

A Neoclassical Model of Financially Constrained Stock Returns

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Abstract

We use the q -theoretical investment model augmented with financial constraints to analyze the effects of these constraints on risk and expected returns. We find that financial constraints reduce firm value and investment rates, and these adverse effects are more important for small firms and firms in relative distress. More strikingly, we also find that constrained firms are *less* risky and earn *lower* expected returns than unconstrained firms, and that financial constraints are more binding in *good* times. Our model helps resolve the anomalies regarding the empirical relations among financial constraints, business cycle, and expected returns.

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