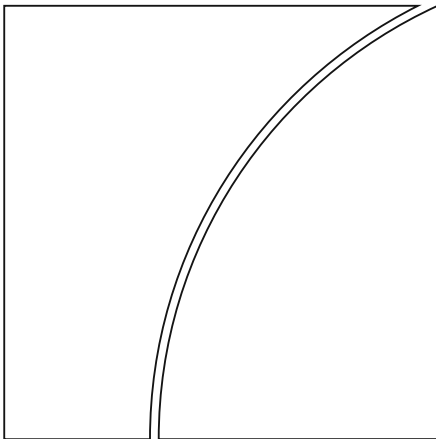




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# Expectations and investment

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## Foreword

The 14th BIS Annual Conference took place in Lucerne, Switzerland, on 26 June 2015. The event brought together a distinguished group of central bank Governors, leading academics and former public officials to exchange views on the topic “Towards ‘a new normal’ in financial markets?”. The papers presented at the conference and the discussants’ comments are released as *BIS Working Papers* nos 561 to 564.

*BIS Papers* no 84 contains the opening address by Jaime Caruana (General Manager, BIS), the keynote address by John Kay (London School of Economics) and remarks by Paul Tucker (Harvard Kennedy School).



# Expectations and investment<sup>1</sup>

Nicola Gennaioli, Yueran Ma<sup>2</sup> and Andrei Shleifer<sup>3</sup>

## Abstract

Using micro data from the Duke University quarterly survey of Chief Financial Officers, we show that corporate investment plans as well as actual investment are well explained by CFOs' expectations of earnings growth. The information in expectations data is not subsumed by traditional variables, such as Tobin's Q or discount rates. We also show that errors in CFO expectations of earnings growth are predictable from past earnings and other data, pointing to the extrapolative structure of expectations and suggesting that expectations may not be rational. This evidence, like earlier findings in finance, points to the usefulness of data on actual expectations for understanding economic behaviour.

JEL classification: E03, E22, E32, G31

Keywords: Expectations, Corporate Investment, Behavioral Macroeconomics

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## 1. Introduction

One of the basic principles of economics in general, and macroeconomics in particular, is that expectations influence decisions. In line with this principle, the use of survey-based expectations data has been the mainstay of macroeconomic analysis since the 1940s, analysing variables such as railroad shippers' forecasts. NBER published several volumes on data of this kind, such as *The Quality and Economic Significance of Anticipations Data* (1960), showing that forecasts are helpful in understanding real decisions by firms, such as investment and production.

The use of expectations data took a nosedive following the Rational Expectations Revolution. First, under rational expectations, the model itself dictates what expectations rational agents should hold to be consistent with the model (Muth (1961)), so anticipations data are redundant. Second, economists became sceptical about the quality of expectations data; in fact this scepticism predates rational expectations (Manski (2004)). According to Prescott (1977), "Like utility, expectations are not observed, and surveys cannot be used to test the rational expectations hypothesis" (underlining his). In finance, as in macroeconomics, the Efficient Markets Hypothesis implies that expectations of asset returns are predicted by the model (Campbell and Cochrane (1999); Lettau and Ludvigson (2001)), so expectations data are not commonly used.

In our view, the marginalisation of research on survey expectations deprives economists of extremely valuable information. Whether or not survey expectations predict behaviour is an empirical question. Moreover, the rational expectations assumption should not be taken for granted, but rather confronted with actual expectations data, imperfect as they are. Today, we have theoretical models that do not rely on the rational expectations assumption and make testable predictions, as well as expectations data to compare alternative models. Indeed, Manski (2004) argues forcefully and convincingly that expectations data are necessary to distinguish alternative models in economics.

As an illustration, take the case of finance, where data on expectations of asset returns have been rejected as uninformative (eg Cochrane (2011)). Yet there is mounting evidence that expectations are highly consistent across different surveys of different types of investors, that they have a fairly clear extrapolative structure, that they predict investor behaviour, and that they are useful in predicting returns (eg Greenwood and Shleifer (2014)). Most important, expectations of returns obtained from surveys are negatively correlated with measures of expected returns obtained from rational expectations models. The trouble seems to be with conventional rational expectations models of asset prices, not with expectations data.

The message we take from this discussion is that expectations data can be used to address two questions: (1) do expectations affect behaviour?; and (2) are expectations rational? The questions are related. If expectations do not affect behaviour, it matters little whether they are rational or not. If, however, expectations do affect behaviour, the question of their rationality becomes quite relevant, since it allows us to consider alternative models of belief formation underlying economic decisions.

In this paper, we try to answer these questions for the case of corporate investment. We use new data assembled by Campbell Harvey and John Graham from Duke University to examine expectations formed by Chief Financial Officers of large

US corporations and their relationship to investment plans and actual investment of these firms. To be more specific, the Duke data are based on quarterly surveys of CFOs which, among other things, collect information on earnings growth expectations and investment plans. We match these data with Compustat to get information on actual investment and other accounting variables. We also consider earnings forecasts made by Wall Street financial analysts regarding individual firms, which happen to be highly correlated with CFO forecasts.

To organise our discussion, we present a simple Q-theory-based model of investment, but one relying on actual expectations rather than stock market data. We then conduct a number of empirical tests suggested by the model of the relationship between earnings growth expectations and planned investment growth, both in the aggregate and firm-level data. The results suggest that expectations are statistically and substantively important predictors of both planned and actual investment; they seem to have explanatory power beyond traditional variables such as market-based proxies of Tobin's Q, discount rates, measures of financial constraints or uncertainty. We then conduct a number of empirical tests on the rationality of expectations. Although these tests face a number of difficulties, our evidence suggests that expectations do not appear to be rational in the sense that – both in the aggregate and at the level of individual firms – errors are consistently predictable from highly relevant publicly available information, such as past profitability. Some evidence points to the extrapolative structure of earnings expectations, similar to the evidence from finance.

Our paper is related to several very large strands of research. Most clearly, it is related to a large literature on determinants of investment, such as Barro (1990), Hayashi (1982), Fazzari, Hubbard, and Petersen (1988), Lamont (2000), and many others. Four papers are particularly closely related to our work. Cummins, Hassett and Oliner (2006) replace the traditional market-based Tobin's Q used in investment equations by Q computed using analyst expectations data, and find that the fit of the equation is much better. Guiso, Pistaferri, and Suryanarayanan (2006) use direct expectations data on Italian firms to study the relationship between expectations, investment plans, and actual investment. Arif and Lee (2014) use accounting data to show that high aggregate investment precedes earnings disappointments, and argue that fluctuations in investor sentiment account for the evidence. Finally, Greenwood and Hanson (2015) study specifically the shipping industry, and find evidence of boom-bust cycles driven by volatile (and incorrect) expectations and investment that follows them.

Our paper is also related to research on expectations in macroeconomics. A large literature studies inflation expectations and their rationality (eg Figlewski and Wachtel (1981); Zarnowitz (1985); Keane and Runkle (1990); Ang, Bakaert and Wei (2007); Monti (2010); Del Negro and Eusepi (2011); Coibion and Gorodnichenko (2012 forthcoming); Smets, Warne and Wouters (2014)). Souleles (2004) finds that consumer expectations are biased and inefficient, yet are strong predictors of household spending. Burnside, Eichenbaum, and Rebelo (2015) present a model of "social dynamics" in beliefs about home prices, and match the model to survey expectations data. Some research suggests that analyst expectations of corporate profits are rational at very short horizons (Keane and Runkle (1998)), although the overwhelming majority of studies reject the rationality of analyst forecasts (De Bondt and Thaler (1990); Abarbanell (1991); La Porta (1996); Liu and Su (2005); Hribar and McInnis (2012)). There is also a literature on expectations shocks in macroeconomics, which

generally maintains the assumption of rational expectations (Lorenzoni (2009); Angeletos and La'O (2009); Levchenko and Pandalai-Nayar (2015)).

Perhaps most closely related to our work is research in behavioural finance, where biases in expectations have been examined for many years (eg Cutler, Poterba and Summers (1990); DeLong et al (1990)). Some of the recent papers include Amronin and Sharpe (2009), Bacchetta, Mertens and Wincoop (2009), Hirshleifer and Yu (2012), and Greenwood and Shleifer (2014), to which we return later. Several of these papers find that investor expectations are extrapolative. In the bond market, Piazzesi, Salomao and Schneider (2013) use data on interest rate forecasts and also find substantial deviations from rationality. Vissing-Jorgensen (2003) and Fuster et al (2011) are two recent Macro Annual papers that also address expectations formation and rationality.

In the next section, we briefly summarise some of the evidence on the relationship between investor expectations and asset prices, and address some of the criticisms of expectations data. Section 3 describes our data. Section 4 presents a simple Q-theory model of expectations and investment that organises our empirical work. Section 5 follows with the basic empirical results on expectations and investment. Section 6 examines the structure of expectations. Section 7 concludes with a brief discussion of implications of the evidence for macroeconomics.

## 2. Recent research on expectations and asset prices in finance

Before turning to our main results on investment, we briefly summarise recent research on expectations and stock market returns, which illustrates the usefulness of expectations data. In recent models with time-varying expected returns (eg Campbell and Cochrane (1999); Lettau and Ludvigson (2001)), expected returns (ER) are given by required returns, which in turn depend on consumption: investors require higher returns when consumption is low (relative to some benchmark), and lower returns when consumption is high. This research does not generally use data on expectations. Rather, it adopts a rational expectations approach in which ERs are determined by the model itself, so ER is inferred from the joint distribution of consumption and realised returns.

As discussed in the introduction, recent work has started to use actual expectations data. For our purposes, the most relevant paper is Greenwood and Shleifer (2014). They use data on expectations of returns from six different surveys of investors, including a Gallup survey, investor newsletters, and the survey of CFOs of large corporations that we use in the current paper. The paper reports four main findings relevant to our analysis, which we summarise in Tables 1 and 2.

First, expectations of aggregate stock returns are highly correlated across investor surveys, despite the fact that different data sets survey different investors and ask somewhat different questions (see Table 1). These measured expectations are also highly positively correlated with equity mutual fund inflows. Survey expectations are thus hardly misleading or uninformative: why would they otherwise be strongly correlated across groups, across questions, and with fund flows?

Second, return expectations appear to be extrapolative: they are high after a period of high market returns, and low after a period of low market returns (see Table 1 and Figure 1).



Third, and critically, expectations of returns are strongly negatively correlated with model-based measures of ER (see again Table 1). Put simply, when investors expect returns to be high, models predict that the ER is low. A plausible interpretation of this finding is that model-based ER does not actually capture expectations.

Fourth, when expectations of returns are high, and ER is low, actual returns going forward are low (see Table 2). To us, this piece of evidence points to the interpretation, dating back to Campbell and Shiller (1987, 1988), that high market valuations and consumption reflect overvaluation and excessive investor optimism (as directly measured by expectations), and portend reversion going forward. Model-based ER, in other words, does not measure expectations, but rather proxies for overvaluation.

We draw two lessons from this analysis. At the most basic level, the research indicates that direct survey estimates of expectations are useful: they have a well defined structure across different surveys, and they predict fund flows as well as future returns. Second, to the extent that the conclusion that survey measures of expectations actually measure expectations is accepted, the evidence points against rational expectations models of stock market valuation. Actual expectations are strongly negatively related to the measures of expected returns that these models generate. In the remainder of this paper, we consider some related findings with respect to corporate investment.

### 3. Data for studying expectations and investment

Our empirical analysis of corporate investment draws on two main categories of data: (1) data on expectations, primarily of future profitability, and (2) data on firm financials and investment activities. We focus on non-financial firms in the United States. We collect data both at the aggregate and at the firm level, and all data are available at quarterly frequencies. Appendix B provides a list of the main variables, including their construction and the time range for which each variable is available.

#### 3.1 Expectations data

We have data on the expectations of two groups of people: CFOs and equity analysts. We first describe these data and then show that expectations of CFOs and equity analysts are highly correlated.

##### a. CFO expectations

Our data on CFO expectations come from the quarterly Duke/CFO Magazine Business Outlook Survey led by John Graham and Campbell Harvey, which was launched in July 1996. Each quarter, the survey asks CFOs their views about the US economy and corporate policies, as well as their expectations of future firm performance and operational plans.<sup>4</sup> Starting in 1998, the CFO survey consistently asks respondents their expectations of the *future 12-month growth* of key corporate variables, including earnings, capital spending, and employment, among others. The original question is presented to the CFOs as follows:

<sup>4</sup> Graham and Harvey (2011) provide a detailed description of the survey. Historical questionnaires are available at [www.cfosurvey.org](http://www.cfosurvey.org).

*Relative to the previous 12 months, what will be your company's PERCENTAGE CHANGE during the next 12 months? (eg +3%, -2%, etc.) [Leave blank if not applicable]*

*Earnings: \_\_\_\_\_; Cash on balance sheet: \_\_\_\_\_; Capital spending: \_\_\_\_\_;*

*Prices of your product: \_\_\_\_\_; Number of domestic full-time employees: \_\_\_\_\_;*

*Wage: \_\_\_\_\_; Dividends: \_\_\_\_\_...*

*(Selected items are listed as examples. For a complete listing, please refer to original questionnaires posted on the CFO Survey's website.)*

We use CFOs' answers on earnings growth over the next 12 months as the main proxy for CFO expectations of future profitability. As the survey does not ask for expectations beyond the next 12 months, we will explain in Section 4 how we interpret and extract information from earnings expectations over the next 12 months.

We then use CFOs' answers on capital spending growth in the next 12 months as a proxy for firms' current investment plans. In the empirical analysis, we investigate how investment plans relate to expectations of future profitability. We adopt this approach in the light of well documented lags between decisions to invest and actual investment spending (Lamont (2000)). With lags in investment implementation, current expectations about future profitability may not translate into capital expenditures instantly. Instead, they will affect current investment plans, and show up in actual investment spending with some delay. As a result, it can be more straightforward to detect the impact of earnings expectations by looking at investment plans. We discuss this issue in more detail in Sections 4 and 5.

