular, we focus on the models that we consider in terms of the linear model specification that we use to estimate the CIQ factors. This allows us to further explore the potential of these factors to capture the CIQ premia and to assess the importance of focusing on these non-linear joint movements. In Table 17, we report the alphas from regressing the returns of the high minus low portfolios obtained from the decile sorting. We find that exposures to these factor sets do not explain the abnormal returns of the CIQ portfolios. In addition, to further examine the relationship with reversal returns, we also report alphas with respect to the FF6 model extended by the short-term reversal factor.[22] The equal-weighted and value-weighted returns are clearly not spanned by this factor, further suggesting that the CIQ factors are not a simple by-product of the reversal phenomenon.

In order for investors to want to hedge against a particular risk in the economy, they must be able to predict the exposure to that risk. To assess the post-formation risk of the CIQ portfolios, we follow the procedure used in Hu et al. (2013). Specifically, we regress the post-formation returns of the equal-weighted high minus low CIQ portfolios on the CIQ factors and report their out-of-sample betas. Table 18 summarizes the results. We see a clear increasing pattern in the post-formation betas, suggesting that the investors are able

[21]We thank the Associate Editor for pointing this out.

[22]Short-term reversal factor data were obtained from the Kenneth French's data library.

Table 16: Annually rebalanced $\Delta CIQ(\tau)$ portfolios

The table reports annualized out-of-sample excess returns of ten portfolios sorted by their exposure to the ΔCIQ(τ) factors. In Panel A, the portfolios are constructed every month and held over the next twelve months. In Panel B, the portfolios are held over the next twelve months, but the first monthly return after formation is excluded. We report the returns of the high minus low (H - L) portfolios and their t-statistics. The data cover the period from January 1963 to December 2018. Each month, we use all the CRSP stocks with at least 48 monthly observations over the last 60 months, and exclude penny stocks with prices below $1.

τ	Low	2	3	4	5	6	7	8	9	High	H - L	t-stat
					Panel A: 1-year holding period							
0.1	4.17	5.20	6.10	5.94	6.28	6.41	6.98	7.69	8.28	8.72	4.55	2.93
0.15	4.00	5.34	6.36	5.91	6.48	6.27	7.05	7.52	7.88	8.50	4.50	2.89
0.2	3.62	6.13	5.90	6.20	6.36	6.16	7.08	7.32	7.70	8.61	4.98	3.23
0.3	3.32	6.05	5.81	6.48	6.40	6.56	6.83	6.81	7.32	8.26	4.93	3.29
0.4	3.81	5.66	6.53	6.33	6.29	6.66	6.55	6.47	6.39	7.53	3.72	2.56
0.5	4.68	5.46	5.87	5.92	6.40	6.93	7.21	6.15	4.86	6.79	2.11	1.48
0.6	4.58	5.62	5.78	6.31	6.00	7.15	6.96	6.38	4.99	6.21	1.63	1.13
0.7	4.10	6.09	5.91	6.21	6.68	6.93	6.52	6.21	6.07	7.51	3.41	2.24
0.8	4.52	6.39	5.54	6.28	7.12	6.76	6.62	6.28	5.78	6.68	2.16	1.31
0.85	4.62	6.03	5.78	6.19	6.68	6.73	6.79	6.39	5.74	6.42	1.79	1.03
0.9	4.55	6.14	5.67	5.92	6.36	6.70	6.61	6.55	5.96	5.97	1.43	0.78
					Panel B: Without next month							
0.1	4.25	5.19	6.19	5.91	6.27	6.32	7.00	7.76	8.21	8.73	4.48	2.81
0.15	4.15	5.34	6.36	6.00	6.39	6.16	7.07	7.57	7.85	8.46	4.31	2.69
0.2	3.70	6.17	5.80	6.29	6.32	6.13	7.07	7.29	7.70	8.59	4.89	3.06
0.3	3.35	6.12	5.86	6.49	6.41	6.47	6.86	6.73	7.39	8.18	4.83	3.10
0.4	3.95	5.65	6.67	6.28	6.35	6.59	6.52	6.48	6.36	7.56	3.60	2.39
0.5	4.80	5.53	5.91	6.06	6.44	6.89	7.13	6.14	4.86	6.76	1.96	1.33
0.6	4.70	5.58	5.86	6.57	5.87	7.21	6.82	6.27	4.97	6.28	1.58	1.07
0.7	4.26	6.16	5.83	6.05	6.63	6.99	6.55	6.29	6.10	7.57	3.31	2.09
0.8	4.49	6.42	5.48	6.36	7.11	6.72	6.66	6.35	5.86	6.78	2.28	1.34
0.85	4.56	6.07	5.67	6.24	6.68	6.71	6.81	6.47	5.75	6.61	2.05	1.15
0.9	4.50	6.13	5.68	5.87	6.37	6.67	6.74	6.55	5.97	6.19	1.70	0.91

to predict the risk associated with the common idiosyncratic movements. For example, for $\tau = 0.2$, the betas increase monotonically from -0.96 to -0.45, meaning that the risk more than doubles for the high portfolio compared to the low portfolio.[23] Moreover, these betas are precisely measured, especially for downside values of τ, as documented by their t-statistics.

5.3 CIQ and Common Volatility

Due to the fact that only the exposures to the lower tail common movements yield a premium, the previous results suggest that the CIQ(τ) risks are not driven by the effect of the common volatility. If it were the case that the volatility is the main driver of the obtained results, we would observe that both exposures to the lower and upper parts of the joint movements are priced, which is not the case. But to explicitly control for the effect of the common idiosyncratic volatility, similarly as in the case of Fama-MacBeth regressions, we perform dependent bivariate sorts by double sorting on betas for PCA-SQ factor and betas for the

[23] We also report the post-formation betas of the value-weighted portfolios in Table 28. Although there is a sizable difference between the low and high portfolio betas, the pattern across the portfolios is not monotonous.

Table 17: Alphas of zero-cost ΔCIQ(τ) portfolios

The table reports annualized out-of-sample alphas and their t-statistics of high minus low portfolios from decile sorts on the exposure to the ΔCIQ(τ) factors. Returns of the portfolios in Panel A are equal-weighted, returns in Panel B are value-weighted. The data cover the period from January 1963 to December 2018. Each month, we use all the CRSP stocks with at least 48 monthly observations over the last 60 months, and exclude penny stocks with prices below $1.

