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The Underinvestment and Overinvestment Hypotheses: an Analysis Using Panel Data

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Abstract

We study the relationship between firm value and investment to test the underinvestment and overinvestment hypotheses. The results obtained, using panel data methodology as the estimation method, indicate that the abovementioned relation is quadratic, which implies that there exists an optimal level of investment. As a consequence, firms that invest less than the optimal level suffer from an underinvestment problem, while those investing more than the optimum suffer from overinvestment. The quadratic relation is maintained when firms are classified depending on their investment opportunities, the optimum being in accordance with the quality of investment opportunities.

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