

Discussion: "In Search of Distress Risk"

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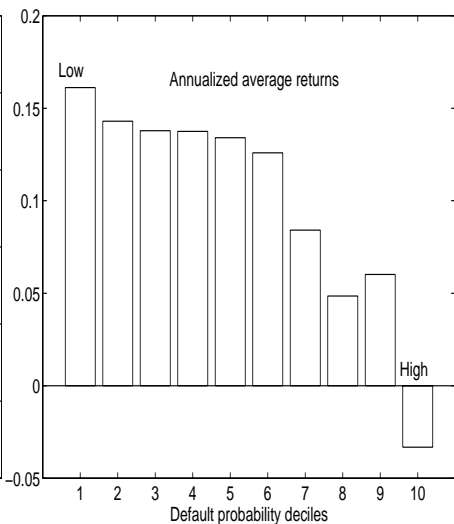
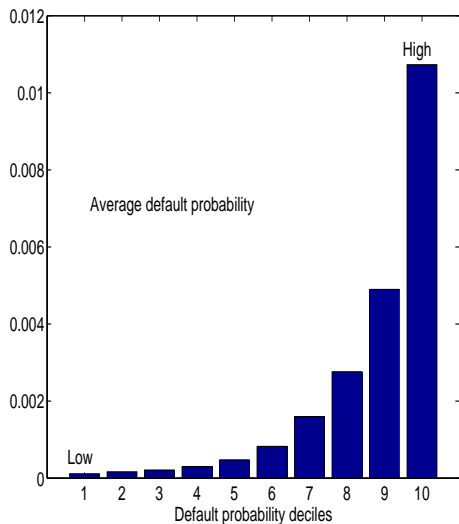
Theme

In search of distress risk

The financial distress anomaly: Distressed stocks have low average returns despite high volatilities, market betas, and SMB and HML loadings

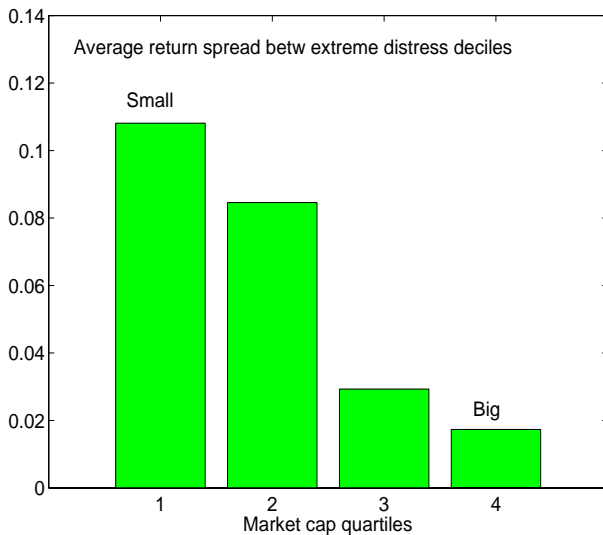
Evidence

The financial distress anomaly



Evidence

The financial distress anomaly: stronger in small firms



Interpretation

Campbell, Hilscher, and Szilagyi (2007)

p. 29: "This result is a significant challenge to the conjecture that the value and size effects are proxies for a financial distress premium. More generally, it is a challenge to standard models of rational asset pricing in which the structure of the economy is stable and well understood by investors (my emphasis)."

Getting behavioral?

And one of the authors is John Campbell. . .

