Investment and The Cross–Section of Equity Returns

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Abstract

We characterize the cross-sectional implications for equity returns in a neoclassical model of investment calibrated to match key moments of the investment rate’s distribution across public US firms over the period 1985-2010. Univariate portfolio sorts show that, consistent with the evidence, small firms earn higher returns than larger firms. However, we find that the model produces a value discount rather than a value premium unless some form of leverage is assumed. This occurs because in the ergodic distribution of the model value firms tend to have high idiosyncratic productivity and large capital stock. When operating leverage is such that the average book-to-market is close to 1, value stocks do earn a higher return than growth stocks. However, the magnitude of the value premium is substantially smaller than in the data. Double-sorting over the size and book-to-market dimensions shows that both variables survive as risk-factors, with a caveat. Conditional on high market size, value stocks earn lower returns than growth stocks.

Key words: Investment Rate, Equity Returns, Adjustment Costs
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