Empirical Corporate Finance in a Dynamic World

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Abstract

The traditional regression methodology of estimating “optimal” capital structure is profoundly misspecified if firms follow dynamic financial policies. Instead, capital structure researchers, under many reasonable scenarios, should estimate the conditional mode of the leverage distribution. This metric is theoretically motivated and robust to a wide range of modeling assumptions. We introduce an empirical methodology to estimate the conditional mode of leverage and apply it to Compustat firms between 1950 and 2005. The estimated cross-sectional optimal leverage ratio decreases from a standard regression estimate of 37% to a mode estimate of 25%. The impact of asset tangibility and depreciation is substantially larger than previously thought, whereas market-to-book ratios are less important than standard moment estimators imply. Our findings should apply to most other areas of corporate finance research and call for a widespread rethinking of empirical tests.

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