Theme

Discussion

The distress anomaly is another manifestation of *the earnings anomaly*

Outline

- 1 Earnings
- 2 From Distress to Earnings
- 3 Interpretation

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1 Earnings

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3 Interpretation

Earnings

Bernard and Thomas (1989): Significant price drift in the direction of earnings surprises

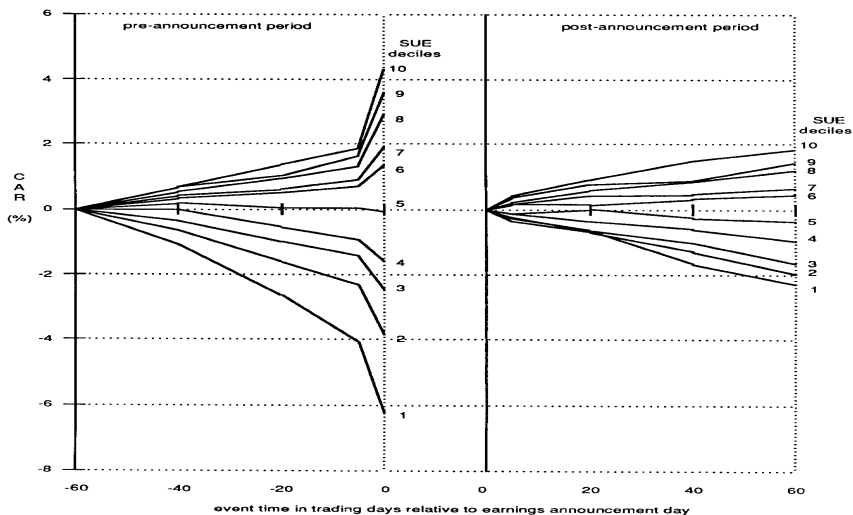


FIG. 2.—Cumulative abnormal returns (CARs) for *SUE* portfolios: all announcements.

Earnings

Bernard and Thomas (1989): The magnitude of the drift is larger for small firms

Panel B: Comparison by firm size: post-announcement abnormal returns.

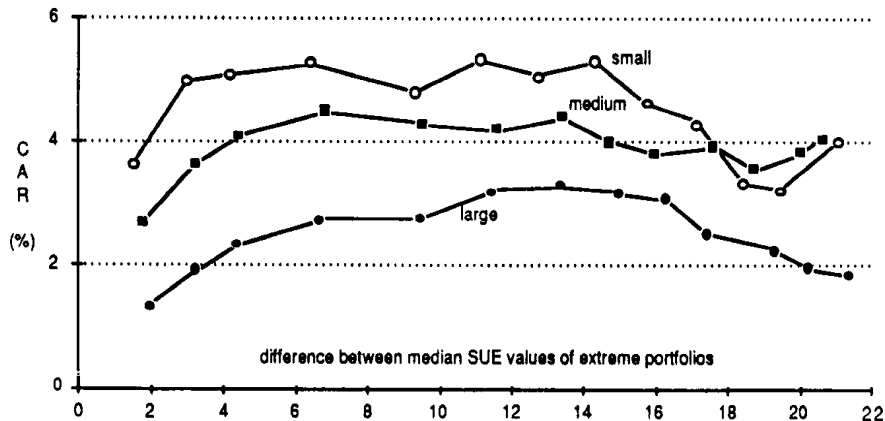


FIG. 6.—Test of an explanation for the drift, based on costs that impede trading. The

Earnings

Related literature in accounting and finance

Stock price drifts in the direction of earnings surprises:

- Ball and Brown (1968); Bernard and Thomas (1989, 1990); Chan, Jegadeesh, and Lakonishok (1996)

More profitable firms earn higher average returns than less profitable firms:

- Haugen and Baker (1996); Piotroski (2000)

Expected cash flows are positively correlated with expected returns:

- Frankel and Lee (1998); Dechow, Hutton, and Sloan (1999); Cohen, Gompers, and Vuolteenaho (2002); Fama and French (2006)

