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The information content of aggregate profitability

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Abstract

Recently, there has been significant interest in the information content of aggregate accounting profitability. I collect evidence on whether aggregate profitability captures information about changes in the cost of capital as predicted by classical investment theory. Consistent with these predictions, I find that the stock market return is *negatively* related to future accounting profitability for several years into the future. I provide evidence that this relation is most likely due to a *positive* association between changes in expected returns which exert a negative impact on stock returns and future profitability. These findings indicate that aggregate accounting profitability reflects significant economic content related to the cost of capital. This study is the first to link changes in accounting profitability to the market cost of capital under an investment-based mechanism.

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