

Does Firm-Level Productivity Predict Stock Returns?

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Abstract

Contrary to the findings of previous studies of U.S. stocks, we show that the total factor productivity (TFP) of Japanese manufacturing firms positively predicts their future returns in the cross-section when controlling for the Fama and French (2015) five factors. Research and development (R&D) expenditures explain a substantial portion of the predictive power of TFP, while bankruptcy risk, macroeconomic risk and capital investment risk do not. Our results suggest that efficient firms with high TFP tend to be innovative in terms of high R&D expenditure. The high return premium of these stocks is compensation for R&D investment risk.

Keywords: Productivity, Total factor productivity (TFP), Stock returns, Research and development (R&D), Innovation, Efficiency, Investment risk

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