

Discussion: “Financial Distress and The Cross Section of Equity Returns”

By Garlappi and Yan

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New Orleans, January 2008

Theme

Garlappi and Yan (2007)

Distress/APR deviations: Important for driving value and momentum

Theme

My discussion

Distress/APR deviations: *Probably irrelevant* for value and momentum

Outline

- 1 Summary
- 2 New Evidence on APR Deviations (APD)
- 3 An Alternative View

Summary

Main insights from Garlappi and Yan (2007)

The magnitude of the value premium increases with the distress likelihood (via the standard leverage hypothesis)

Allowing for APR deviations generates a hump-shaped relation between distress and the value premium:

Distress $\uparrow \Rightarrow$ APR deviations more likely \Rightarrow Equity risk \downarrow

Distressed firms have low *past* realized returns, their low risk means low average *future* returns — momentum (but only the loser side)

APD

A point on calibration

Garlappi and Yan set $\eta = 5\%$ (see Eberhart, Moore, and Roenfeldt 1990):

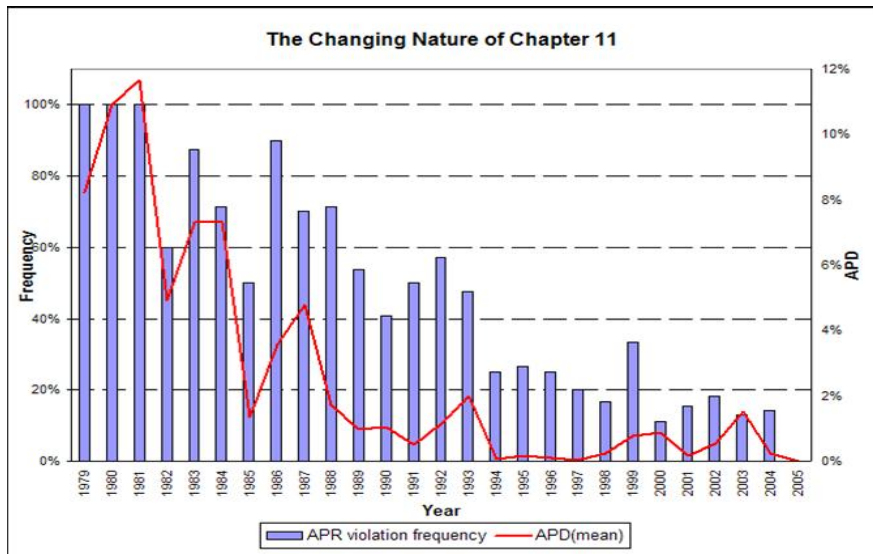
“even if the expected recovery by equity holders upon default is set at a modest level of only 5% of the asset value, both the expected return and β exhibit a hump shape with respect to default probability (p. 15–16).”

In particular, their Figures 1–4 are based on $\eta = 5\%$

New evidence shows that η is very close to zero

APD

Bharath, Panchapegesan, and Werner (2007): The Changing Nature of Chapter 11



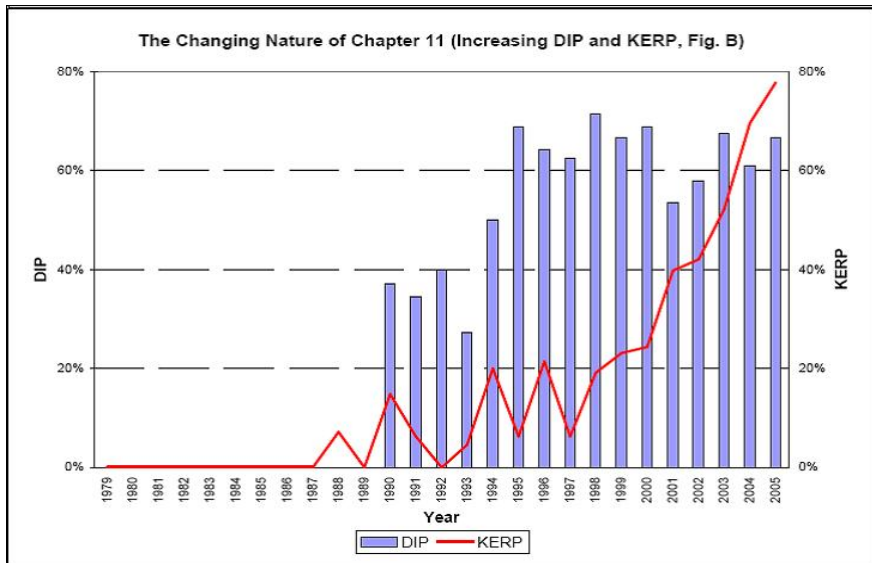
APD

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	N	Mean	Median
Till 1990			
APD/Firm value (%)	117	3.55%	0.76%
APD (in millions of dollars)	111	59.78	0.39
1990-1999			
APD/Firm value (%)	193	0.63%	0.00%
APD (in millions of dollars)	193	2.89	0.00
2000-2005			
APD/Firm value (%)	298	0.44%	0.00%
APD (in millions of dollars)	298	3.28	0.00

APD

Bharath, Panchapegesan, and Werner (2007): The Changing Nature of Chapter 11



APD

Taking stock

Most (if not all) of Garlappi and Yan's results will go away if $\eta \approx 0$

An Alternative View

See, for example, Chen and Zhang (2007): Neoclassical Factors

In its simplest form, neoclassical investment theory says that:

$$\text{Expected return} = \frac{\text{Expected profitability} + 1}{\text{Marginal cost of investment}}$$

The investment channel: Investment, value, new issues, distribution, accruals, asset growth

The productivity channel: Momentum, earnings surprises, profitability, distress

Conclusion

Discussion on “Financial Distress and the Cross Section of Equity Returns”

Cute theoretical exercise, mechanism probably irrelevant in practice