Model/ τ	0.1	0.15	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.85	0.9
						Panel A: Equal-weighted					
CAPM	6.63	7.44	8.06	7.54	6.36	0.64	1.90	2.35	-0.51	-1.47	-2.54
	(4.01)	(4.63)	(5.05)	(5.17)	(4.44)	(0.36)	(1.12)	(1.61)	(-0.32)	(-0.86)	(-1.38)
FF3	4.87	5.65	6.32	5.76	4.70	-0.48	0.32	0.97	-1.27	-2.10	-3.04
	(3.21)	(3.85)	(4.21)	(4.23)	(3.30)	(-0.27)	(0.20)	(0.67)	(-0.83)	(-1.31)	(-1.81)
FF5	4.51	5.12	6.08	5.87	4.99	-0.41	0.02	0.14	-2.00	-2.70	-3.46
	(2.79)	(3.19)	(3.62)	(3.81)	(3.17)	(-0.23)	(0.01)	(0.09)	(-1.26)	(-1.64)	(-2.02)
FF6	5.11	5.65	6.55	6.24	5.31	-0.59	-0.39	-0.05	-2.18	-2.65	-3.33
	(2.94)	(3.29)	(3.65)	(3.92)	(3.57)	(-0.30)	(-0.22)	(-0.03)	(-1.27)	(-1.42)	(-1.72)
FF6 + reversal	5.16	5.72	6.64	6.26	5.16	-1.06	-0.59	-0.12	-1.81	-2.22	-2.79
	(2.55)	(2.91)	(3.23)	(3.51)	(3.25)	(-0.50)	(-0.31)	(-0.07)	(-0.96)	(-1.10)	(-1.34)
						Panel B: Value-weighted					
CAPM	5.63	7.10	9.34	8.39	6.30	3.24	3.19	4.21	1.12	-0.80	-2.13
	(2.38)	(2.92)	(3.84)	(3.42)	(2.65)	(1.41)	(1.38)	(1.68)	(0.44)	(-0.31)	(-0.80)
FF3	2.47	4.36	6.87	6.04	4.06	1.37	0.49	2.25	0.10	-1.99	-3.12
	(1.14)	(1.98)	(3.05)	(2.63)	(1.80)	(0.59)	(0.22)	(0.96)	(0.04)	(-0.87)	(-1.23)
FF5	2.83	4.59	7.64	6.83	5.25	2.59	1.44	3.02	1.88	-0.05	-0.98
	(1.23)	(1.85)	(3.06)	(2.69)	(2.15)	(1.00)	(0.61)	(1.24)	(0.78)	(-0.02)	(-0.37)
FF6	3.43	5.50	8.58	7.87	7.05	3.80	2.44	3.33	2.24	1.11	0.15
	(1.50)	(2.26)	(3.37)	(3.00)	(3.04)	(1.43)	(1.02)	(1.31)	(0.90)	(0.43)	(0.06)
FF6 + reversal	3.72	5.91	9.09	8.33	7.15	3.04	2.26	3.79	2.69	1.87	1.21
	(1.51)	(2.21)	(3.28)	(2.81)	(2.89)	(1.17)	(0.95)	(1.42)	(1.01)	(0.68)	(0.41)

Table 18: Post-ranking ΔCIQ(τ) portfolio betas and their t-statistics

Post-ranking betas of the equal-weighted portfolios sorted on the exposures to the ΔCIQ(τ) factors. The data cover the period from January 1963 to December 2018. Each month, we use all the CRSP stocks with at least 48 monthly observations over the last 60 months, and exclude penny stocks with prices below $1.

τ	Low	2	3	4	5	6	7	8	9	High
0.1	-0.95	-0.75	-0.71	-0.64	-0.58	-0.54	-0.51	-0.50	-0.47	-0.45
	(-4.17)	(-4.12)	(-4.39)	(-4.10)	(-4.01)	(-3.82)	(-3.63)	(-3.62)	(-3.13)	(-2.46)
0.15	-0.97	-0.77	-0.74	-0.65	-0.62	-0.58	-0.51	-0.48	-0.49	-0.48
	(-4.40)	(-4.42)	(-4.86)	(-4.54)	(-4.50)	(-4.37)	(-3.89)	(-3.82)	(-3.57)	(-2.62)
0.2	-0.96	-0.78	-0.73	-0.61	-0.60	-0.59	-0.49	-0.47	-0.45	-0.45
	(-4.36)	(-4.70)	(-4.76)	(-4.31)	(-4.67)	(-4.52)	(-3.91)	(-3.90)	(-3.34)	(-2.51)
0.3	-0.74	-0.61	-0.54	-0.47	-0.44	-0.43	-0.38	-0.35	-0.33	-0.35
	(-4.21)	(-4.87)	(-4.55)	(-4.14)	(-4.22)	(-4.45)	(-3.98)	(-3.87)	(-3.22)	(-2.38)
0.4	-0.36	-0.27	-0.25	-0.22	-0.20	-0.18	-0.16	-0.16	-0.14	-0.16
	(-3.30)	(-3.49)	(-3.63)	(-3.43)	(-3.14)	(-3.01)	(-2.63)	(-2.74)	(-2.06)	(-1.76)
0.5	-0.08	-0.05	-0.04	-0.04	-0.03	-0.03	-0.02	-0.02	-0.01	-0.02
	(-2.39)	(-1.98)	(-1.94)	(-1.79)	(-1.49)	(-1.34)	(-1.02)	(-0.77)	(-0.53)	(-0.52)
0.6	-0.09	-0.06	-0.04	-0.04	-0.03	-0.02	-0.02	-0.01	-0.01	-0.02
	(-2.51)	(-2.12)	(-2.00)	(-1.73)	(-1.63)	(-1.19)	(-0.93)	(-0.66)	(-0.47)	(-0.52)
0.7	-0.15	-0.07	-0.05	-0.04	-0.01	0.00	0.02	0.00	-0.01	-0.01
	(-0.93)	(-0.67)	(-0.56)	(-0.53)	(-0.14)	(-0.04)	(0.23)	(-0.03)	(-0.05)	(-0.09)
0.8	0.10	0.12	0.14	0.18	0.20	0.21	0.26	0.24	0.24	0.25
	(0.45)	(0.97)	(1.27)	(1.63)	(1.87)	(1.88)	(2.23)	(1.81)	(1.57)	(1.20)
0.85	0.24	0.27	0.28	0.32	0.35	0.37	0.39	0.40	0.45	0.47
	(1.03)	(2.07)	(2.44)	(2.79)	(2.92)	(3.09)	(3.08)	(2.78)	(2.64)	(2.06)
0.9	0.49	0.47	0.50	0.54	0.55	0.59	0.62	0.65	0.71	0.79
	(2.10)	(3.35)	(3.78)	(4.25)	(4.41)	(4.42)	(4.23)	(3.82)	(3.68)	(3.15)

Table 19: Dependent bivariate sorts on ΔCIQ(τ) and PCA-SQ exposures

The table contains annualized out-of-sample excess returns of ten portfolios sorted on the exposure to the ΔCIQ(τ) and PCA-SQ factor. Exposure to the PCA-SQ factor are approximately same across the portfolios. We use all the CRSP stocks that have at least 48 monthly observations in each 60-month window. We report returns of the high minus low (H - L) portfolios, their t-statistics, and annualized 6-factor alphas with respect to the four factors of Carhart (1997), CIV shocks of Herskovic et al. (2016), and BAB factor of Frazzini and Pedersen (2014). We also report t-statistics for these alphas. The data cover the period from January 1963 to December 2018. Each month, we use all the CRSP stocks with at least 48 monthly observations over the last 60 months, and exclude penny stocks with prices below $1.

