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# Financial distress and equity returns: A leverage-augmented three-factor model♣

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## Abstract

Our study examines whether financial distress risk is systematic risk using twelve portfolios sorted by size, book-to-market, and leverage and a portfolio of distressed firms covering an 18-year period. It also tests the explanatory power of the risk factors that best capture default risk. The empirical findings show that: (*i*) equity portfolio investment requires systematically both size and value premiums and that SMB and HML capture additional risk missed by the market portfolio; (*ii*) the leverage risk premium is positive for highly leveraged firms; and (*iii*) the risk premium for the relative distress factor is significant only for the distressed firm portfolio. Overall, our results have practical implications for portfolio managers since they advocate a leverage-augmented three-factor model to accurately price assets and to implement efficient portfolio strategies.

***Keywords***: Financial distress; Equity returns; Fama-French three-factor model.

***JEL classification***: G12; G33

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