Title: Breaking Bad: Identifying Instability in Return Prediction Models from the Cross-Section

Abstract

We propose a new approach to forecasting stock returns in the presence of structural breaks that affect multiple portfolios at the same time. Exploiting information in the cross-section increases our ability to identify breaks in return prediction models and enables the onset of a break to be detected more quickly in real time, thereby allowing the parameters of the predictive return regression to be updated with little delay. Empirically, we find that allowing for breaks leads to improved out-of-sample forecasts for a range of predictor variables that have been proposed in the finance literature. The improved forecast accuracy is statistically significant and economically meaningful for a mean-variance investor.