τ	Low	2	3	4	5	6	7	8	9	High	H - L	t-stat	α	t-stat
							Equal-weighted							
0.1	6.09	7.97	7.92	9.28	9.06	9.71	9.37	9.51	10.35	10.13	4.05	3.01	4.04	2.71
0.15	6.09	7.76	8.73	8.87	9.03	8.93	10.16	9.51	10.28	10.02	3.92	2.75	3.85	2.52
0.2	5.63	8.49	8.14	9.01	9.46	9.27	9.53	9.70	10.08	10.11	4.48	3.14	4.60	2.83
0.3	5.43	8.40	8.30	8.95	9.18	9.92	9.26	9.76	10.30	9.94	4.51	3.19	4.34	2.83
0.4	5.57	8.76	8.64	8.94	9.10	9.40	9.22	10.10	10.09	9.60	4.03	2.70	3.60	2.26
0.5	6.77	9.69	9.26	9.66	9.37	9.56	9.20	9.31	9.09	7.48	0.71	0.44	-0.10	-0.05
0.6	6.16	10.00	9.56	9.35	9.63	9.11	9.93	8.70	9.32	7.66	1.49	0.96	0.14	0.09
0.7	6.52	8.93	9.40	9.65	8.81	9.07	9.34	9.37	9.19	9.13	2.61	2.05	1.44	1.06
0.8	7.74	9.21	9.36	9.34	8.94	8.93	8.47	9.11	9.41	8.87	1.14	0.89	-0.20	-0.14
0.85	7.68	9.10	9.06	8.86	9.16	9.03	8.99	9.61	9.02	8.86	1.18	0.87	0.11	0.07
0.9	7.89	9.45	8.89	9.14	9.10	9.15	9.25	8.81	9.17	8.54	0.65	0.45	-0.67	-0.42
							Value-weighted							
0.1	5.29	5.82	5.55	6.07	5.99	5.53	6.95	8.12	8.23	9.80	4.52	2.19	4.13	2.05
0.15	4.67	6.12	6.37	5.26	5.85	6.43	7.30	7.18	8.11	9.39	4.72	2.25	4.68	2.34
0.2	5.07	7.21	4.98	6.92	5.44	6.08	6.68	7.12	8.12	9.58	4.51	2.21	4.86	2.24
0.3	5.02	7.02	5.90	6.50	5.69	6.38	6.73	5.82	8.31	9.39	4.37	2.07	4.59	2.07
0.4	4.30	7.02	5.77	7.04	5.49	6.64	6.44	6.80	8.11	8.12	3.82	1.79	4.36	2.14
0.5	5.68	4.80	5.62	6.10	6.48	5.73	7.78	6.83	7.39	5.35	-0.33	-0.15	-0.85	-0.36
0.6	4.58	5.94	5.69	5.02	6.87	5.48	7.78	7.26	7.93	6.09	1.51	0.72	-0.18	-0.09
0.7	6.06	6.11	6.97	6.68	5.82	7.08	5.77	5.94	7.03	7.59	1.52	0.72	1.24	0.59
0.8	4.64	7.20	6.13	5.54	6.63	7.16	5.28	5.47	6.90	7.14	2.50	1.21	1.56	0.71
0.85	4.62	6.71	6.46	6.13	6.58	5.48	6.22	6.78	6.82	6.36	1.74	0.89	0.56	0.27
0.9	3.65	8.45	6.12	5.74	5.33	6.92	6.01	7.41	5.90	7.13	3.48	1.59	1.64	0.74

ΔCIQ(τ) factors. Every month, we first sort the stocks into ten portfolios based on their PCA-SQ betas. Then, within each of the PCA-SQ-sorted portfolios, we sort the stocks into ten portfolios based on their CIQ(τ) betas. Finally, for each CIQ(τ) portfolio, we collapse all the corresponding CIV portfolios into one CIQ(τ) portfolio. This procedure yields single-sorted portfolios which vary in their CIQ(τ) betas but possess approximately equal PCA-SQ betas. The obtained results summarizes Table 19. For the equal-weighted portfolios, we see that the risk premium captured by the returns of the high minus low portfolios for $\tau \leq 0.4$ remains significant with an annualized return of 4.48% ($t = 3.14$) for $\tau = 0.2$. In case of the value-weighted portfolios, the return remain close to the equal-weighted case with return of 4.51% for $\tau = 0.2$ ($t = 2.21$.). These observations suggest that the CIQ(τ) risk premium captures risk that is not explained to the common volatility as described by the PCA-SQ model.

The portfolio results show that holding risk associated with the common idiosyncratic downside risk is rewarded by a significant premium. On the other hand, exposure to the common idiosyncratic upside potential is not related to robust pricing consequences. In Appendix A in Tables 23, 24, 25, and 26, we provide results of the same analysis using five portfolios instead of ten. The results are qualitatively very similar to the results from the above, confirming the robustness of our claim that the exposure to the common left tail events is priced in the cross-section of returns.

Finally, we repeat the exercise on the simulated universe of stocks. We simulate stocks from the location scale model to see that the risk factors are not quantile dependent and all come from volatility. At the same time, the exercise will show that the choice of a small sample in the moving window does not bias the results. The detailed discussion in Appendix A.2 shows that the premia associated with the exposures to the different quantile levels on the simulated data are the same in magnitude as the exposures to the PCA-SQ factors. The risk premia have identical significance and are constant across quantiles (with opposite signs for downside and upside). Therefore, if the returns were generated by the location scale model, the quantile risk would be equivalent across quantiles and would be captured by the volatility risk.

5.4 Beyond CIQ(τ) Betas

In this subsection, we extend the CIQ betas to further demonstrate the importance of considering quantile-specific risks and their heterogeneous implications. In particular, we have two objectives. First, we specifically capture additional information beyond median dependence from the lower and upper parts of the distribution, respectively, and define *relative* CIQ betas as

$$\beta_i^{rel}(\tau) := \beta_i(\tau) - \beta_i(0.5).$$

The results of the portfolio sorts based on relative betas are summarized in Table 20. These results are in the spirit of the CIQ betas' results presented above. The high minus low portfolio sorted on $\beta^{rel}(0.2)$ yields annual 5.94% excess return (t = 3.22) with 6-factor α = 6.45 (t = 3.17) for the equal-weighted portfolio. In the case of the value-weighted portfolios, we obtain annual return of 6.89% ($t = 2.72$) and $\alpha = 7.12$ ($t = 2.74$).

Second, because there is a little theory on which τ to choose when investing based on the exposure to the CIQ(τ) factors, similar to the case of market return prediction, we want to provide a way to aggregate the information from the downside and upside factors into compressed measures. To summarise the dependence across the entire lower or upper part

Table 20: Portfolios sorted on relative ΔCIQ(τ) betas

The table contains annualized out-of-sample excess returns of ten portfolios sorted on relative ΔCIQ(τ) betas. We report returns of the high minus low (H - L) portfolios, their t-statistics, and annualized 6-factor alphas with respect to the four factors of Carhart (1997), CIV shocks of Herskovic et al. (2016), and BAB factor of Frazzini and Pedersen (2014). We also report t-statistics for these alphas. The data cover the period from January 1963 to December 2018. Each month, we use all the CRSP stocks with at least 48 monthly observations over the last 60 months, and exclude penny stocks with prices below $1.

τ	Low	2	3	4	5	6	7	8	9	High	H - L	t-stat	α	t-stat
							Equal-weighted							
0.1	5.00	7.68	8.41	8.97	8.83	9.55	9.80	10.73	10.56	9.81	4.81	2.71	4.66	2.37
0.15	4.32	7.89	8.76	9.13	9.55	9.19	10.33	10.08	10.05	10.04	5.73	3.16	5.75	2.93
0.2	4.37	7.54	8.73	9.19	8.93	9.85	10.63	10.09	9.71	10.31	5.94	3.22	6.45	3.17
0.3	4.51	7.01	8.43	9.31	10.06	9.66	10.19	10.11	10.00	10.08	5.57	3.17	5.96	3.28
0.4	4.57	8.03	8.52	9.22	9.75	9.85	9.33	9.96	10.43	9.69	5.11	3.22	5.14	3.20
0.5	6.77	9.01	9.95	9.38	9.29	9.48	9.61	9.73	9.11	7.02	0.25	0.14	-0.84	-0.41
0.6	7.52	8.96	8.37	9.53	9.18	10.06	8.89	9.76	9.45	7.64	0.13	0.09	-1.27	-0.84
0.7	6.55	9.44	9.47	8.58	9.33	8.87	9.52	9.19	9.76	8.63	2.09	1.56	0.18	0.12
0.8	8.25	9.09	9.40	8.99	8.68	9.41	9.39	8.89	9.09	8.15	-0.10	-0.07	-1.94	-1.17
0.85	8.30	9.37	9.20	9.32	9.10	8.81	9.46	9.30	8.65	7.82	-0.48	-0.29	-1.88	-1.03
0.9	8.38	9.19	9.54	9.13	9.18	9.53	9.10	9.07	9.00	7.23	-1.15	-0.63	-2.45	-1.31
							Value-weighted							
0.1	3.83	4.53	6.11	6.53	6.49	6.33	6.95	8.51	9.70	8.48	4.66	1.97	2.96	1.29
0.15	4.00	4.72	6.40	6.60	7.20	6.30	7.03	7.39	9.33	9.12	5.11	2.04	4.75	1.94
0.2	2.79	6.25	6.36	6.38	6.61	7.11	7.12	7.23	8.59	9.68	6.89	2.72	7.12	2.74
0.3	3.47	6.24	5.64	6.02	7.85	6.96	6.89	6.53	8.18	9.66	6.19	2.33	6.83	2.50
0.4	3.69	6.37	6.24	6.53	7.16	6.83	6.09	6.27	7.96	8.99	5.30	2.06	7.35	2.87
0.5	3.89	5.44	5.37	5.45	6.36	7.28	7.65	6.36	4.89	7.08	3.19	1.42	3.72	1.42
0.6	5.93	5.56	5.97	5.30	5.70	5.80	6.53	7.13	7.77	6.82	0.89	0.39	0.23	0.08
0.7	4.40	6.63	5.92	7.42	6.85	7.24	5.54	5.88	6.68	7.34	2.94	1.26	2.02	0.77
0.8	5.38	7.48	5.50	6.67	6.78	6.74	6.51	6.12	5.01	6.45	1.07	0.43	0.65	0.25
0.85	5.07	7.05	6.70	6.34	6.51	6.51	6.75	6.29	5.63	5.54	0.48	0.18	0.75	0.29
0.9	4.96	6.84	6.30	6.58	6.26	6.76	6.87	5.37	5.72	5.57	0.62	0.22	1.53	0.55

