

Accepted Manuscript

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Hannes Mohrschladt, Sven Nolte

PII: S0378-4266(18)30189-4
DOI: <https://doi.org/10.1016/j.jbankfin.2018.09.002>
Reference: JBF 5410

To appear in: *Journal of Banking and Finance*

Received date: 15 August 2017
Revised date: 23 August 2018
Accepted date: 1 September 2018

Please cite this article as: Hannes Mohrschladt, Sven Nolte, A New Risk Factor based on Equity Duration, *Journal of Banking and Finance* (2018), doi: <https://doi.org/10.1016/j.jbankfin.2018.09.002>

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A NEW RISK FACTOR BASED ON EQUITY DURATION

Hannes Mohrschladt[§]Sven Nolte^{§,*}

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

JEL: G12

[§]Finance Center Muenster, University of Muenster, Universitätsstr. 14-16, D-48143 Münster, Germany;

*California Institute of Technology, 1200 E California Blvd, 91125 Pasadena, CA, USA; Email: sven.nolte@wiwi.uni-muenster.de.

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