Our analyses use both aggregate time series and firm-level panel data. Aggregate variables are revenue-weighted averages of firm-level responses, and they are published on the CFO survey's website. While the survey does not require CFOs to identify themselves, some respondents voluntarily disclose this information. It is then possible to match a fraction of the firm-level responses with data from CRSP and Compustat to perform firm-level tests. For example, Ben-David, Graham and Harvey (2013) use matched firm-level data to study how managerial miscalibration affects corporate financial policies. Because there are privacy restrictions associated with these data, Graham and Harvey helped us implement firm-level analysis using a subsample of their matched dataset. The firm-level data we use has 1,133 firm-year observations, spanning from Q1 2005 to Q4 2012.<sup>5</sup> We exclude firms that have negative earnings in the past 12 months because in that case earnings growth is not well defined. We also winsorise outliers at the 1% level.

#### *b. Analyst expectations*

We obtain data on equity analysts' expectations of future firm performance from the Institutional Brokers' Estimate System (IBES) data set. Beginning in the 1980s, IBES collects analyst forecasts of quarterly earnings per share (EPS) for the next one to up to 12 quarters. We take consensus EPS forecasts (ie average forecast for a given firm-quarter in the future) and compute forecasts of total earnings by multiplying the number of shares outstanding. To compare the results with those using CFO

<sup>5</sup> The number of observations in our firm-level regressions can be smaller because some respondents do not answer all questions.

expectations, we compute analyst expectations of future 12-months earnings growth. We calculate aggregate analyst expectations of future 12-months earnings growth by summing up expected future earnings of all firms in the next four quarters and then divide by the sum of earnings of all firms in the past four quarters. We calculate firm-level analyst expectations of future earnings growth by taking the forecast of total firm earnings in the next four quarters, and then dividing by total earnings in the past four quarters. We exclude firms that have negative earnings in the past 12 months when calculating expected future earnings growth.

The sample with analyst expectations covers both a longer time span and a larger set of firms. We set the start date of the aggregate time series and firm panel to be Q1 1985 because some of the quarterly Compustat data items we use only become systematically available around 1985 and because aggregate analyst forecasts have some outliers before 1985. We set the end of the sample to be Q4 2012 so we can match expectations to realised next 12-month earnings growth with accounting data ending in Q4 2013. In total, we have 145,281 firm-level observations of expected earnings growth over the next 12 months, and we winsorise outliers at the 5% level.

### *c. Correlation between CFO and analyst expectations*

The expectations of CFOs and analysts with respect to next 12-month earnings growth are highly correlated. Figure 2 shows aggregate time series of expected next 12-month earnings growth from the CFO survey and from analyst forecasts. The raw correlation of these two series is 0.65. At the firm level, the raw correlation between CFO and analyst expectations of next 12-month earnings growth is 0.4 if we demean by firm, and 0.3 if we demean by both firm and time. The high correlation between expectations of CFOs and analysts indicate that expectations data are consistent and meaningful, and expectations of both groups incorporate information about the general business outlook shared by managers and the market.

## 3.2 Firm financials data

We collect aggregate data on firm assets and investment from the Flow of Funds (Table F.102 and Table B.102) and the National Income and Product Accounts (NIPA), and firm-level data from Compustat. A key variable in our analysis is realised earnings, which we use to assess the accuracy of earnings expectations of CFOs and analysts. While Compustat mainly records Generally Accepted Accounting Principles (GAAP) earnings, managers and analysts often use so-called “pro forma earnings” (also called “street earnings”) which adjust for certain non-recurring items (Bradshaw and Sloan (2002); Bhattacharya, Black, Christensen and Larsen (2003)). To make sure we use the same measure of earnings as CFOs and analysts, we collect realised earnings from IBES Actuals files, which closely track earnings as reported by companies in their earnings announcements. These are the numbers that analyst forecasts aim to match and the earnings metric that managers tend to use the most.<sup>6</sup> For simplicity, in the rest of the paper we will refer to IBES actual earnings as “earnings”, and GAAP earnings as “net income”.

<sup>6</sup> We performed detailed checks and verified that IBES actual earnings indeed appear to be closest to forecasts by managers and analysts, in terms of accounting treatment, magnitude, variance and variation over time.

Table 3 presents summary statistics of firms for which we have firm-level CFO expectations (Panel A) and analyst expectations (Panel B), as well as all non-financial firms in Compustat (Panel C). For comparability, the statistics in Panel B and Panel C are generated based on the time period for which we have firm-level CFO expectations (ie from 2005 through 2012). We can see that firms with analyst expectations are mostly larger than the median Compustat firm, and firms with CFO expectations are generally even larger. Firms with CFO and analyst expectations also appear to be more profitable than firms in the full Compustat sample in terms of net income, but otherwise very similar in terms of sales, investment, book-to-market, and Q.

#### 4. Expectations and firm investment: empirical specifications

We motivate our empirical specification with a basic Q-theory model. A firm is run by a risk-neutral owner who discounts the future by factor  $\beta < 1$ ,<sup>7</sup> and the firm's horizon is infinite. In the model, we interpret each period  $t$  to be 12 months. The firm's output in period  $t$  is obtained by combining capital and labour using a constant returns to scale production function  $A_t^{1-\eta} K_t^\alpha L_t^\eta$ . At the beginning of period  $t$ , the owner hires labour  $L_t$  at wage  $w$  and makes decisions about investment during this year  $I_t$ . Investment takes one year to implement, so  $K_{t+1} = (1 - \delta)K_t + I_t$ , where  $\delta$  is capital depreciation rate. The firm's optimal policy in year  $t$  maximises the expected present value of earnings:

$$\max_{\{I_s, L_s\}_{s \geq t}} \mathbb{E}_t \left\{ \sum_{s \geq t} \beta^{s-t} \left[ A_s^{1-\eta} K_s^\alpha L_s^\eta - wL_s - C(I_s, K_s) \right] \right\}$$

subject to  $K_{s+1} = (1 - \delta)K_s + I_s$ . We assume the commonly used quadratic investment costs:

$$C(I_s, K_s) - I_s = \frac{b}{2} \left( \frac{I_s}{K_s} - a \right)^2 K_s,$$

which allow for convex adjustment costs ( $b > 0$ ) and displays constant returns to scale.

In the optimisation problem above, the operator  $\mathbb{E}_t(\cdot)$  denotes the owner's expectations conditional on his information at the beginning of year  $t$ , computed according to his possibly distorted beliefs. We allow for departures from rational expectations, but restrict to beliefs that preserve the law of iterated expectations. By standard arguments, Appendix A shows that the firm's optimal investment chosen at the beginning of year  $t$  is described by:

<sup>7</sup> The assumption of risk neutrality and constant discount rate is for simplicity of exposition. The framework can be extended to incorporate time-varying discount rates, as derived in Lettau and Ludvigson (2002). In our empirical analysis in Sections 4.2 and 4.3, we will explicitly consider time-varying discount rates.

$$\frac{I_t}{K_t} = \left(a - \frac{1}{b}\right) + \frac{\beta}{b} \frac{\mathbb{E}_t \left[ \sum_{s \geq t+1} \beta^{s-(t+1)} \Pi_s \right]}{K_{t+1}}. \quad (1)$$

where  $\Pi_s = A_s^{1-\eta} K_s^\alpha L_s^\eta - wL_s - C(I_s, K_s)$  denotes the firm's earnings in year  $s$ . Equation (1) corresponds to a generic Q-theory equation with quadratic adjustment costs, which takes the form  $I_t / K_t = \eta + \gamma Q$ .

To estimate Equation (1), ideally we would like to know expectations of earnings in all future periods. This is unfortunately not feasible in practice. For instance, CFOs only report expectations of earnings growth in the next 12 months. Formally, in the CFO survey we only have information about  $\mathbb{E}_t(\Pi_t)$ , namely expectations at the beginning of year  $t$  about earnings  $\Pi_t$  in the following 12 months (which are not yet known, so expectations are well-defined). With respect to investment, we have information on: (i) planned investment over the next 12 months, and (ii) actual capital spending in each quarter. We denote investment plans for the next 12 months as  $I_t^p$ , which captures the plan made at the beginning of the year about investment in the rest of the year.

Given implementation lags in the investment process, it may be most straightforward to test how expectations at a given point in time affect firms' investment plans.<sup>8</sup> Accordingly, we approximate Equation (1) by

$$\frac{I_t^p}{K_t} \approx \theta_0 + \theta_1 \frac{\mathbb{E}_t(\Pi_t)}{K_t} \quad (2)$$

This approximation is reliable if expectations about the level of future earnings display significant persistence, namely  $\mathbb{E}_t(\Pi_t) / K_t$  is not too far from  $\mathbb{E}_t(\Pi_{t+1}) / K_{t+1}$  and more generally for earnings further away in the future. We find this assumption to be plausible based on information in the data. Empirically earnings over assets are relatively persistent, and moreover, we verify that they are perceived to be very persistent drawing on evidence from analyst forecasts. The IBES dataset provides analysts' forecasts of future earnings for up to 12 quarters. With firm-level forecasts, we find  $\mathbb{E}_t(\Pi_{i,t+1}) / K_{i,t+1} = 0.83 \mathbb{E}_t(\Pi_{i,t}) / K_{i,t} + \eta_i + \varepsilon_{i,t}$  and  $\mathbb{E}_t(\Pi_{i,t+2}) / K_{i,t+2} = 0.73 \mathbb{E}_t(\Pi_{i,t}) / K_{i,t} + \eta_i + \varepsilon_{i,t}$ . Aggregate persistence implied by analyst forecasts is similar. In addition, lagged profitability is not significant if included in these regressions and neither does it affect coefficients on  $\mathbb{E}_t(\Pi_{i,t}) / K_{i,t}$ . These results suggest that next one-year expectations incorporate a significant amount of information about medium- to long-term expectations. We showed in Section 3 that CFO and analyst expectations are highly correlated, and it is probable that their beliefs share common structures.

<sup>8</sup> Plans are particularly helpful in the context of our data, where we observe forward-looking expectations once a quarter rather than once a year. With lags in investment implementation, it is unlikely that expectations in a given quarter will be immediately reflected in capital spending in the same quarter, or even fully incorporated into capital spending in the next quarter. In comparison, investment plans would be more responsive to contemporaneous expectations. When managers become more optimistic, they would revise their plans upward. As plans get implemented over time, the impact on actual capital expenditures can show up with some delay. For this reason, it is more straightforward to start testing the impact of expectations by looking at investment plans.

Given this corroborating evidence, it appears that within the limitations of our data, Equation (2) is a reasonable approximation of Equation (1). For the purpose of our empirical analysis, it is convenient to log-linearise Equation (2) and express it in growth rates, since all variables in the CFO survey are in terms of percentage change in the next 12 months relative to the past 12 months. By expressing Equation (2) in growth rates we can directly employ these variables, without using them to reconstruct levels. If we denote logs by lowercase variables, then derivations in Appendix A show that our equation for investment plans can be approximated as:

$$\underbrace{i_t^p - i_{t-1}}_{\substack{\text{planned investment growth} \\ \text{in the next 12m}}} \approx \mu_0 \underbrace{[\mathbb{E}_t(\pi_t) - \pi_{t-1}]}_{\substack{\text{expectations of earnings growth} \\ \text{in the next 12m}}} + (1 - \mu_1)(k_t - k_{t-1}) \quad (3)$$

where  $\mu_0, \mu_1$  are log-linearisation constants ( $\mu_1 > 0$ ). The left-hand side term is planned investment growth in the next 12 months, which is available from the CFO survey. The first term on the right-hand side of Equation (3) is expectations of earnings growth in the next 12 months, which we also observe directly in the data. This specification is very similar to previous studies of investment growth such as Barro (1990), Lamont (2000) and many others.

The intuition of Equation (3) is as follows: when firms think that earnings will increase by a lot in the next 12 months, they also tend to believe that future earnings will be higher for a sustained period of time. As a result, they would want to invest more, which leads to an immediate increase in planned investment. In Equation (3) we need to control for the change in capital stock because both investment and profitability are affected by the size of capital stock. We can also arrive at a specification very similar to Equation (3) in a simpler setting with time to build but without adjustment costs.<sup>9</sup> Empirically we use Equation (3) to map a basic investment model to testable predictions in our data set. We instead refrain from testing the parameter restrictions on the right-hand side coefficients that would be implied by a strict adherence to the approximated Q equation.

While investment plans are a convenient starting point to detect the impact of expectations, for Equation (2) to be informative about how expectations influence investment, it must also be the case that plans are closely related to realisations. In Section 5.3, we show that investment plans are highly correlated with actual capital spending over the planned period. In other words, a significant fraction of capital spending over the next few quarters appears to be determined by ex ante investment

<sup>9</sup> One might also consider an alternative approximation of Equation (1) of the following form  $I_{t-1} / K_{t-1} \approx \hat{\theta}_0 + \hat{\theta}_1 \mathbb{E}_t(\Pi_t) / K_t$  where  $I_{t-1}$  denotes realised investment in the past 12 months, and  $\mathbb{E}_t(\Pi_t)$ , as before, is current expectations of earnings in the next 12 months. This approximation is reasonable under two conditions. As in the case of Equation (2), it should be that expectations over future earnings are stable. Moreover, it has to be that respondents received little information and barely updated their beliefs in the past 12 months, so that current expectations about next 12-month earnings, namely  $\mathbb{E}_t(\Pi_t)$ , is close to expectations four quarters ago about earnings over the same period, namely  $\mathbb{E}_{t-1}(\Pi_t)$ . We find this approximation to be less tenable for several reasons. First, from time to time new information arrives over a 12-month period that has a significant impact on people's beliefs. (This can happen even if earnings processes are highly persistent, for example, if it is a random walk.) Second, given implementation lags in real-world investment activities, actual capital spending over a 12-month period tends to be particularly influenced by decisions made at the beginning of the period. As a result, realised capital spending in year  $t-1$ ,  $I_{t-1}$ , may not be well explained by expectations at the end of year  $t-1$ . In the light of these observations, we use the approximation in Equation (2) in the rest of our analysis.

plans, consistent with previous findings by Lamont (2000). To the extent that there is a close correspondence between investment plans and realised investment over the planned period, it would also be of interest to test how current expectations translate into actual capital spending in the next 12 months. This additional test allows us to further assess whether expectations have a substantial impact on actual investment activities. We present results from these tests in Section 5.3.

