This study argues that in corporate diversification there is a bright side (coinsurance effect) and a dark side (diversification discount). While diversification might reduce systematic risk by its impact on the cost of financial distress, it might increase systematic risk because of inefficient cross-subsidization at the same time. Building on a theoretical model, we analyze mergers and acquisitions in the US over the period 1985 to 2014. We find the coinsurance effect to decrease the cost of capital by 36 bp for the average firm. However, at the same time, we observe a 7bp increase in the cost of capital related to the inefficiency of the firm's internal capital market. Both effects are statistically significant and robust to endogeneity concerns, different empirical specifications, and variable measurement.

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