"Misvaluation and Return Anomalies in Distressed Stocks"

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ABSTRACT

We treat distressed stocks as options and construct a valuation model that explicitly takes into account the value of the option to default (or abandon the firm). The long-short strategy that buys distressed stocks that are classified as undervalued by our model and shorts overvalued distressed stocks generates an annual CAPM alpha of about 19%. We also argue that investors' inability to value distressed equities creates valuation uncertainty and favorable conditions for return anomalies to be concentrated among financially distressed stocks. We find that size, value, and momentum anomalies are all concentrated among most misvalued stocks (as classified by our model). The results are robust to various subsamples, return horizons, and alternative distress measures. There is little evidence that more misvalued stocks are harder to arbitrage than less misvalued stocks.