## 5. Expectations and investment

In this section, we test the relationship between investment decisions and earnings expectations. We focus on CFO expectations, and provide supplementary results using expectations of equity analysts. We begin by studying investment plans. In Section 5.1 we consider the role of expectations at the aggregate level, and in Section 5.2 we consider the role of expectations at the firm level. Then, in Section 5.3 we evaluate the relationship between plans and realised investment, and document the link between expectations and actual capital spending.

### 5.1 Expectations and investment plans: aggregate evidence

Figure 3 visually represents the association between aggregate CFO expectations and aggregate investment. Panel A plots CFOs' expectations of next 12-month earnings growth, along with planned investment growth in the next 12 months. Panel B adds to Panel A actual aggregate investment growth in the next 12 months. We see that there is a strong co-movement between earnings expectations and investment plans, and between investment plans and actual capital spending. At the very least, expectations data do not appear to be uninformative noise.

We then estimate versions of Equation (3) using quarterly regressions:

$$\Delta \widehat{CAPX}_{q_t} = \alpha + \beta E_{q_t}^* [\Delta \text{Earnings}] + \lambda X_{q_t} + \epsilon_{q_t}$$

where  $\Delta \widehat{CAPX}_{q_t}$  is planned investment growth in the next 12 months reported in quarter  $q_t$ , and  $E_{q_t}^* [\Delta \text{Earnings}]$  is CFO expectations of next 12-month earnings growth reported in quarter  $q_t$ .  $X_{q_t}$  includes past change in capital stock as shown in Equation (3), as well as a set of additional controls we discuss below. We use Newey-West standard errors with 12 lags.<sup>10</sup>

Table (4) columns (1) and (2) report our baseline results. We find that CFOs' earnings expectations have significant explanatory power for firms' investment plans, both statistically and economically. A one standard deviation increase in earnings growth expectations is associated with a 0.8 standard deviation increase in planned

<sup>10</sup> We check the autocorrelation structure of the errors: autocorrelations are mostly limited to the first four lags, due to the overlapping structure of our data; autocorrelations after four lags are minimal. Our empirical results are not sensitive to alternative choices of Newey-West lags.

investment growth.<sup>11</sup> Put differently, a 1 percentage point increase in CFO expectations is accompanied by a 0.6 percentage point increase in planned investment growth.<sup>12</sup> Quantitatively, CFO expectations have major explanatory power for aggregate investment.

In interpreting these results, three issues arise. First, how do CFO expectations relate to traditional proxies of Tobin's Q? Do data on managers' expectations contain information beyond market price-based measures of Q? Second, is the role of expectations robust to controlling for alternative theories of corporate investment? Third, and finally, could the correlation between expectations and investment reflect a reverse causality problem, whereby investment affects expectations of future earnings rather than the other way around? In the following, we address these issues by augmenting our baseline regressions.

Some variables may affect investment but are likely to do so only through their influence on expectations, such as information relevant for predicting future product demand. In principle, a large part of expectations are formed, perfectly or imperfectly, based on observable information, instead of being exogenous innovations. Thus a flexible enough function of observable information should be able to approximate expectations. The focus of our present analysis is to test the extent to which expectations as a whole, as measured by our data, affect firms' investment decisions. It is not specifically about the impact of variations in expectations not explained by observables (so called "expectational shocks"). Accordingly, we do not pursue an investigation of whether our expectations variables can or cannot be driven out by a full set of factors that are primarily used to explain expectations. Instead, we emphasise controls that represent alternative determinants of investment (such as discount rates, financial constraints etc).<sup>13</sup>

### 5.1.1 CFO expectations and market-based proxies for Tobin's Q

We begin with a comparison of CFO expectations and traditional proxies of Tobin's Q. This exercise helps us assess whether expectations data contain additional information relative to standard market-based Q measures. In Table 4 column (3), we include the empirical proxy of Q. In line with previous research, the explanatory power

<sup>11</sup> At the aggregate level, during the period where we have CFO expectations data, the standard deviation of planned investment growth is about 0.05, and the standard deviation of earnings growth expectations is 0.07.  $0.07 \times 0.6 / 0.05 = 0.8$ .

<sup>12</sup> Due to lags in investment implementation, it is also possible that, at a given quarter, part of the capital spending that firms expect to make in the next 12 months are determined by decisions made, for example, in the last quarter, and therefore affected by expectations then. In aggregate data, we can include lagged expectations, in which case current expectations and past expectations with two lags are significant, and jointly highly significant. Unfortunately, it is difficult to include lagged expectations in firm-level tests, since we do not always observe individual firms continuously. Therefore, in the baseline specifications we include only current expectations.

<sup>13</sup> We thank our discussant Chris Sims for the suggestion of a more careful examination of the role of expectational shocks, as well as the feedback among different variables, through VARs. To the extent that expectations experience a meaningful amount of exogenous shocks above and beyond reactions to observable information, so that what appear to be expectational shocks is not simply measurement error, studying expectational shocks may improve identification. It would also be ideal to have a longer time series (we currently only have 57 quarterly observations of CFO expectations and 112 quarterly observations of analyst expectations) to reliably estimate the dynamic relationships. In our first-step analysis, we study the impact of measured expectations as a whole to show the basic core facts. The investigation of expectational shocks is an interesting issue that we leave to future research.



of equity Q is very weak. It is well known that equity Q is very persistent and does not line up well with fluctuations in investment activities. In our context, to explain investment growth, the direct theoretical counterpart is not Q in levels, but the log change in Q. Barro (1990) shows changes in Q are almost equivalent to stock returns. He finds that changes in Q from the beginning of year  $t-1$  to the beginning of year  $t$  is highly correlated with investment growth in year  $t$ , and stock returns from the beginning of year  $t-1$  to the beginning of year  $t$  perform incrementally better. In column (4), we include past 12-month stock returns. The coefficient on this variable is positive and statistically significant, as predicted by theory. The coefficient on CFO expectations remains large and highly significant.<sup>14</sup> The views of CFOs appear to contain a substantial amount of additional information for investment plans not captured by equity Q.

Recent work by Philippon (2009) finds that a proxy of Q obtained from bond yields is also highly correlated with investment activities. Philippon's bond Q series end in 2007, which is five years before the end of our sample. However, bond Q is highly correlated with credit spread. For example, the correlation between changes in bond Q and changes in credit spread over four quarters is 0.84. Thus in column (5) we include changes in credit spread in the past four quarters in lieu of bond Q. In addition, credit spread can be relevant as a control also because it may reflect credit availability and financial constraints. The coefficient on this variable is negative and significant – consistent with theory – but CFO expectations retain significant explanatory power beyond it.

Overall, CFO expectations explain investment plans beyond market-based Q proxies, statistically and economically. Indeed, CFOs may possess information that markets participants either do not possess or process imperfectly. To the extent that managers' and markets' views differ, it is natural that managers' beliefs have a major impact on investment decisions. As we show in Section 5.3, this result also extends to actual capital spending.

### 5.1.2 CFO expectations and alternative theories of investment

We now test the role of expectations against alternative theories of investment. We introduce a set of variables motivated by these theories, which are the key controls in our analysis.

#### *Time-varying discount rates*

A prominent idea in traditional finance holds that variations in required returns, or discount rates, are central to explaining investment in both financial and real assets (eg Cochrane (1991, 2011)). Lamont (2000) postulates that firm investments rise and fall in response to changes in discount rates so that high investment growth is associated with low future stock returns. Lettau and Ludvigson (2002) argue that time-varying risk premia, as proxied for by the consumption-wealth ratio (known as *cay*), can forecast future investment growth. In Table 4 columns (6) to (8), we control for three common measures of discount rates: log dividend yield, *cay*, and the surplus consumption ratio as constructed by Campbell and Cochrane (1999). *cay* is somewhat significant, surplus consumption is not, and dividend yield tends to enter with the

<sup>14</sup> As illustrated in Section 4, proxies of Q are supposed to represent the Q model precisely, whereas survey data can only represent it approximately. Thus it may not be surprising that Q proxies remain significant in regressions that include survey expectations.

wrong sign. The explanatory power of CFO expectations is unaffected. We get similar results if we include these variables in terms of past 12 month changes instead of in levels.

We can also control for risk premia implied by long-run risks models, as constructed by Bansal, Kiku, Shaliastovich, and Yaron (2014). Unfortunately their series is annual, which leaves us with few observations. We interpolate the series to quarterly frequencies in multiple ways and find it tends to enter with the wrong sign. Taken together, none of these variables compare in their explanatory power to CFO expectations, and their inclusion does not have much of an influence on the coefficient on expectations.

Because proxies for discount rates are generally quite persistent, their coefficients can suffer from Stambaugh (1999) biases. In our case, Stambaugh bias will tend to attenuate the coefficients on discount rates toward zero or make them have the wrong sign.<sup>15</sup> In Appendix C Table C6, we report Stambaugh bias-adjusted results, using a multivariate version of the bootstrap method in Baker, Taliaferro, and Wurgler (2006). The bias-adjusted results are very similar.

### *Financing constraints*

A well-known empirical result, dating back to Fazzari, Hubbard, and Petersen (1988), is that investment is positively correlated with recent firm cash flows. The leading interpretation is that firms are often financially constrained, so they would invest more when high cash flows increase internal resources. In column (9), we control for cash flows in the past 12 months.<sup>16</sup> We can include cash flow variables either in levels or in changes, and results are similar: the coefficient on expectations barely changes, and the coefficient on past cash flows tends to be insignificant. This result confirms earlier findings by Cummins et al (2006) that unveil the fragility of financial constraint variables once earnings expectations are taken into account.

### *Economic uncertainty*

A blooming literature studies the impact of uncertainty on economic activities when investment is irreversible or has fixed adjustment costs (Leahy and Whited (1996); Parigi and Guiso (1999); Bloom, Bond and Van Reenen (2007); Bloom (2009), among others). During periods of high uncertainty, the theory goes, managers do not want to exercise the option of investing: they prefer to wait for better times and information. It is legitimate to ask whether our measure of CFO expectations is important when we include proxies for uncertainty in our regression.

In Table 4 column (10), we include stock price volatility as a standard uncertainty proxy following Leahy and Whited (1996) and Bloom, Bond and Van Reenen (2007), together with economic policy uncertainty as measured by Baker, Bloom and Davis (2013). We can use these variables in levels or in past 12 month changes. In either

<sup>15</sup> Stambaugh bias arises when predictor variables are relatively persistent, and innovations in predictor variables and outcome variables are correlated. In theory, investment should be high when discount rates are low. Thus we would expect a negative coefficient on discount rates. To the extent that innovations in investment and discount rates are negatively correlated, Stambaugh bias will be upward, pushing the coefficient on discount rates closer to or above zero.

<sup>16</sup> Here we use past net income rather than pro forma earnings to be conservative, since the actual internal resources that firms gain from cash flows need to deduct most of the extraordinary items. Results using either form of profit metric to control for past cash flows are very similar.

case, these uncertainty proxies have only weak explanatory power and the coefficient on CFO earnings expectations remains highly significant.

In Table 4 columns (11) and (12), we additionally control for past GDP growth and past investment growth. In the last column, we include multiple controls together. The statistical and economic significance of CFO expectations remains largely intact.

Overall, these tests illustrate that CFO earnings expectations have significant explanatory power which is not accounted for by variables capturing alternative theories, such as time-varying discount rates, financial constraints and uncertainty. As we show below, similar results hold when we connect expectations to actual capital spending. Our results suggest that expectations data provide substantive information about fluctuations in aggregate investment and changes in expectations can be central to understanding investment activities.

### 5.1.3 Reverse causality

One possible concern is our baseline results could be affected by reverse causality. Specifically, if a firm plans to invest a lot in the next 12 months, managers might also expect earnings to increase as investment leads to more output and sales. This mechanism seems unlikely to be driving our results. First, investment in the next 12 months generally does not translate into output and sales immediately. Second, even if it does, investment is an incremental addition to the capital stock. It is unlikely that a 1% increase in investment (which increases the firm's capital stock by much less than 1%) can instantly lead to a 1% or more increase in firm earnings, as would be required to match the magnitude of coefficients in the data.

We further address the reverse causality concern in supplementary tests, drawing on another question in the CFO survey, which asks respondents to rate their optimism about the US economy on a scale from 0 to 100 (with 0 being the least optimistic and 100 the most optimistic). In Appendix C Table C1, we show that CFOs' optimism about the US economy is significantly positively correlated with investment. It is hard to argue that firms' investment plans will mechanically cause CFOs to be more optimistic about the *US economy*. Instead, this result is very much in line with previous findings that firms' expectations and sentiments appear to be a key driver of investment activities.

In Appendix C Table C2, we present the same set of tests using analyst expectations. We find analyst expectations are also significantly correlated with investment plans, although not surprisingly the magnitude of the relationship is smaller; the coefficients on analyst expectations are generally about one half of the size of the coefficients on CFO expectations. The evidence suggests that expectations elicited from different sources are consistent, and there are general views shared by managers and the market that play an important role in shaping aggregate investment dynamics.

