

## ABSTRACT

Titman and Wessels (1988) utilize a structural-equations model (LISREL) to find out the latent determinants of capital structure. Chang, Lee, & Lee (2009) apply a Multiple Indicators and Multiple Causes (MIMIC) model to re-examine the same issue as Titman and Wessels did but found more convincing results. I extended Titman and Wessels' research from using a single-equation approach to a simultaneous-equations approach and use a Structural Equations Model (SEM) which was used by Yang, Lee, Gu & Lee (2009). Most of the empirical work on capital structure indicates that a firm's capital structure can affect its stock returns (Bhandari, 1988). On the other hand, the stock returns can affect capital structure too (Baker & Wurgler, 2002; Lucas & McDonald, 1990; Welch, 2004). Hence, a firm's determinants of its capital structure and those of its stock returns can be decided simultaneously, rather than independently.

By solving the simultaneous equations, I examined the empirical relationship between the two endogenous variables: capital structure and stock returns and found out if they had common determinants as well. My results show that stock returns, size, asset structure, and profitability are the main factors of capital structure, while the primary determinants of stock returns are expected growth, profitability, and value. The level of debt ratios and stock returns are mutually determined by the factors mentioned above and themselves.