Investment Behavior, Observable Expectations, and Internal Funds

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Abstract

We use earnings forecasts from securities analysts to construct more accurate measures of the fundamentals that affect the expected returns to investment. Using a variety of econometric techniques, including semiparametric estimators, we find that investment responds significantly — in both economic and statistical terms — to our new measures of fundamentals. With our controls for expected future profits, we find that internal funds are uncorrelated with investment spending, even for selected subsamples of firms — those paying no dividends and those without bond ratings — that have been found to be "liquidity constrained" in previous studies.

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