## 5.2 Expectations and investment plans: firm-level evidence

In Table 5, we repeat our analysis at the firm level. As before, we start with CFO data. We estimate

$$\widehat{\Delta CAPX}_{i,q_t} = \alpha + \zeta_i + \beta E_{i,q_t}^* [\Delta \text{Earnings}_i] + \lambda X_{i,q_t} + \epsilon_{i,q_t}$$

We report baseline results with firm fixed effects. Results are very similar without fixed effects, or with dynamic panel estimators.<sup>17</sup> Table 5 shows that at the firm level, CFO expectations continue to have substantial explanatory power for investment decisions. The response of a firm's investment plans to CFO expectations is similar in magnitude to the relationship unveiled in the aggregate analysis of Table 4: when CFOs expect earnings growth to increase by 1 percentage point, planned investment growth increases by 0.4 percentage points on average. We then compare CFO expectations with firm-level Q and past 12 month firm stock returns. We use the book-to-market ratio as a proxy for firm-level required returns, and all other firm-level controls directly correspond to their aggregate counterparts in Table 4. After including these controls, alone or together, CFO expectations remain statistically and economically significant. We also examine results adding time fixed effects and the findings are similar.

In Appendix C Table C3 we replicate the firm-level analysis with analyst expectations. The results show that analyst expectations about a firm's earnings growth can also explain investment plans. As before, the size of the coefficients on analyst expectations is about one half of that on CFO expectations. While CFO expectations play a more dominant role, business outlook shared by managers and specialist analysts is nonetheless informative about investment decisions.

### 5.3 From plans to realised investment

A premise for our analysis in Sections 5.1 and 5.2 is that investment plans are key determinants of actual capital spending. With lags in investment implementation, expectations in a given quarter may not translate into realised investment instantly, so changes in plans can help us pinpoint the impact of expectations, and plans will turn into capital expenditures over a period of time. In this section, we evaluate this proposition empirically. In Figure 3 Panel B, it is evident that, at the aggregate level, plans and realised investment over the planned period are closely related. The raw correlation between the two series is 0.78.<sup>18</sup> Figure 3 Panel B also shows that realised investment is highly correlated with investment plans fitted on CFO expectations. Expectations appear to be a key driver not only of investment plans, but also of actual capital spending.

In Tables 6 and 7, we present a full set of results using CFO earnings expectations in a given quarter to forecast actual investment growth in the next 12 months, both at the aggregate and at the firm level. We find that expectations, and CFO expectations in particular, have substantial forecasting power for realised next 12-month investment. Both in the aggregate and at the firm level, a 1 percentage point increase in CFO earnings growth expectations predicts a 0.6 percentage point increase in actual investment growth in the next 12 months. The performance of past

<sup>17</sup> To the extent that strict exogeneity may not be satisfied, fixed effect estimators may be biased in finite sample. In our context, it will bias the coefficient on earnings expectations downwards. Regressions without fixed effects and those using dynamic panel methods show that the bias does not appear to be very important. Given that we do not always continuously observe individual firms in the CFO sample, it is difficult to take first differences and use lagged instruments. Instead, for dynamic panel estimations we apply the forward orthogonal deviations (FOD) transformation as in Arellano and Bover (1995).

<sup>18</sup> Figure 2 uses aggregate investment as measured by private non-residential fixed investment from NIPA. We can alternatively use capital expenditures data from Flow of Funds or Compustat, and results are very similar.

stock returns and changes in credit spread has some improvements, but expectations data retain significant power; they are very informative about realised capital spending both alone and in the presence of a list of important controls.

Taken together, evidence in this section shows that expectations data are highly relevant for understanding corporate investment. They are not simply noise, but contain considerable information for explaining investment activities beyond a host of traditional variables.

## 6. Are expectations rational?

Given that expectations appear to shape investment, it is critical to understand their determinants. We now take a first step in analysing the structure of CFO and analyst expectations about future earnings growth. In particular, we check whether expectations of managers and market participants are consistent with rational benchmarks, or are systematically biased in predictable ways.

The simplest test of rational expectations is to run a regression with realised future earnings growth on the left-hand side and ex ante expectations on the right-hand side. In our context, such tests take the form:

$$\underbrace{\Delta Earnings_i}_{\text{realized next 12m earnings growth}} = \alpha + \beta \underbrace{E_{i,q_t}^* [\Delta Earnings_i]}_{\text{expected next 12m earnings growth}} + \omega_{i,t+1}$$

where  $i$  is a firm index,  $\Delta Earnings_i$  denotes realised earnings growth in the next 12 months, and  $E_{i,q_t}^* [\Delta Earnings_i]$  denotes expectations of next 12 month earnings growth reported in quarter  $q_t$ . The test can be augmented by including on the right hand side a set of variables that are within time  $t$  information set.

Rational expectations postulate that  $\alpha = 0$  and  $\beta = 1$  (and a zero coefficient on any other variable in time  $t$  information set). Using both CFO and analyst expectations, we find  $\beta$  to be significantly lower than one, and a list of variables known at time  $t$  enter significantly. This finding, however, does not necessarily mean that expectations are excessively volatile relative to outcomes. It could be that expectations are measured with error, which would cause a downward bias in  $\beta$ .

An alternative approach is to study the predictability of ex post expectational errors. If expectations are rational, forecast errors should be orthogonal to all information available at the time when the forecast is made, and forecast errors should be unpredictable. If, on the other hand, expectations are systematically biased, then ex post errors would be predictable using information available ex ante. In this case, the structure of error predictability could help us understand potential sources of excessive optimism and pessimism.

To take a first look, consider Figure 4. Panel A shows errors in aggregate CFO expectations about next 12 month earnings growth against past year corporate

profitability. Panel B shows the same series using analysts' expectations data.<sup>19</sup> The figures show a striking pattern: expectational errors appear to be systematic and recurring. In particular, they are consistent with the presence of excessive optimism in good times and excessive pessimism in bad times: future realised earnings growth systematically falls short of expectations when past earnings are high, and exceeds expectations when past earnings are low.<sup>20</sup>

To statistically corroborate the patterns in Figure 4, we present regressions of expectational errors on past profitability. Column (1) of Table 8 Panel A reports the results using CFO data. Column (1) of Table 9 Panel A reports the results using analyst data. In both cases, high past-year profitability is correlated with over-optimism, while low past-year profitability is correlated with over-pessimism.<sup>21</sup> The magnitude of the bias appears large. For instance, a one standard deviation increase in past profitability is associated with a 0.6 standard deviation increase in the magnitude of CFOs' expectational errors.<sup>22</sup> Figure 5 further illustrates these results with scatter plots of expectational errors against past profitability. It shows that the bias is present throughout the sample period, and not driven by a single outlier event.

Column (2) in Panel A of Tables 8 and 9 correlate expectational errors with past GDP growth to check whether over-optimism and over-pessimism are predictable by aggregate economic performance. We also find higher past GDP growth is associated with over-optimism, and vice versa (although the statistical significance on past GDP growth is a bit lower).<sup>23</sup>

One way to interpret these results is that expectations depart from rationality in the direction of being extrapolative: when CFOs or analysts observe good or bad earnings realisation, they think that similar realisation persists into the future and fail to correct for mean reversion. To illustrate, we separately examine, and then compare, how actual future earnings growth and expected future earnings growth correlate with past-year profitability. When past-year earnings over assets increase by 1 percentage point, actual earnings growth in the next 12 months on average slows down by 0.12. However, CFOs only expect next 12-month earnings growth to slow

<sup>19</sup> The errors are computed as aggregate realised next 12-month earnings growth – aggregate CFO (analyst) expectations of next 12-month earnings growth. As we cannot identify the full set of firms that answer the CFO survey in each quarter, this sample may differ from the full sample with which we use to compute aggregate realised earnings growth. For robustness, to make sure that aggregate earnings growth patterns are representative, we alternatively compute aggregate earnings growth by taking the mean or median earnings growth in each quarter. We find this makes very little difference, and we get consistent empirical results in all cases.

<sup>20</sup> Note that earnings in quarter  $t$  are typically announced several weeks into quarter  $t+1$ , thus we use earnings from quarter  $t-5$  through  $t-2$  to compute past-year profitability, so as to ensure that all information in the predictor variable is strictly in the information set of CFOs and analysts when they make forecasts in quarter  $t$ .

<sup>21</sup> To address concerns that past-year profitability is relatively persistent (though it is much less persistent than variables like discount rate proxies), we present bootstrap bias-adjusted results in Appendix C Table C7. We find very similar results.

<sup>22</sup> During the period where we have CFO expectations, the standard deviation of past-year earnings/asset is 0.88, and the standard deviation of expectational errors is 0.13.  $0.88 \times 0.09 / 0.13 = 0.6$ .

<sup>23</sup> To be conservative, past 12-month GDP growth also ends at quarter  $t-2$  because GDP is reported with a lag,

down by about 0.03. The difference between the true and perceived reversion corresponds to the coefficient of  $-0.09$  in Panel A column (1).

We find very similar results at the micro level. In Table 8 Panel B we examine expectational errors of individual CFOs. We use past-year firm profitability and GDP growth as main predictors of expectational errors. Consistent with previous evidence at the aggregate level, expectational errors of individual CFOs are also strongly correlated with firm profitability and general economic conditions, in a way that appears to be extrapolative. At the firm level, as past-year earnings over asset increase by 1 percentage point, next 12-month earnings growth tends to slow down by 0.06, whereas CFOs only expect it to slow down by 0.01 on average. This results in a difference of  $-0.05$ , as shown by Panel B column (1).

Note that profitability is likely to be heterogeneous across firms, and the normal level of earnings over assets can be quite different for established firms than for young firms, and for firms in different industries (this can be of particular concern when we turn to the analyst sample, which is much more heterogeneous than the CFO survey sample). To account for firm-specific average profitability, we include firm fixed effects. In the setting of error predictability regressions, strict exogeneity required by traditional fixed effect estimators may not be satisfied. Under the null of rational expectations, only sequential exogeneity will be satisfied. We perform robustness checks using dynamic panel estimators as in Arellano and Bover (1995),<sup>24</sup> and results are very similar. For standard errors in firm-level tests, we always cluster by firm and we double-cluster by both firm and time whenever the length of the panel makes it appropriate to do so.

In columns (5) and (6) of Table 8 Panel B, we report results adding time fixed effects, which helps us assess the extent to which expectational errors load on the idiosyncratic component of firm profitability. By teasing out aggregate shocks, time fixed effects may also attenuate issues in rational expectations tests when the panel is relatively short (this can be a concern with the CFO panel, which spans seven years and 28 quarters, and is less of a concern with the analyst panel, which covers 28 years and 112 quarters).<sup>25</sup> We find that CFOs seem to significantly extrapolate the idiosyncratic component of past profitability. Together, results in Table 8 show that the extrapolative structure of CFO expectations appears pervasive. Past-year economic conditions, and both the aggregate and the idiosyncratic component of firm profitability, are all correlated with CFOs' expectational errors.

In Table 9, we perform the same set of tests as in Table 8 using analyst expectations. The results are similar: analysts also tend to overestimate next 12-month earnings growth when past-year firm profitability is high and when past-year economic conditions are favourable, and underestimate future earnings growth when the past year is rough.

At first glance, the patterns in CFO and analyst expectations are quite consistent with extrapolative biases observed in financial markets. As shown by Greenwood and Shleifer (2014), many market participants – including both individual and institutional

<sup>24</sup> The forward orthogonal deviations (FOD) transformation studied by Arellano and Bover (1995) is most helpful as our CFO panel contains gaps.

<sup>25</sup> One possible concern is that time fixed effects may not completely tease out aggregate shocks if different firms are affected differently by an aggregate shock. For this to affect our results, it has to be that firms which happen to have a profitable past year are hit harder by an adverse aggregate shock, and vice versa. We do not find very compelling evidence for this concern.

investors, as well as CFOs surveyed by Graham and Harvey – tend to extrapolate stock price trends formed in the past year. They generally think that past year’s trend would continue, whereas in reality it tends to revert. As explained in Section 2 and shown in Figure 1, investors tend to become significantly more optimistic about stock market performance in the next 12 months when market returns in the past year are high, and vice versa (Figure 1 Panel A). Corporate CFOs are equally extrapolative in their expectations about next 12-month market returns (Figure 1 Panel B). Piazzesi, Salomao, and Schneider (2013) also find that bond market investors tend to perceive interest rate trends to be more persistent than they are. The extrapolative tendency in expectations formation resonates with the well known representativeness bias in human judgment (Kahneman and Tversky (1972); Tversky and Kahneman (1974)), which can lead people to view events similar to recent experiences as typical and likely, and to discount scenarios that are different from the prevailing situation (Gennaioli, Shleifer, and Vishny (2015)).

While our evidence is consistent with extrapolation in earnings expectations, there can certainly be other reasons which contribute to apparent deviations from rationality. In the following, we address a set of possible concerns.

## Alternative explanations of deviations from rationality

### *a. Misinterpretation of survey question*

First, we would like to make sure that the apparent errors in expectations do not simply reflect respondents misinterpreting the survey question. This could be a concern for CFO expectations, as CFOs are directly asked to provide forecasts of earnings growth in the next 12 months, and there could be alternative definitions of next 12-month earnings growth. This is not an issue, however, for analyst expectations, since analysts provide forecasts of total earnings in specific future quarters, and we compute the implied expected next 12-month earnings growth by combining their forecasts with actual past earnings; we then compare this variable to realisations to test forecast accuracy.<sup>26</sup>

Specifically, while the CFO survey asks about earnings growth in the next 12 months defined as the percentage change of earnings in the next 12 months relative to earnings in the past 12 months, one might worry that respondents could instead provide expectations about earnings 12 months from now relative to current earnings. If this were true, then when we compare survey responses to actual earnings growth in the next 12 months – which we follow the survey question to define as earnings in the next 12 months over earnings in the past 12 months – we might get spurious errors. For clarity of exposition, we denote next 12-month earnings growth defined by the survey as

$$\Delta \text{Earnings}_t = \text{earnings in the next 12 months} / \text{earnings in the past 12 months} ;$$

<sup>26</sup> In other words, in the case of analysts, we compute expected next 12-month earnings growth = analyst forecasts of earnings in the next 12-months/actual earnings in the past 12 months, and compare it to realised next 12-month earnings growth = actual earnings in the next 12 months/actual earnings in the past 12 months. We can alternatively normalise analyst forecasts of next 12-month earnings by current assets, and results are very similar.



we denote the alternative interpretation as  $\Delta\text{Earnings}_t^{alt} = \frac{\text{earnings 12 months from now}}{\text{current earnings}}$ ;

and we denote CFO responses as  $E_t^{CFO}$ .

