Anomalies and Financial Distress

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Abstract

This paper explores commonalities across asset-pricing anomalies. In particular, we assess implications of financial distress for the profitability of anomaly-based trading strategies. Strategies based on price momentum, earnings momentum, credit risk, dispersion, idiosyncratic volatility, and capital investments derive their profitability from taking short positions in high credit risk firms that experience deteriorating credit conditions. Such distressed firms are highly illiquid and hard to short sell, which could establish nontrivial hurdles for exploiting anomalies in real time. The value effect emerges from taking long positions in high credit risk firms that survive financial distress and subsequently realize high returns. The accruals anomaly is an exception - it is robust amongst high and low credit risk firms as well as during periods of deteriorating, stable, and improving credit conditions.