The Cross-Section of Credit, Variance, and Skew Risk∗

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January 2014

∗Paul Schneider acknowledges support from the Swiss National Science Foundation grant “Trading Asset Pricing Models”, and the Swiss Finance Association grant “Term Structures and Cross-Sections of Asset Risk Premia”. Christian Wagner acknowledges support from the Center for Financial Frictions (FRIC), grant no. DNRF102. We are grateful to Ian Martin for helpful comments. The authors alone are responsible for any errors and for the views expressed in the paper.

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Abstract

This paper finds a strong relation between corporate credit default swap (CDS) information and higher moments of equity returns, as predicted by structural models. We use CDS spreads to measure the level of credit risk and to estimate credit market-implied risk premia. The results document that implied volatilities of equity options as well as ex-ante variance and skewness increase with CDS spread levels. Furthermore, excess returns from trading options, variance, and skewness are strongly related to credit risk premia. We reconcile these findings with the predictability of equity returns via default probabilities and option-implied moments, and show that there is a strong common component behind returns on trading credit, equity, volatility and skew.

Keywords: Equity options, credit risk, variance risk, skew risk, cross-sectional asset pricing.