We provide two checks to show that respondents do not appear to misinterpret the question. First, Figure 2 shows that CFO responses and analyst expectations are quite consistent when analyst expectations are computed following the survey definition of next 12-month earnings growth. However, if we instead compute analyst expectations of earnings four quarters from now relative to current earnings, the result would look much more different from CFO responses. Second and more importantly, if we compute actual earnings four quarters from now relative to current earnings (namely  $\Delta\text{Earnings}_t^{alt}$ ) and compare it to CFO responses, then CFOs would look to be much more wrong. In particular, while aggregate CFO responses are 0.54 correlated with  $\Delta\text{Earnings}_t$ , it is only 0.1 correlated with  $\Delta\text{Earnings}_t^{alt}$ . In addition, even if we construct expectational error as  $\Delta\text{Earnings}_t^{alt} - E_t^{CFO}$ , this variable is still predictable by past 12-month profitability.<sup>27</sup> Across all robustness checks, we find actual CFO responses are closest to the survey's intended definition of next 12-month earnings growth, and by comparing CFO responses to  $\Delta\text{Earnings}_t$  we get the most conservative results with respect to deviations from rationality.

#### *b. Asymmetric loss functions*

A common concern with forecast data is respondents might have asymmetric loss functions that cause them to report expectations which deviate from their objective views. For instance, analysts may want to please firm management and release upward biased forecasts (Lim (2001)). In the case of CFOs, reputational or other "publicity" considerations are unlikely to be at play, as individual responses in the CFO survey are never published. From this perspective, CFOs should not have much incentive to bias their responses for signalling purposes.

The main challenge for explanations with asymmetric loss functions is to account for the time-varying nature of expectational errors. Commonly used specifications of asymmetric loss functions (such as the LINEX function, and the Lin-Lin function under certain assumptions) generally yield optimal forecasts that are linear in objective expectations and conditional variance of the forecast variable. Given that conditional volatility of earnings tends to be higher in bad times, for asymmetric loss functions to generate more "pessimism" in bad times and more "optimism" in good times, it has to be the case that overpredicting is more costly than underpredicting. In this case, however, we would expect reported expectations to be consistently biased

<sup>27</sup> Relatedly, to test the accuracy of earnings expectations, it is highly important that we use the same earnings measure as CFOs and analysts. As mentioned in Section 3, we use pro forma actual earnings from IBES instead of GAAP earnings. The earnings measures we use are the ones CFOs report in earnings announcements and the ones analysts generally aim to match. In addition, we check that they are closest to CFO and analyst forecasts in terms of magnitude, variance, and variation over time. When compared to GAAP earnings, CFO and analyst expectations appear to be much more wrong, and error predictability remains.

downwards (with the magnitude increasing in the size of the conditional variance), which is not the case for either CFOs or analysts.<sup>28</sup>

While we do not find compelling reasons why asymmetric loss functions can drive our results, we nevertheless perform a set of robustness checks. In Table 8 and Table 9 we control for various proxies of volatility, including the VIX index and recent stock price volatility. We find that the volatility terms do not enter significantly, and our main results are unchanged. This evidence suggests that it is the level of past earnings that affects systematic forecast errors, whereas uncertainty plays a minor role.

### *c. Risk-neutral probability weighting*

Another possible concern is that CFOs might be reporting expectations not under physical probabilities, but under certain types of risk-neutral probabilities. Note that reporting expectations of future earnings growth is distinctively different from pricing, or calculation of expected returns of an asset. In the context of pricing, future cash flows may be discounted using a stochastic discount factor, or correspondingly, weighted by risk-neutral probabilities. In the context of forecasting future earnings growth, it is not very plausible that any *discounting* is present and that there is an associated stochastic discount factor from optimising theories.<sup>29</sup> It is possible that certain scenarios might be more salient in people's minds that lead to distorted probability weighting, but this explanation would fall into the category of cognitive biases (Bordalo et al (2012)).

### *d. Conditional expectations vs other conditional moments*

Properties of rational expectations tests are stated under the case where respondents provide conditional expectations of variables of interest. One concern could be that respondents might be reporting conditional medians, conditional modes, or other conditional moments instead of conditional expectations. For medians in particular, we can perform robustness checks with least absolute deviations regressions, which yield similar results as OLS. More generally, for this type of problem to affect our results, it has to be that, following high past profitability, the moment people report is greater than the conditional mean, and vice versa. We check the distribution of future earnings growth conditioning on past profitability, and do not find any evidence that conditional medians and modes follow this pattern (Appendix C Figure C1 plots the distribution of next 12-month earnings growth given a certain level of past profitability). Although we may not be able to rule out the possibility that respondents report some other moments that happen to behave this way, it is not obvious what these moments could be and why respondents across different groups all prefer to use them. Certainly, more precise elicitation of expectations will be highly beneficial, as stressed by Manski (2004), but within available data, we do not find

<sup>28</sup> One might also consider alternative scenarios where CFOs and analysts have time-varying loss functions. For this to explain our results, it has to be that people prefer to underpredict in bad times and to overpredict in good times. We do not find compelling reasons why it is optimal to follow this strategy.

<sup>29</sup> In addition, to the extent that high earnings are associated with low SDF (ie if general earnings are high in good states), earnings growth under risk-neutral probabilities (which is always a well defined mathematical object, though its economic interpretation may be unclear) will be consistently lower than earnings growth under physical probabilities. We find no evidence that either CFOs or analysts appear to be persistently pessimistic.

compelling evidence that the observed over-optimism and over-pessimism could be well explained by respondents reporting alternative conditional moments.

*e. Information rigidities and rational inattention*

Finally, recent research also points to other frictions that can affect expectations formation, including information rigidities (Mankiw and Reis (2002)) and inattention (Sims (2003, 2010)). While these frictions are likely to be important in many economic settings, they may not be natural explanations for the extrapolative errors in CFOs' and analysts' earnings expectations. Although there is some possibility that managers and analysts do not pay full attention to information such as GDP growth, it is not quite plausible that past firm earnings are not in their information set, or that such information just slips their minds. After all, earnings are quite important for firms, as well as to management compensation. Similarly, analysts, who are designated to forecast future earnings and whose performance is judged in part by the accuracy of their forecasts, are also unlikely to be oblivious to firm earnings.<sup>30</sup>

Overall, our evidence points to systematic extrapolative biases in CFO and analyst expectations. While we may not be able to definitively rule out that some combinations of limited sample span, measurement error, and more complicated versions of informational frictions and loss functions could contribute to some these results, extrapolation stands out as the most natural and parsimonious explanation. The findings also echo accumulating evidence in finance that extrapolation arises in many settings, and appears to be a common psychological tendency in expectations formation.

## 7. Summary and implications

Our analysis of data on earnings expectations and investment yields two basic conclusions. First, expectations data appear to be extremely helpful in understanding corporate investment plans and actual investment, more so than some traditional measures of determinants of investment. Second, several empirical tests appear to reject the rational expectations benchmark, pointing to the extrapolative nature of expectations.

At a minimum, the evidence endorses Mankiw's (2004) call for collecting and using expectations data to evaluate economic theories. Our project would not have been possible without Campbell Harvey and John Graham's CFO data. But as is often the case with a preliminary analysis and with limited data, there are many questions that we cannot address with the limited data we have.

An important challenge raised by this analysis, as well as by previous work, is to construct plausible models of expectations. In macroeconomics, in particular, such models have to come to grips with some version of the Lucas critique, which was applied initially precisely to Cagan's and other models of adaptive expectations. In our view, market participants might be backward-looking and extrapolative to some

<sup>30</sup> We also test the extent to which expectational errors are predictable by the forecast itself or by past forecasts. We find that higher forecasts are associated with less-than-expected actuals, and vice versa. However, this result could be especially susceptible to the influence of measurement errors, as any random measurement error of the forecast would mechanically affect expectational errors. Thus we interpret it with extra caution.

extent, but surely they also have some ideas of how the economy evolves that are forward-looking. Developing models along these lines is an open problem. Our own approach has been to use psychological models of expectations that incorporate both forward and backward-looking elements (eg Bordalo et al (2013); Gennaioli et al (2015)), but this research is still some way from being ready for a macroeconomic model.

The larger question of course is whether expectations have a significant role to play in macroeconomic modelling. A recent literature in macroeconomics considers expectations "shocks", and discusses the extent to which they can contribute to economic fluctuations (Beaudry and Portier (2004); Angeletos and La'O (2009); Lorenzoni (2009); Barsky and Sims (2012); Angeletos and La'O (2013); Levchenko and Pandalai-Nayar (2015)). Our perspective is quite different; the evidence suggests that expectations have a fairly precise extrapolative structure, and do not just vibrate randomly. They are not noise; there is a systematic pattern of errors. Moreover, we believe – and our evidence seems supportive of this belief – that market participants make common expectational errors. Here we show that these errors are common to analysts and CFOs; we suspect the beliefs of policymakers are highly correlated with those of market participants. It seems to us that, as a consequence, plausible models would consider common errors among many economic agents, which therefore would have potential aggregate effects.

The final question is whether such errors can account for some part of macroeconomic fluctuations, such as aggregate overbuilding in important sectors like the housing market, or prolonged recessions with a lack of corporate investment and hiring. Our data have limitations for quantifying how the erroneous component of expectations affects investment, since the rational level of investment is not observable, but has to be inferred from making additional assumptions about the decision-makers' environment and information, which requires extra discretion. It is a further step still that a common error translates into aggregate investment distortions. We leave this to future work.

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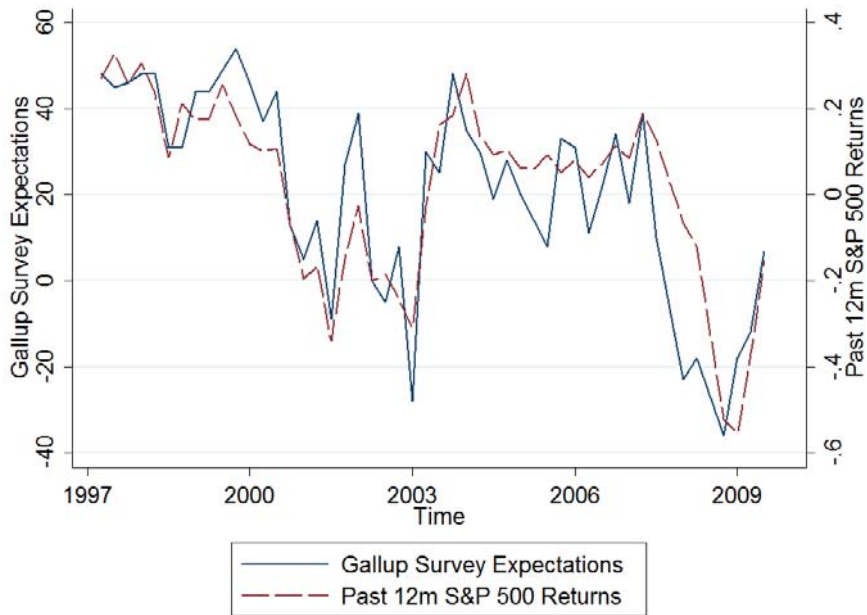
## Figures and tables

### Stock market expectations of investors and CFOs and past stock returns

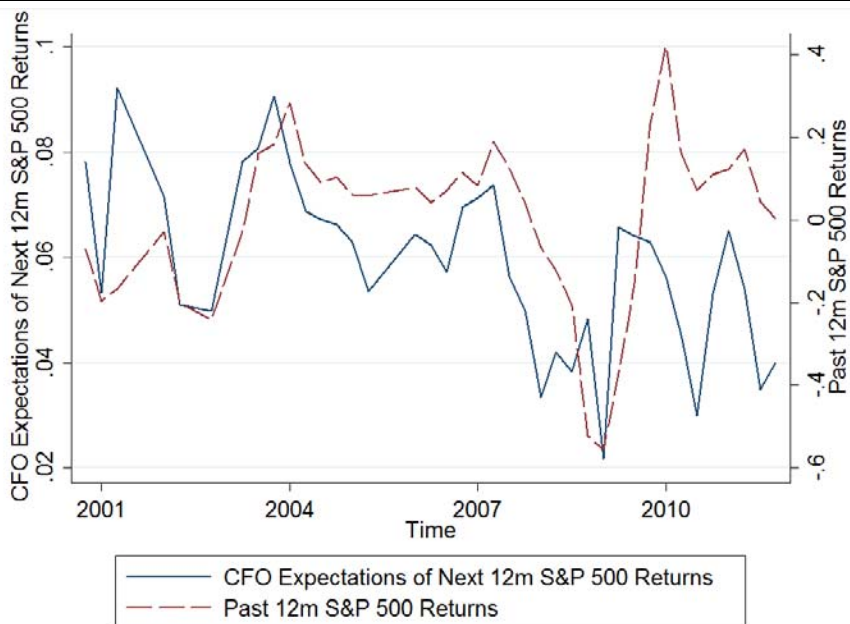
The dashed line denotes S&P 500 index returns in the past 12 months. In Panel A, the solid line denotes expectations from the Gallup survey (% optimistic – % pessimistic about performance of the stock market in the next 12 months). In Panel B, the solid line denotes the average response in the CFO survey, to the question “Over the next year, I expect the average annual S&P 500 return will be: \_\_\_.” Frequency is quarterly.

