



MACROECONOMICS

Asset Tangibility, Macroeconomic Risks and the Diversification Discount

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Working paper

Some research (e.g., Lang and Stulz (1994) and Berger and Ofek (1995)) has concluded that conglomerates tend to trade at a discount relative to a comparable group of companies focused on single lines of business. It is believed, that this is because investors prefer to diversify within their portfolios, which gives them the flexibility to add or reduce their exposure to particular segments of the economy, rather than to invest in a diversified company that cannot quickly or easily dispose of underperforming assets.

However, the so-called diversification discount associated with conglomerates is not static. The authors' review of the data shows that the discount decreases during recessions and credit crunches. They assert this is because single-segment firms — particularly young and fast growing firms, which tend to have low asset tangibility — experience a larger decrease in value compared to conglomerates.

This paper concludes that this is because recessions and credit shocks tighten the collateral constraint of low tangibility firms more than they do for conglomerates, which tend to have high asset tangibility. A tightening of the collateral constraint forces firms to reduce leverage, which in turn leads to lower profits, lower investment and more costly external financing.

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