of the factor structure, we define *downside* and *upside* CIQ betas as

$$\beta_i^{down} := \sum_{\tau \in \tau_{down}} F\big(\beta_i(\tau)\big)$$
$$\beta_i^{up} := \sum_{\tau \in \tau_{up}} F\big(\beta_i(\tau)\big)$$

where $F\big(\beta_i(\tau)\big) = \frac{Rank(\beta_i(\tau))}{N_t+1}$. We obtain the downside and upside CIQ betas as an average cross-sectional rank of the CIQ betas for the downside and upside τs, respectively. Results of the portfolio sorts based on those betas are summarized in Table 21. We can see that the long-short portfolios sorted on downside CIQ betas provide significant excess returns of 5.19% ($t = 3.02$) and 6.44% ($t = 2.48$) annual returns using equal- and value-weighted schemes, respectively. On the other hand, an investment strategy based on upside beta does not yield significant abnormal returns using either weighting approach.

To summarize the relative betas through the whole downside or upside parts of the joint

Table 21: Ten univariate sorted portfolios on combination CIQ betas

The table contains annualized out-of-sample excess returns of ten portfolios sorted on downside (upside) and relative downside (upside) CIQ betas. We use all the CRSP stocks that have at least 48 monthly observations in each 60-month window. We report returns of the high minus low (H - L) portfolios, their t-statistics, and annualized 6-factor alphas with respect to the four factors of Carhart (1997), CIV shocks of Herskovic et al. (2016), and BAB factor of Frazzini and Pedersen (2014). The data cover the period from January 1963 to December 2018. Each month, we use all the CRSP stocks with at least 48 monthly observations over the last 60 months, and exclude penny stocks with prices below $1.

Weighting	Variable	Low	2	3	4	5	6	7	8	9	High	H - L	t-stat	α	t-stat
Equal	β^{down}	4.71	7.20	8.54	9.23	9.48	10.20	9.26	10.49	10.34	9.90	5.19	3.02	5.66	3.19
	β^{up}	7.73	9.45	9.54	8.73	9.23	9.08	9.43	9.30	8.56	8.30	0.57	0.36	-1.43	-0.79
	$\beta^{down,rel}$	4.33	7.68	8.47	8.97	9.71	9.78	10.10	9.90	10.07	10.34	6.02	3.25	6.43	3.26
	$\beta^{up,rel}$	8.58	9.04	8.89	8.87	9.26	9.05	9.07	9.03	9.24	8.31	-0.27	-0.18	-2.00	-1.23
Value	β^{down}	3.08	6.41	5.90	5.85	5.72	8.06	6.96	7.59	8.31	9.52	6.44	2.48	7.15	2.88
	β^{up}	4.72	6.57	5.02	6.59	7.11	7.21	6.53	5.57	5.50	7.51	2.79	1.17	2.38	0.96
	$\beta^{down,rel}$	2.97	6.35	5.79	6.47	6.85	6.73	7.53	6.61	8.38	10.37	7.40	2.90	7.52	2.91
	$\beta^{up,rel}$	5.60	7.08	6.71	5.39	7.38	6.51	6.58	6.10	5.36	6.64	1.04	0.43	0.32	0.13

structure, we introduce *downside* and *upside relative* betas

$$\beta_i^{down,rel} := \sum_{\tau \in \tau_{down}} F\big(\beta_i^{rel}(\tau)\big),$$
$$\beta_i^{up,rel} := \sum_{\tau \in \tau_{up}} F\big(\beta_i^{rel}(\tau)\big),$$

which are obtained as a mean cross-sectional rank of the relative betas associated with the exposure to the downside or upside CIQ(τ) factors, respectively. The associated returns are also summarized in Table 21. Similarly as in the case of the relative betas, downside relative betas provide investment strategy with significant abnormal returns of 6.02% ($t = 3.25$) and 7.40% ($t = 2.90$) on an annual basis using equal- or value-weighted returns, respectively. The returns of the portfolios based on relative upside betas remain insignificant.

6 Conclusion

We investigate the pricing implications of the exposures to the common idiosyncratic quantile factors. These factors capture non-linear common movements in various parts of the distributions across a large panel of stocks. Similarly, as the quantile regression extends the classical linear regression, our quantile factor model of asset returns extends the approximate factor models used in empirical asset pricing literature. We show that the downside quantile factors can robustly predict the market return out-of-sample. We also provide evidence that the expected returns are associated with the exposures to the downside common movements in contrast to the upside movements. Importantly, the quantile dependent factors provide richer information to investors in comparison to other downside risk or volatility factors. We perform various robustness checks to show that these results are not attributable to other previously proposed risk factors. Most notably, we aim to prove that the common volatility does not drive the results.

Future research may focus on better interpretability of the quantile factor models using the characteristics-based quantile factor model proposed by Chen et al. (2023). This investigation may identify which stock characteristics are related to the exposure to common downside events. From a theoretical perspective, future endeavors could explore the link between theoretical quantile asset pricing models, such as the model of Ramos et al. (2020), and quantile factor models. Furthermore, an important direction may extend the arbitrage pricing theory into the quantile domain in the spirit of Renault et al. (2022).

