Risk Price Variation: The Missing Half of the Cross-Section of Expected Returns

2019 AQR Insight Award Honorable Mention

The Law of One Price is a bedrock of asset pricing theory and empirics. Yet real world frictions can violate the Law by generating unequal compensation across assets for the same risk exposures. We develop new methods for cross-sectional asset pricing with unobserved heterogeneity in compensation for risk. We extend k-means clustering to group assets by risk prices and introduce a formal test for whether differences in risk premia across market segments are too large to occur by chance. Using portfolios of U.S. stocks, international stocks, and assets from multiple classes, we find significant evidence of cross-sectional variation in risk prices for all 135 combinations of test assets, factor models, and time periods. Variation in risk prices is as important as variation in risk exposures for explaining the cross-section of expected returns.

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