Panel A. Expectations in Gallup Survey and past year stock returns

Figure 1



Panel B. Expectations in CFO Survey and past year stock returns



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## Expectations of next 12-month Earnings Growth by CFOs and analysts

The solid line is aggregate CFO expectations of next 12-month earnings growth from the CFO survey. The dashed line is aggregate analyst expectations of next 12-month earnings growth computed from analyst EPS forecasts. Frequency is quarterly.

Figure 2



## CFO earnings growth expectations and investment

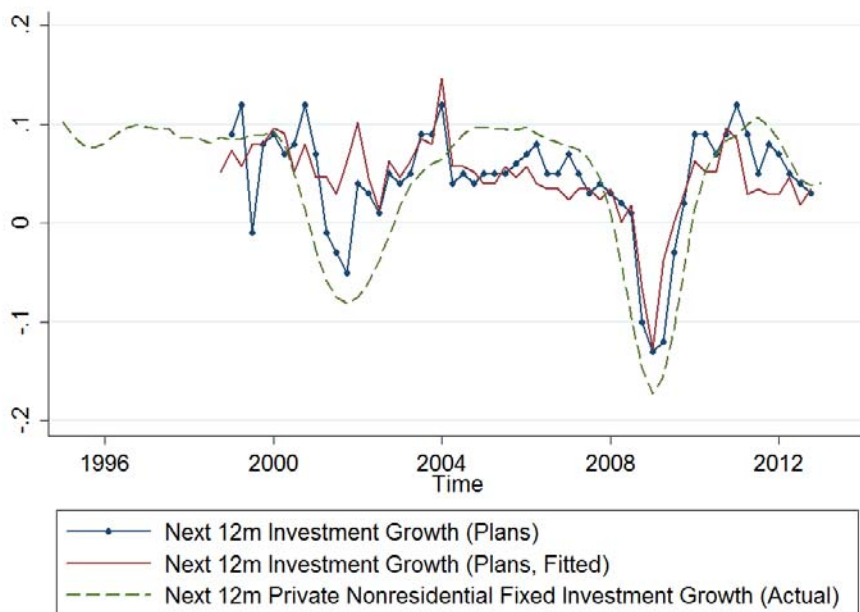
The plots below present aggregate CFO expectations of future earnings growth, aggregate planned investment growth, and aggregate actual investment growth. In Panel A, the solid line is aggregate CFO expectations of next 12-month earnings growth. The solid line with circles is aggregate planned investment growth in the next 12 months. In Panel B, the solid line is planned investment growth in the next 12 months fitted on contemporaneous CFO earnings expectations. The solid line with circles is aggregate planned investment growth in the next 12 months. The dashed line is actual growth of private non-residential fixed investment in the next 12 months. Frequency is quarterly.

Panel A. CFO earnings expectations and investment plans

Figure 3



Panel B. CFO earnings expectations, investment plans, and realised investment

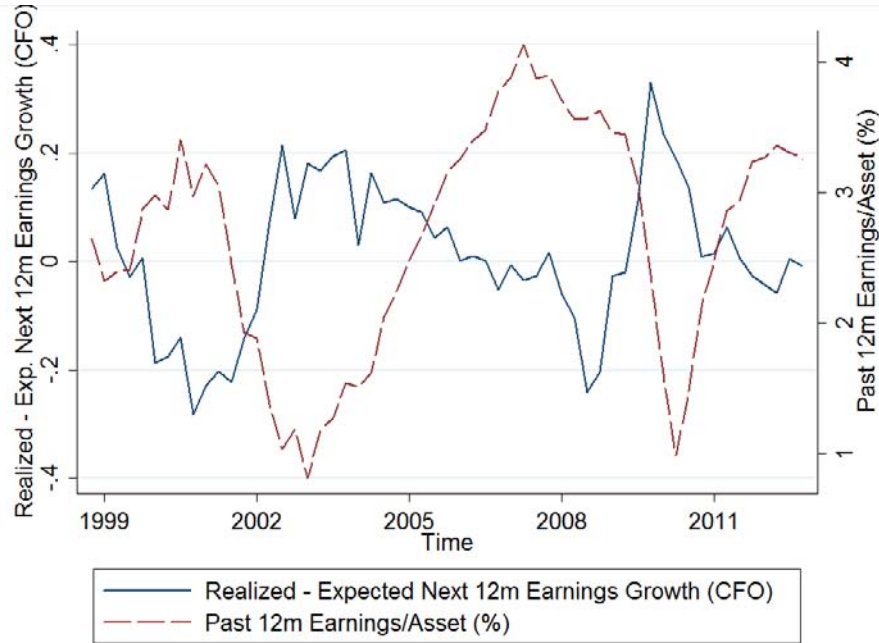


### Errors in earnings expectations and past profitability: time series plots

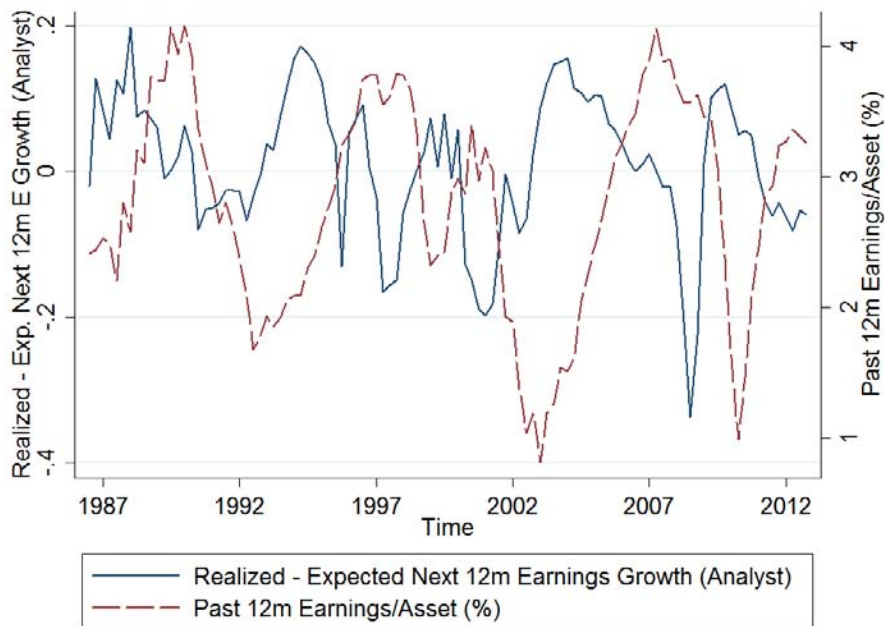
The plots below show aggregate errors in earnings expectations and past 12-month corporate profitability. In both panels, the dashed line is aggregate earnings over assets in the past 12 months. In Panel A, the solid line is aggregate earnings growth in the next 12 months minus aggregate CFO expectations of earnings growth in the next 12 months. In Panel B, the solid line is aggregate earnings growth in the next 12 months minus aggregate analyst expectations of earnings growth in the next 12 months. Series are linearly detrended. Frequency is quarterly.

Panel A. Errors in CFO expectations and past-year profitability over time

Figure 4



Panel B. Errors in analyst expectations and past-year profitability over time



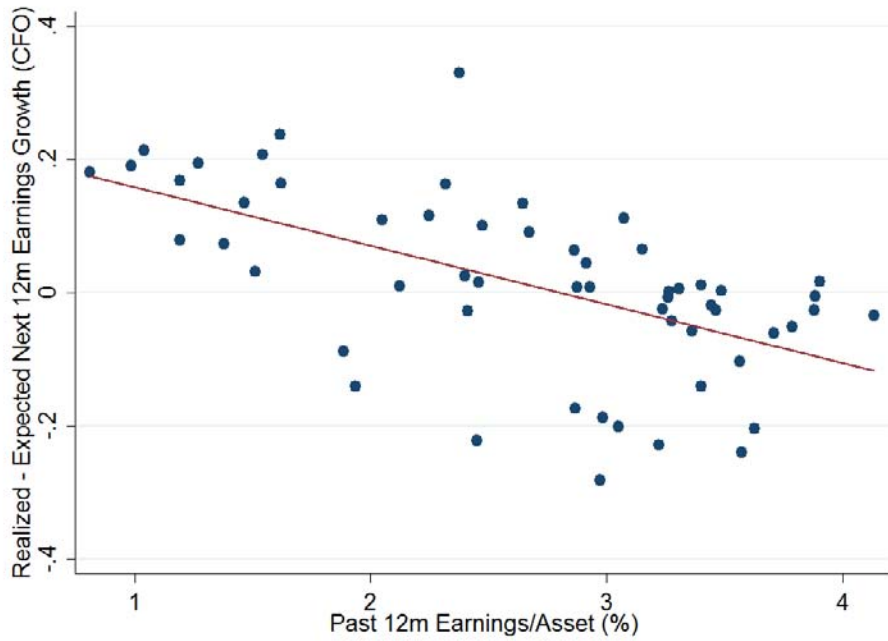
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## Errors in earnings expectations and past profitability: Scatter plots

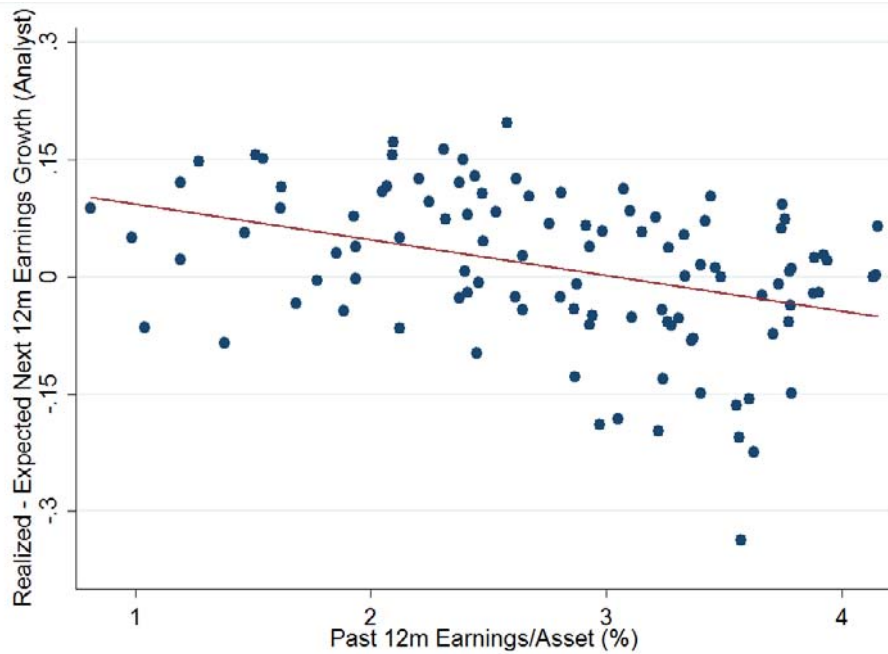
Scatter plots of aggregate errors in earnings expectations against past 12-month corporate profitability. Variables are identical to those in Figure 4. Frequency is quarterly.

Panel A. Scatter plot of errors in CFO expectations on past-year profitability

Figure 5



Panel B. Scatter plot of errors in analyst expectations on past-year profitability



## Correlations among different measures of investor expectations of stock market returns and model-based expected returns

This table shows correlations between different measures of investor expectations about future aggregate stock market returns, as well as correlations between survey expectations and discount rate proxies. Survey expectations variables are described in detail in Greenwood and Shleifer (2014). CFO Survey refers to the Duke/CFO Magazine Survey, and AAI refers to surveys run by the American Association of Individual Investors. Investor Intelligence aggregates opinions expressed in newsletters published by institutional investors. Shiller denotes the survey led by Robert Shiller, and Michigan is University of Michigan Survey of Consumers. Horizon of survey expectations is mostly the next 12 months (Gallup, CFO survey, Shiller); the AAI survey asks about next six-month expectations, and the horizon in Investor Intelligence and the Michigan survey varies. Among the discount rate proxies, log(D/P) denotes log dividend yield, cay refers to the consumption-wealth ratio in Lettau and Ludvigson (2001), and surplus consumption is constructed by Campbell and Cochrane (1999). Discount rate proxies are presented in a way so that the value is increasing in model-based expected returns (we use the negative of surplus consumption because high surplus consumption should be associated with low expected returns). Numbers in brackets denote p-values on the hypothesis that the correlation between the two series is zero.

Table 1

	Gallup	CFO Survey	AAI	Investor Intelligence	Shiller	Michigan
CFO Survey	0.77 [0.000]					
AAI	0.64 [0.000]	0.56 [0.000]				
Investor Intelligence	0.60 [0.000]	0.64 [0.000]	0.55 [0.000]			
Shiller	0.39 [0.000]	0.66 [0.000]	0.51 [0.000]	0.43 [0.000]		
Michigan	0.61 [0.003]	-0.12 [0.922]	0.60 [0.003]	0.19 [0.395]	-0.56 [0.020]	
Log(D/P)	-0.33 [0.000]	-0.44 [0.003]	-0.31 [0.000]	-0.19 [0.000]	-0.55 [0.000]	-0.57 [0.006]
cay	0.02 [0.776]	0.14 [0.380]	-0.02 [0.788]	-0.19 [0.000]	0.37 [0.000]	0.00 [0.988]
-Surplus Consumption	-0.48 [0.000]	-0.53 [0.000]	-0.28 [0.000]	-0.05 [0.191]	-0.67 [0.000]	-0.74 [0.000]
Past 12m Stock Returns	0.78 [0.000]	0.36 [0.018]	0.37 [0.000]	0.43 [0.000]	0.05 [0.578]	0.44 [0.042]
Equity Fund Flows	0.70 [0.000]	0.71 [0.000]	0.41 [0.000]	0.20 [0.000]	0.33 [0.000]	0.40 [0.068]

## Expectations of stock returns and realised future stock returns

This table presents results from Table 6 in Greenwood and Shleifer (2014). The regressions are  $R_t^x = a + bX_t + u_t$ , where  $R_t^x$  denotes next 12-month stock market returns (in excess of the risk free rate), and X is a predictor variable. The independent variables include measures of expectations from investor surveys and discount rate proxies. Selected investor expectations variables are starred to indicate that they are rescaled versions of the raw data. The rescaled versions can be interpreted in units of nominal stock returns. Details see Greenwood and Shleifer (2014). The regressions are monthly. Standard errors are Newey-West with 12 lags. In columns (1) to (6), for each measure of survey expectations, we show the p-value on the test that  $b = 1$  (which is the null under rational expectations).