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A Appendix A

Table 22: Correlations between standardized CIQ(τ) and non-linear factors

The table reports correlations between CIQ(τ) factors estimated on volatility standardised returns and factors related to the asymmetric and variance risk. The data cover the period from January 1960 to December 2018.

variable / τ	0.1	0.15	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.85	0.9
Panel A: *Levels of factors*											
PCA-SQ	-0.68	-0.66	-0.59	-0.47	-0.23	0.06	0.12	0.44	0.61	0.65	0.70
CIV	-0.29	-0.26	-0.24	-0.16	-0.03	0.04	0.07	0.19	0.28	0.28	0.30
TR	0.07	0.07	0.06	0.02	-0.04	-0.02	-0.04	-0.19	-0.19	-0.19	-0.17
VRP	0.04	0.05	0.06	0.07	0.10	-0.08	-0.03	0.03	0.03	0.00	0.01
VIX	-0.17	-0.15	-0.11	-0.01	0.16	0.08	0.13	0.30	0.33	0.30	0.28
Panel B: *Differences of factors*											
PCA-SQ	-0.54	-0.50	-0.44	-0.32	-0.11	0.17	0.17	0.35	0.51	0.55	0.60
CIV	-0.20	-0.17	-0.17	-0.12	-0.06	0.06	0.07	0.11	0.15	0.15	0.13
TR	0.11	0.09	0.09	0.04	-0.03	-0.03	-0.03	-0.24	-0.26	-0.27	-0.25
VRP	0.14	0.12	0.10	0.07	0.02	-0.05	-0.03	-0.06	-0.07	-0.11	-0.10
VIX	0.20	0.23	0.23	0.22	0.22	0.07	0.10	0.10	0.05	0.01	-0.06

Table 23: Portfolios sorted on the exposure to the ΔCIQ(τ) factors

The table contains annualized out-of-sample excess returns of five portfolios sorted on the exposure to the ΔCIQ(τ) factors. We report returns of the high minus low (H - L) portfolios, their t-statistics, and annualized 6-factor alphas with respect to the four factors of Carhart (1997), CIV shocks of Herskovic et al. (2016), and BAB factor of Frazzini and Pedersen (2014). We also report t-statistics for these alphas. The data cover the period from January 1963 to December 2018. Each month, we use all the CRSP stocks with at least 48 monthly observations over the last 60 months, and exclude penny stocks with prices below \$1.

τ	Low	2	3	4	High	H - L	t-stat	α	t-stat
				Equal-weighted					
0.1	6.38	8.69	9.11	10.32	10.17	3.78	2.59	4.36	2.79
0.15	6.10	8.91	9.49	10.23	9.94	3.85	2.58	4.65	3.05
0.2	5.90	9.08	9.62	10.09	9.99	4.08	2.78	5.20	3.47
0.3	5.97	8.82	9.79	10.21	9.88	3.90	2.81	4.89	3.56
0.4	6.38	9.11	9.34	10.29	9.56	3.19	2.55	4.00	3.22
0.5	7.89	9.67	9.38	9.67	8.07	0.18	0.14	-0.04	-0.03
0.6	7.80	9.46	9.70	9.52	8.19	0.39	0.30	-0.55	-0.42
0.7	7.56	9.49	9.10	9.47	9.06	1.50	1.31	0.29	0.22
0.8	8.69	9.23	9.11	9.07	8.57	-0.12	-0.10	-1.37	-0.98
0.85	8.66	9.26	9.21	9.24	8.30	-0.36	-0.26	-1.59	-1.07
0.9	8.91	9.14	9.35	9.11	8.16	-0.75	-0.48	-1.83	-1.22
				Value-weighted					
0.1	4.74	6.10	6.63	7.58	9.16	4.42	2.20	4.26	2.24
0.15	4.36	6.13	6.71	7.38	9.08	4.72	2.39	5.40	2.90
0.2	4.98	6.07	6.75	7.15	9.07	4.09	2.09	5.39	3.05
0.3	5.06	5.87	7.00	6.82	8.03	2.97	1.57	4.43	2.59
0.4	5.14	5.96	6.83	6.71	7.57	2.42	1.36	4.40	2.53
0.5	4.67	5.44	6.80	7.07	5.43	0.77	0.46	0.90	0.45
0.6	5.24	4.85	6.51	7.64	6.11	0.87	0.50	-0.16	-0.09
0.7	4.96	7.37	6.52	6.08	6.75	1.79	1.06	1.48	0.84
0.8	6.11	6.13	6.69	6.28	5.99	-0.11	-0.06	-0.49	-0.28
0.85	6.12	6.31	6.58	6.50	5.92	-0.20	-0.11	-0.39	-0.22
0.9	5.92	6.18	6.91	5.90	5.86	-0.06	-0.03	-0.20	-0.11

Table 24: Dependent bivariate sorts on ΔCIQ(τ) and PCA-SQ exposures

The table contains annualized out-of-sample excess returns of five portfolios sorted on the exposure to the ΔCIQ(τ) and PCA-SQ factor. Exposure to the PCA-SQ factor are approximately same across the portfolios. We report returns of the high minus low (H - L) portfolios, their t-statistics, and annualized 6-factor alphas with respect to the four factors of Carhart (1997), CIV shocks of Herskovic et al. (2016), and BAB factor of Frazzini and Pedersen (2014). We also report t-statistics for these alphas. The data cover the period from January 1963 to December 2018. Each month, we use all the CRSP stocks with at least 48 monthly observations over the last 60 months, and exclude penny stocks with prices below $1.

τ	Low	2	3	4	High	H - L	t-stat	α	t-stat
					Equal-weighted				
0.1	6.91	8.58	9.39	9.77	10.02	3.11	2.78	3.22	2.57
0.15	7.03	8.64	9.39	9.68	9.93	2.90	2.57	2.97	2.44
0.2	6.84	8.65	9.61	9.46	10.12	3.28	2.91	3.63	2.91
0.3	6.84	8.55	9.81	9.43	10.04	3.20	2.86	3.42	2.84
0.4	7.03	8.98	9.19	9.85	9.63	2.60	2.29	2.69	2.22
0.5	8.07	9.61	9.35	9.37	8.27	0.20	0.16	-0.33	-0.25
0.6	8.07	9.59	9.35	9.30	8.36	0.30	0.24	-0.75	-0.60
0.7	7.59	9.68	8.90	9.31	9.19	1.59	1.59	0.93	0.86
0.8	8.28	9.58	8.81	8.95	9.06	0.78	0.80	-0.03	-0.03
0.85	8.36	9.05	8.97	9.63	8.67	0.30	0.31	-0.50	-0.44
0.9	8.49	9.10	9.27	9.23	8.59	0.11	0.09	-0.85	-0.70
					Value-weighted				
0.1	5.43	5.79	6.05	6.96	8.58	3.15	2.07	2.20	1.68
0.15	5.58	6.15	5.90	7.25	7.77	2.19	1.43	1.76	1.24
0.2	6.08	5.88	5.97	6.80	7.91	1.83	1.30	1.95	1.42
0.3	6.21	6.09	6.25	6.22	8.04	1.83	1.23	2.11	1.50
0.4	5.56	6.56	6.15	6.75	7.08	1.51	0.96	1.99	1.30
0.5	5.15	5.58	6.25	7.02	6.42	1.27	0.80	0.28	0.16
0.6	5.55	5.27	6.08	7.41	7.22	1.67	0.99	0.19	0.11
0.7	6.01	6.41	6.58	5.68	7.56	1.55	0.98	0.55	0.39
0.8	5.77	6.12	6.28	6.15	6.65	0.88	0.59	-0.56	-0.37
0.85	5.81	6.12	6.53	6.29	6.48	0.67	0.49	-0.59	-0.40
0.9	5.15	6.63	6.36	6.49	6.71	1.56	0.97	0.05	0.03

Table 25: Portfolio results with 1-year holding period

The table summarizes returns of the CIQ(τ) portfolios which are held for one year after their formation. The returns are value-weighted. The data cover the period from January 1963 to December 2018. Each month, we use all the CRSP stocks with at least 48 monthly observations over the last 60 months, and exclude penny stocks with prices below $1.

