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Does the Market Value Innovative Investments? A Comparison of CAPEX with Investments in R&D and IT

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Abstract

The paper examines the stock market's relative response to innovative investments using a novel dataset that tracks all R&D, IT and capital expenditures (CAPEX) made by Australian firms over the period 1994 to 2006. Continuous disclosure rules in Australia help ensure that the sample is less affected by endogeneity issues, where companies may 'select' which announcements to make, giving rise to a sample selection bias. We report positive and statistically significant cumulative average abnormal returns (CAARs) of between 3.03% and 5.24%, which are substantially higher than those reported by comparable US studies. Investments in R&D and IT generate higher CAARs, particularly on a value-weighted basis, indicating positive benefits to scale in undertaking innovative investments. On a per-dollar spent basis, innovative investments return, on average, about 85 cents per dollar, compared to 64 cents for CAPEX. Cross-sectional regressions show firm size, growth options, leverage, and investor uncertainty as key drivers in explaining announcement returns. Consistent with the view that innovative investments involve greater uncertainty for investors, compared to CAPEX, we report a significantly higher dispersion of investor opinion around their announcement, which also has a larger negative impact on their value. Collectively, the results suggest that markets do not react myopically to innovative expenditures. Our findings run counter to claims by some managers that markets are inherently myopic, and who use this perception to justify underinvestment in strategic-type investments.

Keywords: Information technology, innovative investments, dispersion of investor opinion, abnormal returns, myopia

JEL Classification: G3, Q3

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