Optimal Diversification: 
Reconciling Theory and Evidence*

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Abstract

In this paper we show that the main empirical findings about firm diversification and performance are consistent with the maximization of shareholder value. In our model, diversification allows a firm to explore better productive opportunities while taking advantage of synergies. By explicitly linking the diversification strategies of the firm to differences in size and productivity, our model provides a natural laboratory to investigate quantitatively several aspects of the relationship between diversification and performance. Specifically, we show that our model is able to rationalize both the evidence on the diversification discount (Lang and Stulz (1994)) and the documented relation between diversification and firm productivity (Schoar (2002)).

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*This paper combines our earlier papers "Optimal Diversification" and "The Performance of Optimally Diversified Firms: Reconciling Theory and Evidence".

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