τ	Low	2	3	4	High	H - L	t-stat
			Panel A: 1-year holding period				
0.1	4.78	6.01	6.23	7.26	8.25	3.47	2.71
0.15	4.83	6.14	6.28	7.22	7.86	3.04	2.34
0.2	5.12	6.05	6.18	7.10	7.77	2.65	2.12
0.3	4.95	6.11	6.43	6.74	7.41	2.45	2.10
0.4	4.77	6.41	6.42	6.43	6.69	1.91	1.79
0.5	5.10	5.80	6.56	6.72	5.47	0.37	0.34
0.6	5.14	5.95	6.46	6.65	5.38	0.25	0.22
0.7	5.41	5.97	6.74	6.32	6.34	0.93	0.79
0.8	5.72	5.86	6.84	6.41	5.98	0.26	0.21
0.85	5.50	5.92	6.63	6.55	5.87	0.38	0.29
0.9	5.47	5.83	6.52	6.57	5.98	0.51	0.38
			Panel B: Without next month				
0.1	4.80	6.04	6.18	7.31	8.19	3.39	2.61
0.15	4.88	6.17	6.18	7.26	7.82	2.93	2.21
0.2	5.20	6.05	6.14	7.07	7.77	2.57	1.99
0.3	5.01	6.13	6.38	6.74	7.46	2.44	2.02
0.4	4.82	6.47	6.42	6.42	6.66	1.84	1.67
0.5	5.22	5.87	6.55	6.67	5.51	0.29	0.25
0.6	5.15	6.14	6.43	6.56	5.40	0.25	0.22
0.7	5.51	5.86	6.77	6.37	6.33	0.82	0.67
0.8	5.75	5.86	6.82	6.46	6.00	0.25	0.20
0.85	5.50	5.91	6.61	6.58	5.92	0.42	0.31
0.9	5.47	5.80	6.49	6.65	6.05	0.58	0.41

Table 26: Alphas of zero-cost portfolios obtained from quintile sorts

The table reports annualized out-of-sample alphas and their t-statistics of high minus low portfolios from quintile sorts on the exposure to the ΔCIQ(τ) factors. Returns of the portfolios in Panel A are equal-weighted, returns in Panel B are value-weighted. The data cover the period from January 1963 to December 2018. Each month, we use all the CRSP stocks with at least 48 monthly observations over the last 60 months, and exclude penny stocks with prices below $1.

Model/ τ	0.1	0.15	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.85	0.9
						Panel A: Equal-weighted					
CAPM	5.40	7.44	8.06	7.54	6.36	0.64	1.90	2.35	-0.51	-1.47	-2.54
	(3.89)	(4.63)	(5.05)	(5.17)	(4.44)	(0.36)	(1.12)	(1.61)	(-0.32)	(-0.86)	(-1.38)
FF3	4.05	5.66	6.32	5.76	4.69	-0.49	0.33	0.97	-1.28	-2.11	-3.06
	(3.15)	(3.85)	(4.21)	(4.23)	(3.30)	(-0.28)	(0.20)	(0.67)	(-0.83)	(-1.31)	(-1.81)
FF5	4.34	5.12	6.08	5.87	4.99	-0.41	0.02	0.14	-2.00	-2.70	-3.46
	(3.17)	(3.19)	(3.62)	(3.81)	(3.17)	(-0.23)	(0.01)	(0.09)	(-1.26)	(-1.64)	(-2.02)
FF6	4.81	5.65	6.55	6.24	5.31	-0.59	-0.39	-0.05	-2.18	-2.65	-3.33
	(3.34)	(3.29)	(3.65)	(3.92)	(3.57)	(-0.30)	(-0.22)	(-0.03)	(-1.27)	(-1.42)	(-1.72)
FF6 + reversal	4.86	5.72	6.64	6.26	5.16	-1.06	-0.59	-0.12	-1.81	-2.22	-2.79
	(2.88)	(2.91)	(3.23)	(3.51)	(3.25)	(-0.50)	(-0.31)	(-0.07)	(-0.96)	(-1.10)	(-1.34)
						Panel B: Value-weighted					
CAPM	5.83	7.10	9.34	8.39	6.30	3.24	3.19	4.21	1.12	-0.80	-2.13
	(2.86)	(2.92)	(3.84)	(3.42)	(2.65)	(1.41)	(1.38)	(1.68)	(0.44)	(-0.31)	(-0.80)
FF3	3.16	4.32	6.82	6.00	4.01	1.33	0.47	2.21	0.05	-2.03	-3.17
	(1.80)	(1.97)	(3.05)	(2.64)	(1.79)	(0.58)	(0.21)	(0.95)	(0.02)	(-0.88)	(-1.24)
FF5	3.53	4.59	7.64	6.83	5.25	2.59	1.44	3.02	1.88	-0.05	-0.98
	(1.92)	(1.85)	(3.06)	(2.69)	(2.15)	(1.00)	(0.61)	(1.24)	(0.78)	(-0.02)	(-0.37)
FF6	4.22	5.50	8.58	7.87	7.05	3.80	2.44	3.33	2.24	1.11	0.15
	(2.25)	(2.26)	(3.37)	(3.00)	(3.04)	(1.43)	(1.02)	(1.31)	(0.90)	(0.43)	(0.06)
FF6 + reversal	4.18	5.91	9.09	8.33	7.15	3.04	2.26	3.79	2.69	1.87	1.21
	(2.00)	(2.21)	(3.28)	(2.81)	(2.89)	(1.17)	(0.95)	(1.42)	(1.01)	(0.68)	(0.41)

A.1 Other Specifications of the Common Linear Factors

In this section, we illustrate how the specification of the common linear structure affects the asset pricing results of the CIQ factors. We report the portfolio results using five-factor model of Fama and French (2015) and its extension using the momentum factor.[24]

[24] Further results are available on request.

Table 27: Portfolios sorted on the exposure to the $\Delta CIQ(\tau)^{FF5}$ and $\Delta CIQ(\tau)^{FF6}$ factors

The table contains annualized out-of-sample excess returns of ten portfolios sorted on the exposure to the ΔCIQ(τ) factors. We report returns of the high minus low (H - L) portfolios, their t-statistics, and annualized 6-factor alphas with respect to the four factors of Carhart (1997), CIV shocks of Herskovic et al. (2016), and BAB factor of Frazzini and Pedersen (2014). We also report t-statistics for these alphas. The data cover the period from January 1963 to December 2018. Each month, we use all the CRSP stocks with at least 48 monthly observations over the last 60 months, and exclude penny stocks with prices below $1.

