

How a company's financial structure affects its stock returns

Will the collapse of Silicon Valley Bank spell losses for companies with a similar financial structure? Stock returns of companies with similar levels of financial flexibility are more closely correlated, particularly in times of crisis.



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The collapse of Silicon Valley Bank in the U.S. sent global stock markets into a tailspin. In times of crisis, how closely correlated stock returns of different firms are may be linked to how similar they are in terms of financial flexibility.

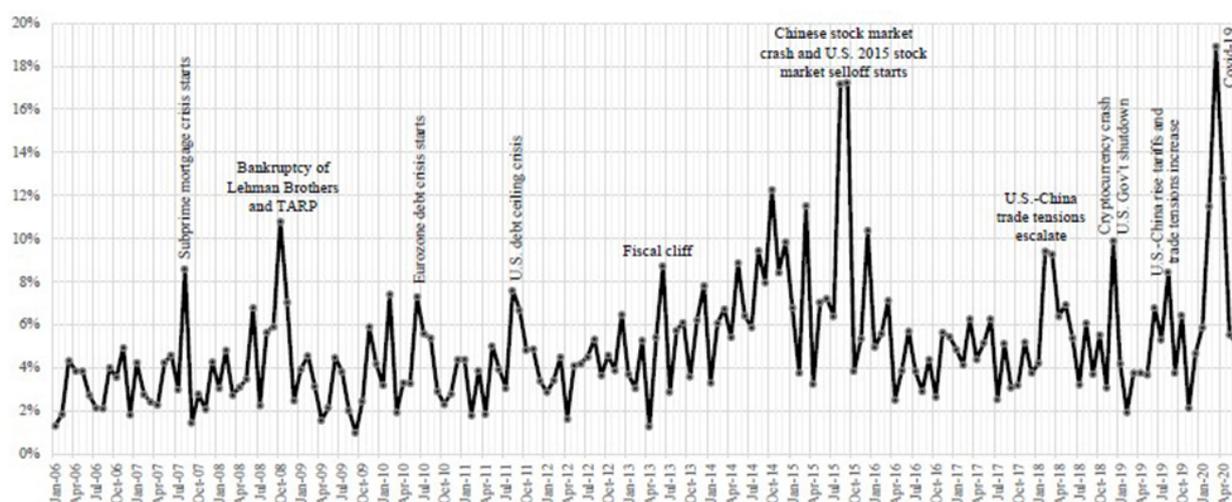
This effect — in which the more similar in financial flexibility two firms are, the more their

market returns are correlated — is known as comovement. And it's more pronounced in times of crisis, as coauthors Teng Huang, Anil Kumar, [Stefano Sacchetto](#) and [Carles Vergara](#) show in a 2021 paper [Stock Comovement and Financial Flexibility](#).

That's what happened in March 2020, when COVID-19 was declared a pandemic. While there was much talk about which stocks climbed in the pandemic (Zoom, pharma companies) and which fell (hotels, airlines), few seemed to be talking about the markets getting more correlated. But the shares in companies with similar financial structures were moving in a more correlated way than they had in the previous 14 years. The COVID-19 outbreak confirmed that comovement is exaggerated when external shocks suddenly (and unexpectedly) affect the value of key collateralizable assets, namely real estate, and thus affect firms' financial flexibility, understood as the ability to raise financing when needed.

The same had happened before, such as following the bankruptcy of Lehman Brothers in 2008 and during China's stock market turbulence in 2015, as illustrated in Figure 1.

Figure 1: Average Pairwise Stock Comovement Among S&P500 firms. This figure shows the average pairwise correlation of FF5 daily stock return residuals among firms in the S&P500 index for each month between January 2006 and July 2020.



Source: <http://dx.doi.org/10.2139/ssrn.3470759>

The figure shows that under fairly typical trading conditions (between the labeled peaks in the chart), pairs of stocks have some residual correlations — that is to say, comovement after

controlling for size (small cap v. large cap), risk, price-to-book ratios (value v. growth), profitability and investment, which are the five factors named in the famous Fama-French five-factor model (FF5, 2015).

Practical implications of stock comovement

How does this impact executives, asset managers and general investors?

- **CEOs and other senior managers** should be aware that decisions regarding their company's financial structure (for example, the amount of debt, cash and collateralizable assets held) have an effect on the comovement of their stock with other firms' stocks, and so, on the amount of risk that the firm's shareholders cannot diversify away.
- **Asset managers and executives at financial institutions** who want to diversify their holdings — or improve their market predictions — should take a look at financial structures with the understanding that they will affect market correlation.
- **Investors in general** should take note that when two firms have more similar levels of financial flexibility, their stocks comove more. That's important when diversifying portfolios.
- **Regulators** must be aware that regulations that affect financial flexibility may have unintended consequences on comovement in the stock markets. This should matter to regulators because it may impact the extent to which investors can diversify their equity portfolios in order to mitigate risk.

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