Limits-to-arbitrage, Investment Frictions, and the Investment Effect: New Evidence

F.Y. Eric C. Lam
Hong Kong Institute for Monetary Research

Ya Li
LSK School of Business and Administration
The Open University of Hong Kong

Wikrom Prombutr
Department of Finance, College of Business Administration
California State University

K.C. John Wei
School of Accounting and Finance
Hong Kong Polytechnic University

March 2019

Summary

This study comprehensively reexamines the debate over behavioral and rational explanations for the investment effect in an updated sample. We closely follow the previous literature and provide several differences. All our tests include five prominent measures of corporate investment and corporate profitability either as a standard control or as a structural variable in q-theory and recent investment-based asset pricing models. We test simple composite indices of limits-to-arbitrage or investment frictions. The competing explanations are compared by

controlling the frictions indices against each other in regressions and by analyzing the effect of orthogonalized frictions indices. Both classical and Bayesian inferences show that limits-to-arbitrage tend to be supported by more evidence than investment frictions for all investment measures. Investment frictions are clearly important for investment-to-assets. Various robustness checks regarding model specifications and index definitions are performed. The relative importance of the two hypotheses depends on the variables used in constructing the indices. When idiosyncratic volatility and cash flow volatility are used in measuring investment frictions, the inference is more favorable for the rational explanation.