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STRATEGIES

To Make a Stock Pop, Innovate

By MARK HULBERT

ESPECIALLY when times are tough, beware of companies that cut their spending on research and development. The stock market tends to punish such businesses and reward those with a commitment to R.& D. — often years before long-term projects reap benefits.

Those conclusions come from a study, “Do Innovations Really Pay Off? Total Stock Market Returns to Innovation,” which has been accepted for publication in Marketing Science, a peer-reviewed journal. The study’s authors are Ashish Sood, an assistant professor of marketing at Emory University, and Gerard J. Tellis, a professor of marketing at the University of Southern California.

There is a big temptation for companies to cut their R.& D. spending, especially during bear markets. That’s because such expenses immediately reduce the earnings a company can otherwise report, in return for rewards that are uncertain at best. And even if there are rewards, they surely won’t materialize for several years.

Such thinking is shortsighted, however, according to the professors, who focused their study on R.& D. expenditures at 69 publicly traded companies in 19 technological categories from 1977 through 2006. All the companies had significant research-and-development efforts, and the professors compared their stock performance with that of the overall market and of otherwise comparable competitors that didn’t announce any R.& D. efforts.

The study tried to determine the long-term benefits of R.& D., calling it a protracted process that is “the total of a firm’s activities in researching, developing and introducing any new product based on a new technology, from the initiation of the technology to about a year after introduction of the new product.”

Over the 30 years covered in the study, the 69 companies had a total of 219 such projects. The average duration of each project, Professor Tellis said in an interview, was about four and a half years.

Some of these companies, like Hewlett-Packard, are well known. For H.P., the study focused on its research and development of computer monitors and printers. It found that it earned a “very high rate of return” on its R.& D. investment, Professor Tellis said.

On average, the professors found that shares of a company with R.& D. operations rose just after it announced the start of such projects. The increases occurred even though potential sales of any new products were generally several years away.

IN fact, the professors found that the biggest price jumps tended to occur early in the R.& D. process, which they divided into various stages — from the project's initial setup and various development phases to the product's introduction and, in some cases, the winning of awards for successful innovation. Typically, shares rose much higher in the setup and development phases than they did when product sales began.

This suggests that investors don't have to wait for those sales if they want to gain from a successful R.& D. project. On the contrary, the professors wrote, the "markets respond promptly and substantially to announcements about innovation at all stages of the innovation project."

It is understandable that many investors haven't noticed this pattern, Professor Sood said in an interview. That's because most previous academic studies of the market's reaction to R.& D. have focused only on what happens in the commercialization stage. But, he argues, it is precisely because the stock market does a good job of discounting R.& D.'s future benefits that such a focus systematically underestimates the market's actual reward for these expenditures.

Of course, not all R.& D. projects succeed. When they don't, the stock market typically drives down the prices of the companies' stocks. But the professors also found that the successes more than made up for the failures. As a result, the stock of the average company that initiated an R.& D. project fared better than the overall market, and better than rivals without R.& D. operations.

This means that it makes sense to invest in a diversified portfolio of companies with ambitious research and development programs, Professor Tellis says. If history is any guide, investors who do so will not only beat the market over the long term, but will also reap immediate gains as R.& D. projects unfold.

Mark Hulbert is editor of The Hulbert Financial Digest, a service of MarketWatch. E-mail: strategy@nytimes.com.