In this paper, we provide a comprehensive analysis of the relationship between external financing transactions — equity offerings, debt offerings and bank borrowings — and future stock returns. Previous research has focused on individual categories of financing transactions (common stock issues, debt issues, common stock repurchases etc.). However, firms frequently engage in refinancing transactions that involve little net change in total capital, but simply shuffle capital between different categories (e.g., issuing debt to repurchase equity). These transactions represent potential omitted variables in prior research.

For example, a firm issuing debt to repurchase equity may consider both its debt and equity underpriced, but its equity relatively more underpriced. Under such circumstances, past research would mistakenly classify the issuance of debt as an attempt to exploit the perceived overvaluation of debt. By simultaneously examining all external financing transactions, we provide more powerful tests of the mispricing hypothesis.

Our results provide several new insights. First, we find that our comprehensive measure of net external financing has a stronger relation with future stock returns than the individual categories of financing transactions examined in previous research. Second we show that, after controlling for refinancing transactions, there is a strong and consistent relation between all major categories of external financing and future stock returns. Finally, we show that the predictive ability of net changes in external financing with respect to future stock returns hinges critically on the use of the proceeds.

Taken as a whole, our results suggest that the predictable future stock returns are primarily attributable to overinvestment.
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