Table 2

	Realised next 12m aggregate stock market returns								
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Gallup*	-1.985 (-1.370)								
CFO Survey		-0.021 (-0.670)							
AAII*			-1.655 (-0.892)						
Investor Intelligence*				-1.534 (-2.323)					
Shiller*					-0.612 (-0.228)				
Michigan						-0.081 (-3.964)			
Log(D/P)							0.072 (1.424)		
cay								3.095 (3.031)	
-Surplus consumption									0.958 (4.147)
[p-val, b=1]	[0.040]	[0.000]	[0.154]	[0.000]	[0.550]	[0.000]			
N	132	39	285	579	123	22	579	579	579
R <sup>2</sup>	0.057	0.03	0.015	0.036	0.004	0.342	0.03	0.107	0.116

t-statistics in parenthesis. Standard errors are Newey-West with 12 lags.

## Summary statistics

Summary statistics of firms covered in the CFO survey sample, analyst forecast sample, and full Compustat sample. Mean, median, standard deviation, and selected percentiles are presented. For comparability, all statistics are based on the sample period for which we have CFO expectations (2005 to 2012).

Table 3

Variable	Mean	Std	5%	25%	50%	75%	95%
Panel A. Sample with CFO expectations							
CFO expectations of next 12m earnings growth	0.07	0.19	-0.25	0.02	0.10	0.15	0.30
Realised next 12m earnings growth	0.09	0.48	-0.60	-0.11	0.09	0.26	0.85
Realised next 12m earnings/asset	0.06	0.06	-0.02	0.03	0.06	0.10	0.16
CFO expectations of next 12m capital spending growth	0.05	0.23	-0.3	0	0.3	0.1	0.5
Asset	21,808.42	101,176.00	80.48	541.10	1,959.22	6,453.33	44,791.00
Market value	14,326.91	48,370.41	75.81	550.28	1,843.50	6,848.73	45,621.37
Q	1.51	0.73	0.67	0.99	1.35	1.84	2.97
BTM	0.49	0.31	0.16	0.29	0.41	0.60	1.06
Annual net income/asset	0.03	0.17	-0.18	0.02	0.06	0.10	0.18
Annual sales/asset	1.09	0.67	0.27	0.61	0.92	1.38	2.55
Annual capx/asset	0.04	0.03	0.01	0.02	0.03	0.05	0.11
Annual capx growth	0.13	0.53	-0.52	-0.18	0.06	0.33	1.11
Panel B. Sample with analyst forecasts							
Next 12m earnings growth implied by analyst EPS forecasts	0.16	0.34	-0.31	-0.01	0.12	0.28	0.81
Realised next 12m earnings growth	0.09	0.47	-0.65	-0.12	0.09	0.30	0.86
Realised next 12m earnings/asset	0.07	0.05	0.00	0.04	0.06	0.10	0.16
Asset	6,355.03	26,367.43	114.72	401.15	1,178.22	3,835.99	26,735.00
Market value	6,610.21	23,094.48	129.51	473.98	1,287.45	3,887.96	25,692.68
Q	1.53	0.83	0.65	0.93	1.29	1.90	3.27
BTM	0.51	0.32	0.14	0.29	0.45	0.66	1.10
Annual net income/asset	0.06	0.07	-0.03	0.03	0.06	0.10	0.17
Annual sales/asset	1.12	0.63	0.32	0.64	1.00	1.46	2.37
Annual capx/asset	0.05	0.04	0.01	0.02	0.04	0.07	0.15
Annual capx growth	0.17	0.55	-0.54	-0.17	0.08	0.38	1.20
Panel C. All Compustat firms							
Asset	3,021.22	16,706.02	0.44	25.34	201.06	1,278.93	12,105.00
Market value	3,684.34	16,780.76	17.35	107.49	433.32	1,726.60	14,127.71
Q	1.53	0.91	0.61	0.88	1.24	1.90	3.51
BTM	0.55	0.38	0.11	0.28	0.47	0.73	1.24
Annual net income/asset	-0.11	0.39	-0.87	-0.11	0.02	0.07	0.15
Annual sales/asset	1.01	0.70	0.10	0.47	0.89	1.41	2.40
Annual capx/asset	0.05	0.04	0.00	0.01	0.03	0.06	0.14
Annual capx growth	0.16	0.68	-0.69	-0.28	0.04	0.42	1.53



## CFO earnings growth expectations and investment plans: aggregate evidence

This table presents aggregate quarterly regression  $\Delta \widehat{CAPX}_t = \alpha + \beta E_t^*[\Delta Earnings] + \lambda X_t + \epsilon_t$ .  $E_t^*[\Delta Earnings]$  is aggregate CFO expectations of earnings growth in the next 12 months.  $\widehat{CAPX}_t$  is aggregate planned investment growth in the next 12 months. All control variables are measured at the end of quarter t-1. Past 12-month stock returns is index returns from the end of quarter t-5 to the end of quarter t-1. Past 12-month aggregate credit spread change is log change in credit spread from the end of quarter t-5 to the end of quarter t-1. Past 12-month changes in stock volatility and Bloom policy uncertainty index, as well as past-12 month asset growth, are calculated in the same way (ie as the log difference between values at the end of quarters t-1 and t-5). Past-12 month change of net income/asset is net income from t-4 to t-1 normalised by asset at the end of quarter t-5 minus normalised net income in the previous four quarters. Past-12 month GDP (investment) growth is the log difference between GDP (investment) in quarters t-4 through t-1 and GDP (investment) in the previous four quarters. A constant is included but not reported, and a linear time trend is included. Standard errors are Newey-West with 12 lags.

Table 4

	Planned investment growth in the next 12 months						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
CFO Expectations of	0.6313	0.5959	0.5869	0.4235	0.4853	0.5997	0.5435
Next 12m Earnings Growth	(9.39)	(11.65)	(11.40)	(7.21)	(12.83)	(11.79)	(9.78)
Q			0.0532 (1.68)				
Past 12m Agg. Stock Returns				0.1082 (3.64)			
Past 12m Credit Spread Change					-0.0352 (-2.26)		
Log(D/P)						0.0271 (0.62)	
cay							-0.9700 (-1.86)
Past 12m Asset Growth		0.2181 (3.97)	0.1461 (2.39)	0.0784 (1.89)	0.2643 (5.88)	0.2481 (2.97)	0.2536 (3.92)
Observations	56	56	56	56	56	56	56
R-squared	0.616	0.660	0.672	0.741	0.685	0.663	0.674

t-statistics in parentheses. Standard errors are Newey-West with 12 lags.

Table 4 (continued)

	Planned investment growth in the next 12 months					
	(8)	(9)	(10)	(11)	(12)	(13)
CFO Expectations of	0.5969	0.5429	0.5301	0.5882	0.5573	0.4315
Next 12m Earnings Growth	(11.37)	(8.20)	(14.03)	(8.55)	(16.72)	(8.21)
Past 12m Credit Spread Change						-0.0447 (-1.49)
Surplus Consumption	0.0154 (0.30)					
Past 12m Change of Net Income/Asset		0.0433 (1.70)				-0.0433 (-1.03)
Past 12m Agg. Stock Vol Change			-0.0044 (-0.37)			0.0421 (2.51)
Bloom Policy Uncertainty Index (Past 12m Change)			-0.0328 (-2.11)			-0.0303 (-2.23)
Past 12m GDP Growth				0.6118 (0.77)		2.3154 (1.89)
Past 12m Investment Growth					-0.1300 (-2.26)	-0.5391 (-2.69)
Past 12m Asset Growth	0.2114 (3.40)	0.1716 (3.25)	0.2376 (4.22)	0.0547 (0.29)	0.3859 (6.21)	0.4349 (3.59)
Observations	56	56	56	56	56	56
R-squared	0.660	0.672	0.694	0.666	0.667	0.739

t-statistics in parentheses. Standard errors are Newey-West with 12 lags.

## CFO earnings growth expectations and investment plans: firm-level evidence

This table presents firm-level quarterly regression  $\Delta \widehat{CAPX}_{i,t} = \alpha + \eta_i + \beta E_{i,t}^*[\Delta Earnings] + \lambda X_{i,t} + \epsilon_{i,t} \cdot E_{i,t}^*[\Delta Earnings]$  is firm-level CFO expectations of earnings growth in the next 12 months.  $\Delta \widehat{CAPX}_{i,t}$  is firm-level planned investment growth in the next 12 months. All control variables are measured at the end of quarter t-1. Past 12-month firm stock returns, change of net income/asset, change of stock volatility, investment growth, and asset growth are firm-level counterparts of variables defined in Table 4. A constant is included but not reported, and firm fixed effects are included. Standard errors are clustered by firm. R-squared excludes firm fixed effects.

Table 5

	Planned investment growth in the next 12 months										
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
CFO Expectations of	0.4200	0.4259	0.4639	0.3487	0.3887	0.3713	0.4172	0.3420	0.4139	0.4233	0.3149
Next 12m Earnings	(4.44)	(4.50)	(4.40)	(3.25)	(3.94)	(3.99)	(4.25)	(3.16)	(4.35)	(4.28)	(2.80)
Q			0.0384								
			(1.53)								
BTM				-							
				(-4.32)							
Past 12m Firm Stock					0.0833						
					(3.49)						
Past 12m Credit						-					-
						(-4.39)					(-2.99)
Past 12m Change of							0.0025				0.0025
							(2.23)				(1.16)
Past 12m Firm Stock								-			-
								(-2.87)			(-0.33)
Bloom Policy									-		0.0385
(Past 12m Change)									(-2.35)		(0.96)
Past 12m GDP									1.0087		0.6293
									(1.86)		(0.95)
Past 12m Investment										0.0010	0.0048
										(0.05)	(0.19)
Past 12m Asset		0.1163	0.1089	0.0529	0.0626	0.0964	0.0929	0.0393	0.0800	0.1276	0.0008
		(1.37)	(1.15)	(0.63)	(0.69)	(1.17)	(0.97)	(0.40)	(1.00)	(1.39)	(0.01)
Observations	850	834	740	761	764	834	809	719	834	790	692
R-squared	0.095	0.104	0.125	0.139	0.132	0.132	0.114	0.115	0.109	0.105	0.132
Number of id	194	190	171	172	176	190	187	168	190	187	164

t-statistics in parentheses. Standard errors are clustered by firm.

## CFO earnings growth expectations and realised investment growth: aggregate evidence

This table presents aggregate quarterly regression  $\Delta CAPX_t = \alpha + \beta E_t^*[\Delta Earnings] + \lambda X_t + \epsilon_t$ .  $E_t^*[\Delta Earnings]$  is aggregate CFO expectations of earnings growth in the next 12 months.  $\Delta CAPX_t$  is next 12-month growth in private non-residential fixed investment. All control variables are the same as those in Table 4. Standard errors are Newey–West with 12 lags.

Table 6

	Realised investment growth in the next 12 months						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
CFO Expectations of	0.7041	0.5903	0.5853	0.2799	0.2611	0.6278	0.4569
Next 12m Earnings Growth	(5.40)	(8.14)	(8.41)	(3.52)	(3.20)	(7.38)	(5.74)
Q			0.0278				
			(0.37)				
Past 12m Agg. Stock Returns				0.1975			
				(4.20)			
Past 12m Credit Spread Change					-0.1035		
					(-3.82)		
Log(D/P)						0.2202	
						(2.68)	
<i>cay</i>							-2.4272
							(-2.27)
Past 12m Asset Growth		0.7021	0.6645	0.4473	0.8382	0.9458	0.7909
		(6.48)	(3.53)	(3.43)	(11.72)	(10.36)	(8.32)
Observations	57	57	57	57	57	57	57
R-squared	0.380	0.610	0.611	0.748	0.719	0.721	0.655

t-statistics in parentheses. Standard errors are Newey–West with 12 lags.

Table 6 (continued)

	Realised investment growth in the next 12 months					
	(8)	(9)	(10)	(11)	(12)	(13)
CFO Expectations of	0.5899	0.3727	0.3725	0.5563	0.5913	0.2168
Next 12m Earnings Growth	(8.43)	(3.42)	(6.22)	(3.94)	(6.57)	(2.08)
Past 12m Credit Spread Change						-0.0995 (-2.43)
Surplus Consumption	-0.0097 (-0.06)					
Past 12m Change of Net Income/Asset		0.1779 (3.06)				0.0487 (0.88)
Past 12m Agg. Stock Vol Change			-0.0362 (-3.15)			0.0405 (2.40)
Bloom Policy Uncertainty Index (Past 12m Change)			-0.0501 (-2.48)			-0.0154 (-1.12)
Past 12m GDP Growth				2.8443 (1.68)		3.2147 (1.88)
Past 12m CAPX Growth					0.0032 (0.02)	-0.2927 (-1.21)
Past 12m Asset Growth	0.7063 (7.22)	0.5112 (5.00)	0.7221 (9.00)	-0.0570 (-0.12)	0.6980 (2.40)	0.3239 (0.67)
Observations	57	57	57	57	57	57
R-squared	0.610	0.717	0.695	0.675	0.610	0.795

t-statistics in parentheses. Standard errors are Newey–West with 12 lags.

