"The Dynamics of Investment, Payout and Debt"

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Abstract

We present a dynamic agency model of investment, borrowing and payout decisions by a mature corporation operating in perfect financial markets. Risk-averse managers implement an inter-temporal strategy that maximizes their lifetime utility of managerial rents. They under-invest and smooth payout and rents. Debt is the shock-absorber for operating income and investment. Managers do not rebalance capital structure, so shocks to debt levels persist. Managers implement precautionary savings by paying down debt, even when interest is tax-deductible. We generate empirical predictions that differ from conventional agency models and from dynamic models based on financing frictions.