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Leverage Constraints and Asset Prices: Insights from Mutual Fund Risk Taking*

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ABSTRACT

Prior theory suggests that time variation in the degree to which leverage constraints bind affects the pricing kernel. We propose a measure for this leverage constraint tightness by inverting the argument that constrained investors tilt their portfolios to riskier assets. We show that the average market beta of actively managed mutual funds—intermediaries facing leverage restrictions—captures their desire for leverage and thus the tightness of constraints. Consistent with theory, it strongly predicts returns of the betting-against-beta portfolio, and is a priced risk factor in the cross-section of mutual funds and stocks. Funds with low exposure to the factor outperform high-exposure funds by 5% annually, and for stocks this difference reaches 7%. Our results show that the tightness of leverage constraints has important implications for asset prices.

JEL Classification: G12, G23

Keywords: Leverage constraints, asset prices, betting-against-beta, mutual fund performance, cross-section of stock returns.

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