## CFO earnings growth expectations and realised investment growth: firm-level evidence

This table presents firm-level quarterly regression  $\Delta CAPX_{i,t} = \alpha + \eta_i + \beta E_{i,t}^+[\Delta Earnings] + \lambda X_{i,t} + \epsilon_{i,t} \cdot E_{i,t}^+[\Delta Earnings]$  is firm-level CFO expectations of earnings growth in the next 12 months.  $\Delta CAPX_{i,t}$  is firm-level actual capital expenditure growth in the next 12 months. All control variables are the same as those in Table 5. A constant is included but not reported, and firm fixed effects are included. Standard errors are clustered by firm. R-squared excludes firm fixed effects.

Table 7

	Realised investment growth in the next 12 months										
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
CFO Expectations of Next 12m Earnings Growth	0.5970 (5.13)	0.5930 (5.04)	0.5482 (3.94)	0.4069 (3.23)	0.3787 (3.08)	0.4118 (3.47)	0.6137 (4.99)	0.3243 (2.53)	0.5622 (4.61)	0.6043 (4.83)	0.3610 (2.53)
Q			0.1298 (1.88)								
BTM				-0.5246 (-4.51)							
Past 12m Firm Stock Returns					0.3047 (4.32)						
Past 12m Credit Spread Change						-0.3801 (-4.62)					-0.1354 (-1.43)
Past 12m Change of Net Income/Asset							-0.0003 (-0.08)				0.0002 (0.05)
Past 12m Firm Stock Vol Change								-0.4806 (-5.76)			-0.3511 (-3.24)
Bloom Policy Uncertainty Index (Past 12m Change)								-0.0844 (-0.96)			0.0493 (0.54)
Past 12m GDP Growth									2.4608 (1.22)		2.8272 (1.35)
Past 12m CAPX Growth										-0.2917 (-4.68)	-0.3074 (-4.26)
Past 12m Asset Growth		0.3565 (1.83)	0.2850 (1.36)	0.1675 (0.78)	0.1914 (1.00)	0.3300 (1.69)	0.3371 (1.69)	0.1248 (0.65)	0.2582 (1.36)	0.6969 (4.59)	0.4428 (2.48)
Observations	852	845	760	784	788	845	819	741	845	810	717
R-squared	0.043	0.054	0.063	0.086	0.103	0.125	0.057	0.175	0.060	0.152	0.271
Number of id	193	193	172	176	180	193	189	170	193	187	166

t-statistics in parentheses. Standard errors are clustered by firm.

## Predicting errors in CFO expectations

Quarterly regressions of errors in CFO expectations of next 12-months earnings growth on past profitability and past economic conditions. In Panel A, the dependent variable is aggregate earnings growth in the next 12 months minus aggregate CFO expectations of earnings growth in the next 12 months. Independent variables include aggregate earnings/asset and GDP growth in the four quarters prior to quarter t-1. Controls include VIX by the end of quarter t-1 and aggregate stock volatility as of quarter t-1. In Panel B, the dependent variable is firm-level earnings growth in the next 12 months minus firm CFO expectations of earnings growth in the next 12 months. Independent variables include firm-level earnings/asset in the four quarters prior to quarter t-1, and volatility of firm stock in quarter t-1. A constant is included by not reported. In Panel A, standard errors are Newey–West with 12 lags. In Panel B, standard errors are clustered by firm. R-squared excludes firm and time fixed effects.

Table 8

### Panel A. Aggregate evidence

	Realised – CFO Expected Next 12m Earnings Growth					
	(1)	(2)	(3)	(4)	(5)	(6)
Past 12m Earnings/Asset (%)	-0.0881 (-6.48)		-0.0915 (-8.85)		-0.0882 (-7.42)	
Past 12m GDP Growth		-3.2999 (-3.06)		-3.6632 (-3.38)		-4.2078 (-3.30)
VIX			-0.2552 (-1.51)	-0.3288 (-1.46)		
Agg. Stock Index Vol					-0.0089 (-0.02)	-0.4101 (-1.52)
Observations	57	57	57	57	57	57
R-squared	0.335	0.225	0.361	0.266	0.335	0.269

t-statistics in parentheses. Standard errors are Newey–West with 12 lags.

### Panel B. Firm-level evidence

	Realised – CFO Expected Next 12m Earnings Growth					
	(1)	(2)	(3)	(4)	(5)	(6)
Past 12m Firm Earnings/Asset (%)	-0.0511 (-5.14)		-0.0500 (-5.22)		-0.0324 (-3.40)	-0.0353 (-3.56)
Past 12m GDP Growth		-4.1472 (-2.44)		-2.811 (-1.75)		
Firm Stock Vol			0.3959 (1.74)	0.2229 (0.94)		0.5299 (1.13)
Firm Fixed Effects	Y	Y	Y	Y	Y	Y
Time Fixed Effects			No			Yes
Observations	606	651	594	638	606	594
R-squared	0.082	0.032	0.103	0.033	0.037	0.050
Number of id	142	147	139	144	142	139

t-statistics in parentheses. Standard errors clustered by firm.

## Predicting errors in analyst expectations

Quarterly regressions of errors in analyst expectations of next 12 months earnings growth on past profitability and past economic conditions. In Panel A, the dependent variable is aggregate earnings growth in the next 12 months minus aggregate analyst expectations of earnings growth in the next 12 months. In Panel B, the dependent variable is firm-level earnings growth in the next 12 months minus analyst expectations of earnings growth in the next 12 months. All control variables are the same as in Table 8. A linear time trend is included. A constant is included by not reported. In Panel A, standard errors are Newey–West with 12 lags. In Panel B, standard errors are clustered by firm and time. R-squared excludes firm and time fixed effects.

### Panel A. Aggregate evidence

Table 9

	Realised – Analyst Expected Next 12m Earnings Growth					
	(1)	(2)	(3)	(4)	(5)	(6)
Past 12m Earnings/Asset (%)	-0.0456 (-3.68)		-0.0550 (-6.16)		-0.0467 (-3.76)	
Past 12m GDP Growth		-1.3940 (-1.70)		-1.1277 (-1.67)		-1.6171 (-1.64)
VIX			-0.2904 (-1.73)	-0.3260 (-2.52)		
Agg. Stock Index Vol					-0.0991 (-0.47)	-0.1116 (-0.51)
Observations	106	112	91	91	106	112
R-squared	0.144	0.057	0.245	0.078	0.150	0.062

t-statistics in parentheses. Standard errors are Newey–West with 12 lags.

### Panel B. Firm-level evidence

	Realised – Analyst Expected Next 12m Earnings Growth					
	(1)	(2)	(3)	(4)	(5)	(6)
Past 12m Firm Earnings/Asset (%)	-0.0080 (-7.43)		-0.0081 (-7.36)		-0.0061 (-6.71)	-0.0062 (-6.63)
Past 12m GDP Growth		-1.6167 (-3.83)		-1.6235 (-3.72)		
Firm Stock Vol			0.0158 (0.26)	-0.0256 (-0.50)		-0.0123 (-0.40)
Firm Fixed Effects	Y	Y	Y	Y	Y	Y
Time Fixed Effects			No			Yes
Observations	103,930	123,430	100,451	115,120	103,930	100,451
R-squared	0.005	0.004	0.006	0.004	0.003	0.003
Number of id	4,432	5,080	4,227	4,606	4,432	4,227

t-statistics in parentheses. Standard errors clustered by firm and time.



## Comments by Philipp Hildebrand<sup>1</sup>

This is a “very cool” paper, raising deeper questions than might appear at first sight. Perhaps most excitingly, it offers a way to predict firm investment, a quest that was at the heart of a very heated research paper-based controversy in the 1990s between Glenn Hubbard and Luigi Zingales.<sup>2</sup>

This is not just a matter of academic interest, but also one that has potentially significant policy implications. It has in fact been a big puzzle in recent years why capex has been so low despite record low interest rates and ample cash reserves – and instead we are seeing in the US financial spending (share buy-backs and M&As) amounting to nearly 100% of operating cash flow. Well, earnings expectations have been relatively depressed, and so as the paper predicts, capex has been depressed. But it is also the case that firms have often preferred to engage in share buybacks to give a short-term boost to earnings. That is almost certainly bad for long-term returns.

I see three key take-aways from the paper:

1. Contrary to standard macro theory, earnings expectations, as measured by surveys, do matter – both for stock-market valuations, and for investment decisions;
2. Analysts and CFO earnings expectations are extrapolative and usually wrong;
3. Higher investment actually leads to lower returns over a 12-month horizon.

I generally agree with the findings, although a quibble might be that the results might be unduly affected by the impact on returns of the global financial crisis. I will share some comments on these three take-aways and outline the implications for an investment firm.

### 1. Measured expectations matter for both investment decisions and stock valuations

This runs contrary to what rational expectations theory would suggest. That in itself is not terribly surprising, but it is worth noting because, of course, for lack of a superior alternative, many macro models still use that approach to modelling expectations.

This discrepancy between the reality of how financial decisions are made and how macro models are built illustrates that, sadly, there is still a long way to go in welding together financial and macroeconomic thinking. But this paper is clearly a useful step, or set of steps, on that path and, along with the efforts deployed for several years already by the IMF, it is very much to the BIS’s credit to keep pushing in

<sup>1</sup> Vice Chairman of BlackRock.

<sup>2</sup> Hubbard and his co-authors claimed they could forecast investment using the lens of “financial constraints”. Kaplan and Zingales took the same data, looked carefully and stated that none of the results held. (There was also a reply and a reply to the reply). A consequence of that debate was massive retreat of researchers into the ivory tower (more precisely, into the estimation of complicated structural models, somewhat losing sight of reality).

this direction. There are none better than Hyun Shin and Claudio Borio to lead this effort.

## 2. Analysts and CFOs' earnings expectations are usually wrong

This is actually a well known phenomenon in the investment community. We even use signals based on them, particularly in our systematic investment activities: when earnings expectations are high, we know it is time to sell (with some variations depending on the phase of the cycle we are in). When getting near the top of the cycle, high earnings portend bad days ahead, and vice-versa when getting near the trough of a downturn.

What is interesting is that in our empirical research underpinning our investment strategies, we find that not all expectations suffer from this problem; for example purchasing manager surveys indices (PMIs) or lending officer surveys, are usually quite reliable in predicting turns in the business cycle. And even CFOs are a valuable source of information when it comes to other things than earnings forecasts. What accounts for this difference in forecast performance?

- Analyst and CFO earnings forecasts are more likely to be contaminated by bias;
- They do not reflect a hands-on upstream grasp of economic activity;
- They tend to be firm-centric and lack a broad perspective.

In the very short term however, given the prevalence of so-called momentum strategies, earnings expectations are a relevant indicator – but essentially as a gauge of market sentiment.

## 3. Higher investment is correlated with lower returns

This is completely counterintuitive but sadly not a data fluke. In fact it is another kind of law of nature that is familiar to investment professionals: high capex is an almost foolproof predictor of lower returns, at least over the short to medium-term horizon most investors care about.

What is going on here? Literally this means that what investment does take place is not very good at generating growth, ie there is a very material misallocation of resources. But why? Because investment decisions are driven by backward-looking, extrapolative earnings expectations. This is in fact a recipe for chronic overinvestment in sectors with high momentum and underinvestment in sectors with low momentum – which is consistent with the facts on the ground.

A potentially very adverse implication for long-term growth is that such market dynamics de facto discourage capex, including the genuinely growth-enhancing type. It is perhaps no coincidence that private companies and companies with high family ownership tend to outperform – because they can take a longer view on returns.

This leads us to the debate over how to promote long-termism from corporate CEOs and whether excessively short stock holding periods – in other words short-

termism by stock investors – is to blame. Conventional wisdom, backed by some data, is that stock holding periods have shortened dramatically in recent decades. This actually seems worth investigating further. In recent years there has been a shift towards index-based investing – now 90% of our AUM invested in equities<sup>3</sup> – a model under which a stock is held for as long as it remains part of the index. But there has also been a rise in high-frequency trading. So it may be that some stockholders have very short holding periods, but it is not clear they dominate the market in volume terms.

Is there a need to do more and incentivise long-term stock holding with differentiated voting rights, as under new French legislation and considered more broadly at the EU level? We actually think this would be counterproductive. In fact, evidence from the earnings of firms with such regimes suggests they do not perform as well as those that apply a “one share, one vote” regime – possibly because they tend to have worse corporate governance across the board. Much more important would be to refocus performance analysis and rewards to the longer term.

To conclude, what does a large asset manager like BLK make of all this?

As far as our investment processes go, we are moving in two directions:

- For the top-down part, macro-factor investing, and an area on which we are putting increased emphasis; in fact we just hired Professor Andrew Ang to help us spearhead this effort: basically, since we cannot really predict returns, we focus instead on the underlying fundamental factors driving the returns, such as economic growth or real rates; this allows us to make sure that our risk exposures are fundamentally balanced; this isn't mainstreamed yet but definitely the direction of travel;
- For the bottom-up part, rather than looking at earnings expectations, we seek to identify genuinely good growth – in the balance sheets, in the cash flows for instance. Although admittedly we have not found such signals to identify “good” investment. For that, nothing beats a long track-record of a good return on equity.
- Both types of investment processes are increasingly informed by the use of big data, for example using machine-learning to skim through the 6000+ analyst reports we receive every day in multiple languages, tracking patterns of consumer searches for durable goods on the internet (based on this, we correctly forecasted the 2013 turnaround in the Spanish economy and the US slowdown in Q1 of this year; or using software to read online commentary to gain insight on employee attitudes toward their firm, a strong indicator of future performance.

Finally, we as a shareholder try to engage directly with CEOs to push them to focus explicitly and demonstrably on long term performance and value generation.

<sup>3</sup> For the entire industry of externally managed assets, index-based equities represent only a third of total AUM. We do not know to what extent internally managed assets follow such strategies.

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