τ	Low	2	3	4	5	6	7	8	9	High	H - L	t-stat	α	t-stat
	Panel A: CIQ$(\tau)^{FF5}$													
	Equal-weighted													
0.1	4.60	7.29	8.37	8.85	8.53	9.75	9.29	10.76	9.92	9.32	4.72	2.88	5.41	2.88
0.15	4.35	7.17	8.34	9.45	8.74	8.88	9.93	10.18	10.17	9.45	5.10	3.12	5.88	3.31
0.2	3.84	7.07	7.98	8.82	9.41	9.72	9.99	9.83	10.54	9.47	5.63	3.47	6.43	3.64
0.3	3.85	7.01	7.87	8.97	9.23	9.56	10.20	9.71	10.40	9.85	5.99	3.63	6.59	3.73
0.4	3.83	7.93	8.25	8.53	9.02	9.15	9.71	10.34	10.43	9.48	5.65	3.59	6.07	3.71
0.5	6.26	8.12	8.93	8.76	9.71	9.90	9.34	9.04	9.05	7.54	1.28	0.76	0.45	0.24
0.6	5.79	8.13	9.37	8.49	9.31	9.88	9.04	9.35	9.50	7.80	2.02	1.32	0.59	0.34
0.7	5.64	7.88	8.47	8.92	8.74	9.56	9.38	9.87	9.45	8.74	3.10	2.05	0.96	0.53
0.8	6.77	8.70	9.03	8.79	9.23	8.77	9.54	8.52	9.28	8.01	1.24	0.79	-0.90	-0.49
0.85	6.89	8.72	8.98	9.03	9.27	9.05	9.09	9.00	8.83	7.82	0.93	0.58	-0.68	-0.35
0.9	7.54	9.51	9.30	8.43	9.23	9.31	8.71	9.29	7.98	7.36	-0.17	-0.10	-1.87	-1.00
	Value-weighted													
0.1	3.28	5.68	5.98	6.96	5.94	6.59	5.94	8.11	8.56	8.79	5.51	2.47	6.14	2.47
0.15	3.72	5.57	5.98	6.38	6.28	7.10	6.01	7.64	8.78	10.08	6.36	2.81	7.26	3.03
0.2	3.21	5.35	6.32	6.03	6.43	6.58	7.34	7.21	9.22	9.19	5.99	2.46	7.29	2.87
0.3	2.45	5.86	5.95	5.51	6.60	6.69	7.64	6.82	7.86	10.80	8.35	3.28	10.29	3.88
0.4	1.74	6.73	4.64	5.76	6.68	6.49	7.36	6.76	8.56	10.57	8.83	3.33	9.75	3.49
0.5	4.48	5.57	5.52	4.51	6.74	6.47	7.99	6.24	6.02	9.22	4.75	1.81	5.70	2.00
0.6	4.95	4.82	5.73	5.27	5.98	6.91	7.48	6.11	6.76	7.46	2.51	0.99	2.52	0.87
0.7	3.02	6.41	6.01	6.21	5.65	6.94	7.42	6.14	7.17	7.97	4.95	1.93	3.02	1.06
0.8	3.07	7.24	5.70	5.97	6.72	6.25	6.83	6.27	6.87	6.56	3.49	1.33	2.56	0.92
0.85	3.27	6.87	6.25	6.03	6.06	6.69	6.85	6.71	6.53	5.94	2.68	1.03	2.23	0.86
0.9	5.43	6.14	5.97	5.83	6.52	6.68	6.58	6.12	6.54	5.39	-0.04	-0.02	-0.47	-0.18
	Panel B: CIQ$(\tau)^{FF6}$													
	Equal-weighted													
0.1	6.26	7.45	8.35	9.43	9.01	9.02	9.57	9.74	9.53	8.31	2.05	1.27	3.38	1.77
0.15	5.31	7.19	8.39	9.37	9.27	9.13	9.50	9.67	10.19	8.64	3.33	2.04	4.67	2.39
0.2	4.87	7.17	8.35	9.51	8.46	9.81	9.53	9.69	10.60	8.67	3.80	2.41	4.82	2.58
0.3	4.39	7.56	7.71	9.44	8.84	9.41	9.46	10.31	10.68	8.86	4.48	2.81	4.76	2.70
0.4	4.25	7.85	8.65	9.02	9.29	8.89	10.22	10.01	9.91	8.58	4.33	2.81	4.10	2.53
0.5	5.94	7.35	8.41	9.26	9.77	9.66	9.47	9.38	9.47	7.95	2.00	1.10	0.98	0.45
0.6	5.73	7.66	9.09	8.84	9.37	9.87	8.78	9.63	8.75	8.96	3.23	1.92	2.07	1.15
0.7	5.29	8.73	8.81	9.07	9.01	9.12	9.12	9.26	9.82	8.42	3.13	2.20	0.03	0.02
0.8	6.68	8.22	9.27	8.80	9.45	8.81	9.44	8.82	8.85	8.32	1.64	1.10	-1.25	-0.74
0.85	7.19	8.23	8.96	9.17	9.53	9.10	8.66	9.11	8.75	7.96	0.77	0.52	-2.20	-1.30
0.9	6.93	8.94	8.57	8.96	9.45	9.54	8.69	9.40	8.38	7.80	0.87	0.58	-2.02	-1.15
	Value-weighted													
0.1	4.93	5.43	6.58	6.70	6.47	6.06	6.89	7.21	7.40	8.03	3.10	1.34	3.98	1.44
0.15	4.19	6.03	6.82	5.89	5.77	7.13	7.18	7.54	8.44	7.93	3.74	1.72	5.21	2.05
0.2	3.97	6.55	6.57	6.36	6.30	6.90	7.45	7.21	8.90	8.25	4.28	1.92	5.11	2.13
0.3	3.93	5.19	5.96	6.47	5.88	7.68	8.24	6.42	8.19	8.65	4.72	2.12	5.37	2.12
0.4	3.71	5.83	4.67	6.28	7.86	6.16	6.86	6.95	7.12	7.99	4.27	1.90	5.09	1.97
0.5	5.35	5.42	5.95	7.05	6.38	5.68	6.93	7.93	5.48	6.13	0.78	0.30	0.41	0.14
0.6	5.89	6.28	6.31	6.44	5.96	5.22	6.82	6.78	5.61	7.23	1.35	0.57	0.60	0.22
0.7	3.53	7.07	6.63	6.76	5.76	5.44	6.88	6.24	6.25	8.10	4.56	1.91	1.36	0.52
0.8	3.99	6.59	7.19	6.76	6.15	5.43	7.54	6.63	6.21	6.45	2.46	1.12	0.39	0.17
0.85	5.29	6.78	6.63	7.18	5.99	6.76	6.62	6.44	6.20	5.64	0.35	0.15	-1.50	-0.63
0.9	5.05	6.98	6.66	6.69	6.62	7.23	5.78	6.52	5.47	5.88	0.82	0.36	-1.43	-0.61

Table 28: Post-ranking ΔCIQ(τ) portfolio betas and their t-statistics

Post-formation betas of the value-weighted portfolios sorted on the exposure to the ΔCIQ(τ) factors. The data cover the period from January 1963 to December 2018. Each month, we use all the CRSP stocks with at least 48 monthly observations over the last 60 months, and exclude penny stocks with prices below \$1.

τ	Low	2	3	4	5	6	7	8	9	High
0.1	-1.19	-0.92	-0.79	-0.78	-0.74	-0.67	-0.60	-0.58	-0.77	-0.80
	(-6.17)	(-5.70)	(-5.97)	(-6.33)	(-6.25)	(-6.12)	(-5.61)	(-5.10)	(-6.03)	(-4.72)
0.15	-1.20	-0.99	-0.81	-0.79	-0.71	-0.67	-0.66	-0.55	-0.76	-0.81
	(-6.59)	(-7.01)	(-6.16)	(-6.33)	(-6.35)	(-5.81)	(-6.71)	(-5.04)	(-7.28)	(-4.58)
0.2	-1.16	-0.96	-0.79	-0.72	-0.67	-0.57	-0.61	-0.54	-0.60	-0.80
	(-6.66)	(-7.15)	(-6.22)	(-5.84)	(-6.01)	(-4.54)	(-6.94)	(-4.88)	(-6.59)	(-4.77)
0.3	-0.86	-0.69	-0.60	-0.52	-0.47	-0.45	-0.37	-0.38	-0.43	-0.62
	(-6.06)	(-6.60)	(-6.08)	(-4.82)	(-4.44)	(-4.51)	(-3.76)	(-4.29)	(-5.46)	(-4.47)
0.4	-0.42	-0.36	-0.28	-0.26	-0.21	-0.20	-0.18	-0.16	-0.20	-0.29
	(-5.44)	(-5.61)	(-4.83)	(-4.28)	(-3.45)	(-3.62)	(-3.18)	(-2.93)	(-3.75)	(-3.17)
0.5	-0.11	-0.07	-0.05	-0.05	-0.04	-0.03	-0.03	-0.02	-0.01	-0.01
	(-4.25)	(-3.96)	(-3.27)	(-2.85)	(-2.68)	(-2.00)	(-1.94)	(-1.25)	(-0.65)	(-0.38)
0.6	-0.12	-0.09	-0.07	-0.05	-0.05	-0.03	-0.02	-0.02	-0.02	-0.01
	(-4.68)	(-4.41)	(-4.11)	(-3.30)	(-3.20)	(-2.17)	(-1.43)	(-1.16)	(-1.00)	(-0.49)
0.7	-0.20	-0.22	-0.16	-0.12	-0.08	-0.06	0.01	0.01	-0.02	-0.13
	(-1.68)	(-2.60)	(-2.06)	(-1.67)	(-1.15)	(-0.77)	(0.09)	(0.19)	(-0.23)	(-1.04)
0.8	-0.07	-0.09	-0.01	0.09	0.11	0.17	0.17	0.18	0.27	0.08
	(-0.44)	(-0.70)	(-0.15)	(0.96)	(1.19)	(1.77)	(1.72)	(1.62)	(2.04)	(0.37)
0.85	0.02	0.11	0.14	0.23	0.27	0.31	0.32	0.37	0.41	0.35
	(0.14)	(0.91)	(1.40)	(2.33)	(2.59)	(3.05)	(2.97)	(2.90)	(2.93)	(1.40)
0.9	0.22	0.31	0.32	0.44	0.52	0.49	0.58	0.52	0.71	0.67
	(1.53)	(2.70)	(3.07)	(4.33)	(4.97)	(4.52)	(4.77)	(3.86)	(4.59)	(2.58)

