Researchers find building innovative capacity led to higher stock prices

October 3 2016

Firms need to invest in innovation in order to create new technologies and move the economy forward, according to new research from the University of Houston.

Those that do invest in building their innovative capacity are rewarded over the long run by higher stock market returns and profits, said Praveen Kumar, professor and chairman of the Department of Finance at the UH C.T. Bauer College of Business.

Kumar and Dongmei Li of the University of South Carolina analyzed the long run financial market and profitability implications of investments by companies for a study published in the October issue of the *Journal of Finance*.

"Firms in innovation-driven industries proactively use capital investment to facilitate generation of new growth options by building (innovative capacity)," the researchers wrote. "Moreover, (innovative capacity) investment increases expected revenues by allowing the firm to generate higher quality-based sales from innovations, conditional on their being generated and exercised."

Kumar noted that scientific breakthroughs generally benefit the economy only when they are developed into products and technologies.

"Commercializing and developing these breakthroughs require large investments by innovative firms," he said. "Analyzing the long run

financial rewards of investments in innovation are crucial to understanding the prospective economic impact of STEM initiatives."

The study argues that by looking at traditional and investments in innovative capacity - things like building and equipping long-term research facilities and acquiring patents - separately, firms can identify a difference in stock market and profitability response, which is not apparent when the two are grouped together.

Previous research has found that the stock of companies with high rates of capital investment generally tend to "underperform" immediately following the investment, Kumar said. But that research hasn't distinguished between investment in innovative capacity and traditional capital investment to determine if stock market response differs between the two.

"If innovative and traditional investment companies are pooled together, we tend to observe that stock markets punish higher investments, at least in the short run," he said.

By separating the investments, large research and development firms, with greater financial resources to ultimately develop innovations, are rewarded over time by the stock market, generating higher profits, leading to shareholders gaining more in the longer run.

"This is important information for managers of these companies since it encourages them to invest in an innovative capacity, which would lead to development of new products and technologies, which is helpful for the entire economy," Kumar added.

Provided by University of Houston