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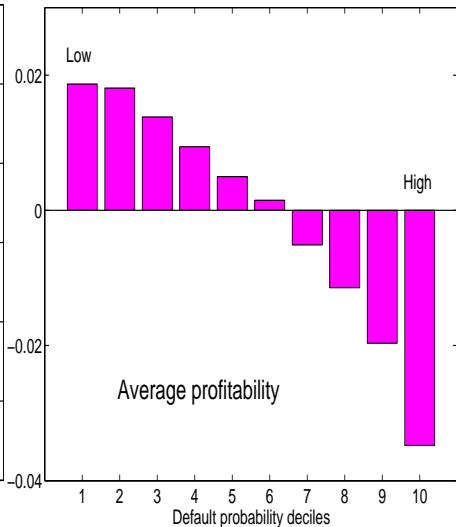
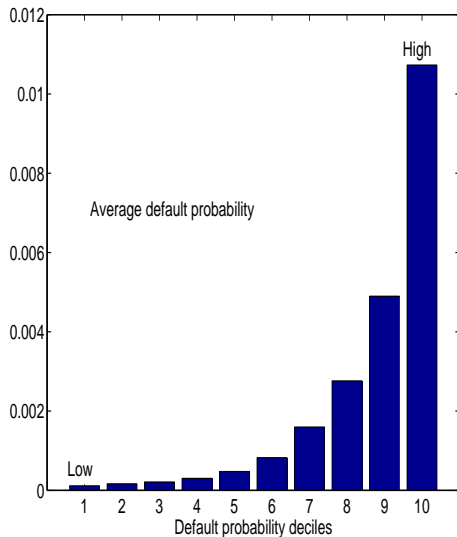
From Distress to Earnings

Intuition

Low distress \Rightarrow High profitability \Rightarrow High average return

From Distress to Earnings

Cross correlation (default probability, profitability) = -0.80



From Distress to Earnings

Evidence: Logit regressions

From the magnitude of the regression coefficient, profitability is the most important predictor of failure rate

Table 3: Logit regressions on predictor variables:

NIMTA	TLMTA	EXRET	SIGMA	RSIZE	CASHMTA	MB	PRIZE
-29.67	3.36	-7.35	1.48	0.08	-2.40	0.05	-0.94

From Distress to Earnings

Evidence: Fama-MacBeth cross-sectional regressions, testing portfolios

18 Testing portfolios from Jan 1981 to Dec 2003:

- 10 one-way sorted distress deciles
- 4 extreme portfolios from the two-way distress/size sort
- 4 extreme portfolios from the two-way distress/book-to-market sort

Data source: Jens

From Distress to Earnings

Evidence: Fama-MacBeth cross-sectional regressions

PHAT	NITA
-1.26	
(-1.64)	
	0.36
	(2.62)
0.76	0.45
(0.89)	(2.78)

Profitability dominates default probability in a direct horse race

Evidence

Fama-MacBeth cross-sectional regressions of returns on characteristics

Standardized regressors (coefficients \times 100):

PHAT	RSIZE	SIGMA	PRICE	EXRET	NIMTA	CashMTA	TLMTA	MB
	-0.37	0.79	0.28	0.32	0.63	-0.01	-0.21	0.19
	(-1.05)	(0.80)	(0.38)	(0.51)	(1.27)	(-0.07)	(-0.76)	(0.69)
0.41	-0.22	0.41	-0.26	0.71	0.62	-0.08	-0.27	0.06
(0.78)	(-0.58)	(0.36)	(-0.37)	(0.96)	(0.98)	(-0.54)	(-0.97)	(0.20)

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Interpretation

The q -theoretic perspective

Liu, Whited, and Zhang (2007, “Regularities”) infer unobservable expected returns from observable characteristics

- In a two-period q -theoretic model:

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

the profitability-return correlation decreases with market cap

- Intuition: High cash flow, but low market value \Rightarrow high discount rate
- Partial empirical success in generating the earnings anomaly

Can the q -theory generate the distress anomaly? Future work...

Conclusion

Discussion: "In search of distress risk"

Reinforces the view that the value effect is not due to distress risk

Worthwhile to point out the link between the distress-return relation and the earnings-return relation

Most important, the q -theory provides an explanation for the earnings anomaly (related to the distress anomaly) without underreaction