

Accepted Manuscript

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PII: S0261-5606(18)30115-3

DOI: <https://doi.org/10.1016/j.jimonfin.2018.03.002>

Reference: JIMF 1884

To appear in: *Journal of International Money and Finance*



Please cite this article as: W. de Groot, J. Huij, ARE THE FAMA-FRENCH FACTORS REALLY COMPENSATION FOR DISTRESS RISK?, *Journal of International Money and Finance* (2018), doi: <https://doi.org/10.1016/j.jimonfin.2018.03.002>

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Wilma de Groot and Joop Huij*

ABSTRACT

In this paper, we revisit the question whether the Fama-French factors are manifestation of distress risk premiums. To this end, we develop new tests specifically aimed at dissecting the Fama-French factor returns from a distress risk premium. While we find that value and small-cap exposures are typically associated with distress risk, our results also indicate that distress risk is not priced and that the small-cap and value premiums are priced beyond distress risk. Moreover, the distress risk exposures of common small-cap and value factors do not have explanatory power in asset pricing tests. Our results are robust to international out-of-sample analyses and have important implications for investors engaging in small-cap and value strategies.

JEL Classification: G11, G12, G14

Keywords: book-to-market effect, value anomaly, small-cap effect, market efficiency, default risk, bankruptcy, credit spread, bond spread, distress risk, credit rating

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