

## Abstract

The empirical evidence in the volatility tests literature suggests that movements in stock prices cannot be satisfactorily explained purely in terms of changes in fundamentals. This paper shows how to obtain proxies for the fundamental and fads components of changes in stock prices and asks the question: do only fundamentals matter for investment decisions? It is found that changes in real investment are significantly associated with movements in both components of stock prices. The point estimates suggest that changes in fundamental have a greater effect. However the difference in response is not statistically significant. These conclusions are shown to be robust to modifications and extensions of the model, such as monopolistic competition in the output market and the introduction of financial distress/agency costs considerations.