Abstract

Under the premise that stock return is not only explained by systematic risk, idiosyncratic risk can be priced as well. Previous research has shown that idiosyncratic risk is positively related with stock return. This study investigates whether idiosyncratic risk can explain stock return in Indonesian Stock Market from period of 2009 to 2019. It employed EGARCH models with Fama French Three Factors as the mean process to estimate expected idiosyncratic volatility. The findings showed a positive and significant relation between stock return and expected idiosyncratic volatility. However, the effect is not as profound after adjusting for time effect. In addition, the study also showed the relation between stock return and expected idiosyncratic volatility with different mean processes. Interestingly, significance level is increasing under all other mean processes while maintaining its positive sign. ANOVA test was conducted as well and showed that expected idiosyncratic volatility with different mean processes are statistically different from each other.

Keywords: Idiosyncratic risk, Stock returns, EGARCH, Fama French Three Factors, Indonesian Stock Market