Abstract

We study returns in the universe of leveraged value small-capitalization stocks, a universe with historically significant exposure to common risk factors. We separate future winners and losers within this universe of risky stocks by adopting machine-learning-based mispricing strategy. The strategy considers 34 stock-level characteristics to predict 1-month-ahead returns and construct a long-short portfolio accordingly. The portfolio yields abnormal risk-adjusted returns of 0.42% per month out-of-sample, uncovering statistically significant mispricing. The machine-learning algorithm is trained on leveraged value small-capitalization stocks, so it captures universe-specific nonlinearities and variable interactions. The nonlinear effects and predictive power of individual variables are extracted and presented as well. We found no evidence of a relationship between the magnitude of the mispricing and credit cycles, or market volatility.

JEL Classification	G11, G12, G14,
Keywords	Anomalies, Predictability of returns, Asset pricing tests, Leveraged equities, Value stocks
Title	Mispricing in leveraged value small-capitalization stocks