Does fundamental volatility help explain credit risk?

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[Abstract]: We examine whether accounting based measures of volatility are incremental to market based measures of volatility in predicting bankruptcies out of sample and in explaining credit spreads. A considerable portion of market returns is driven by changes in discount rates (Shiller, 1981; 1984), and, therefore, may not accurately reflect the underlying volatility of a firm's assets. While sampled with lower frequency, and subject to measurement error, accounting returns directly reflect the underlying fundamental volatility of an issuer.
Therefore, combining both accounting and market based measures of volatility should generate a superior measure of total volatility. We find that combining accounting and market based measures of volatility improves the out of sample prediction of bankruptcy and crosssectional explanatory power for credit spreads.