A.2 Simulation Study

We present a simulation exercise to illustrate how the CIQ(τ) premiums would look like if the driving force behind them were simply common volatility. We simulate the returns from the following model

$$r_{i,t} = \alpha_i + \beta_i r_{m,t} + \gamma_i (V_t - \bar{V}) - \gamma_i \lambda^V + e_{i,t} \tag{18}$$

where V_t is the common variance factor, and the variance of the idiosyncratic error follows the factor structure proposed by Ding et al. (2022)

$$\begin{aligned} e_{i,t} &= \sqrt{V_{i,t}} z_{i,t}, \\ V_{i,t} &= V_t \exp(\mu_i + \sigma_i u_{i,t}) = V_t \tilde{V}_{i,t}, \\ z_{i,t},\, u_{i,t} &\sim i.i.d.\, N(0,1). \end{aligned} \tag{19}$$

Time-series variation of the returns drive two common factors – market factor, $r_{m,t}$, and variance factor V_t. The expected return of a stock is then equal to

$$\mathbb{E}[r_i] = \alpha_i + \beta_i \mathbb{E}[r_m] + \gamma_i \lambda^V. \tag{20}$$

We assume that the market factor follows a simple GARCH(1,1) process of Bollerslev (1986), which we fit on the market return from the empirical analysis. We assume that the log of the variance factor follows a modified HAR model of Corsi (2009)

$$\begin{aligned} \log V_{t+1} &= \theta_0 + \theta_m x_t^m + \theta_y x_t^y + v_{t+1} \\ v_{t+1} &\sim i.i.d.\, N(0, \sigma_v^2) \end{aligned} \tag{21}$$

where x_t^m and x_t^y are the previous month's log-variance and average log-variance over the last 12-month period, respectively. The common variance process is approximated by the cross-sectional average of the squared residuals from the time series regression of stock returns on the market factor. We fit the model from equation 21 on this time series. When simulating this time series, we initialize the process by randomly selecting 12 consequent observations of the common variance process estimated from the data and using those observations for iterating forward.

We calibrate the simulation setting to match the CRSP data sample we employ in the empirical investigation. We estimate stock-level market beta, β_i, using time-series regression of stock return on the market return. Exposure to the common variance, γ_i, is estimated by regressing the stock return on the estimate of the common variance process. Price of risk associated with the variance exposure, λ^V is chosen to be equal to 3×10^{-3}.[25] We estimate stock-level parameters of the idiosyncratic error variance–μ_i, σ_i–as the sample mean and standard deviation of $\log \tilde{V}_{i,t}$. To approximate the $\tilde{V}_{i,t}$, we use squared residuals from the time-series regression of the stock return on the market return. Then, to simulate these parameters, we approximate their distribution by normal distribution, with the mean equal to the estimates' cross-sectional average and the variance equal to the cross-sectional variance of the estimates.

We simulate the panel of 2,500 stocks with 120 observations. We repeat the simulation 1,000 times. Each time, we simulate stock returns by randomly choosing parameters for the stock-level process from the normal distribution with mean and variance corresponding to their sample counterparts. We remove the common time variation in stock returns by first forming the common linear factor

$$f_t = \frac{1}{N} \sum_{i=1}^{N} r_{i,t}, \quad t = 1, \ldots, T \tag{22}$$

and then regressing the returns on this factor

$$r_{i,t} = \alpha_i + \hat{\beta}_i f_t + \hat{e}_{i,t}, \tag{23}$$

which yields the residuals $\hat{e}_{i,t}$. Those residuals are then used to form the common volatility and quantile factors. We construct the volatility factor as the first principal component of those squared residuals. ΔCIQ(τ) factors are estimated as discussed in Section 2. Exposures to those factors are then estimated using univariate time-series regressions of stock returns on the increments of the volatility or quantile factors, respectively.

Similarly, as in the empirical investigation, we sort stocks into decile portfolios based on their estimated exposure to the factors to infer the associated risk premiums. We proxy the premiums by computing high minus low returns of the portfolios. Table 29 reports the average premiums for all the CIQ(τ) factors. We observe that the premium is positive for the downside values of τ, negative for the upside ones and insignificant for the median. The magnitude of the premiums is comparable across all τ and, on average, in absolute value equal to 9.44%. The premium associated with the exposure to the PCA-SQ factor is -6.09%. We also compute associated t-statistics as a ratio between average premium and its standard deviation across all the simulations. All the premiums except for the median value

[25] This value corresponds to approximately 6% annual high minus low premium obtained from ten portfolios portfolios sorted on the exposure to the common variance. The choice of this value is not essential for the results that we present here.

Table 29: Simulated risk premia

The table contains risk average premiums computed from high minus low returns of decile portfolios sorted on exposure to the CIQ(τ) risks. We simulate the returns using common variance factor model proposed by Ding et al. (2022). We simulate panel of 2,500 stocks with 120 monthly observations. We perform the simulation 1,000 times. t-statistics are obtained by dividing the average premium by its standard deviation. We also report proportion of rejections of non-significance of CIQ(τ) betas from multivariate cross-sectional regressions of average returns on those betas and market betas.

τ	Premium	t-stat	Rejections
0.1	9.34	2.62	0.96
0.15	9.37	2.56	0.96
0.2	9.38	2.51	0.96
0.3	9.50	2.54	0.97
0.4	9.37	2.26	0.96
0.5	0.35	0.03	0.96
0.6	-9.61	-2.70	0.96
0.7	-9.60	-2.72	0.96
0.8	-9.52	-2.67	0.96
0.85	-9.42	-2.58	0.96
0.9	-9.35	-2.56	0.96

are significant, with values around 2.6 in absolute value. The t-value associated with the PCA-SQ factor is -2.33. Next, we present the proportion of rejections of non-significance of CIQ(τ) betas at a 5% significance level from multivariate cross-sectional regressions of average returns on those betas and market betas. We can see that the proportions are virtually identical for both upside and downside betas of around 96%. The ratio for the PCA-SQ betas is 90%.

As we can see from the results, if there was a common volatility element present in the return, which is compensated in the cross-section, the CIQ(τ) risk premium would be symmetrical around the median. Moreover, the exposure to the PCA-SQ factor would be priced in this case. Overall, the evidence from the simulation exercise suggests that the CIQ(τ) risk premiums we observe in the data are not attributable to the common volatility compensation.