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Abstract: We introduce a new risk factor linking a firm's equity duration to investment opportunity risk. Low-duration firms generate short-run cash flows and face strong reinvestment risk. High-duration firms have long-run cash flows and their present value increases when discount rates decrease as a result of a deteriorating investment environment. Our empirical analysis reveals a significant return premium of low-duration stocks, confirming that investors charge a risk premium for stocks with returns that are positively related to the investment environment. Our newly introduced risk factor carries significant risk premiums in cross-sectional asset pricing tests. These premiums are robust to including further risk factors and a variety of different test specifications. Notably, our duration risk factor retains high explanatory power on the cross-section of stock returns in a model including direct measurement of the investment environment via state variable innovations.

Keywords: Duration, Multifactor models, Asset pricing, State variable innovations

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