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Asset growth and stock returns: Evidence from Asian financial markets

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ABSTRACT

This study examines the effect of corporate asset growth on stock returns using data on nine equity markets in Asia. For the period from 1981 to 2007, we find a pervasive negative relation between asset growth and subsequent stock returns. Such relation is weaker in markets where firms' asset growth rates are more homogeneous and persistent and in markets where firms rely more on bank financing for growth. On the other hand, corporate governance, investor protection, and legal origin do not influence the magnitude of the asset growth effect in Asian markets.

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1. Introduction

The relationship between finance and growth has been long debated in academic research, and there has been ample evidence that a well-functioning financial system contributes positively to a country's economic growth (see, e.g., Demirgüç-Kunt and Levine (2008) for an extensive survey of the literature). At the micro-economic level, an important channel for the financial systems to facilitate economic growth is to efficiently coordinate financing and investment activities across firms, to the effect that capital flows from firms with low investment opportunities to firms with highly profitable prospects.

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Using U.S. data, however, many studies have found evidence discordant with micro-level financial efficiency: firms experiencing rapid growth by raising external financing and making capital investments and acquisitions, subsequently have poor operating performance and disappointing stock returns, whereas firms experiencing contraction via divesture, share repurchase, and debt retirement, subsequently report good operating results and high stock returns. Recently, Cooper et al. (2008, hereafter CGS) summarize the synergistic effects of investments and financing on stock returns by a simple measure of total asset growth. They show that in U.S. high asset-growth stocks underperform low asset-growth stocks and attribute this finding to over-investments by corporate managers and an excessive-extrapolation bias by investors when they value stocks based on firms' past growth.

In this study, we explore the asset growth effect in an international setting — specifically, in nine Asian markets: Japan (a well-developed economy), China (one of the most rapidly growing economies), Hong Kong, Taiwan, Korea, Malaysia, Singapore, Thailand, and Indonesia. We focus on the asset growth effect in the Asian financial markets for the following reasons. The Asian economies have generally experienced fast economic growth during recent decades, which is accompanied by rapid asset growth at firm level and active capital market activities (e.g., Shaffer, 2002). Further, corporate ownership and governance characteristics in Asian financial markets are very different from the U.S. — such as highly concentrated ownership of public corporations and complicated, pyramid-like systems of corporate control (Claessens et al., 2000). The looming corporate governance concern is the expropriation of minority shareholders by controlling shareholders, instead of the conflicts of interest between managers and diverse shareholders — the latter is believed to be a source of the asset growth effect in the U.S. (Cooper et al., 2008).

More importantly, in contrast to the well-developed capital markets of the U.S., many Asian economies (notably China, Japan, Taiwan, Korea, Thailand, and Indonesia) primarily rely on bank-based financial systems. Even for firms operating in Asian economies with well-developed capital markets, bank financing is often a major source of asset growth. Capital market-based and bank-based financial systems could affect firms' financing behavior and investment efficiency differently. For example, in these two types of financial systems, the mechanisms to bond the interests of firms and investors can be quite different (Datta et al., 1998; Puri, 1996, 1999). There are at least two channels through which a bank-based system may affect the asset growth effect. First, banks have direct access to corporate financial information and bank financing may have an important monitoring effect on a firm's business performance (Townsend, 1979; Diamond, 1984, 1991; Puri, 1996, 1999). Thus bank financing may effectively curb firms' overinvestment tendency. Second, the banking system may underfund firms' growth opportunities, resulting in capital rationing and causing firms to underinvest and grow more homogeneously. Weinstein and Yafeh (1998), for example, show that banks could discourage firms from investing in risky but profitable projects, as banks are the major debtholders and tend to be more risk averse than equityholders. Thus, we are interested in whether the economic growth, corporate governance characteristics, and in particular, the prominence of the bank system, make a difference in explaining the growth–return relation between the U.S. and Asian markets, and across the Asian markets.[1]

Using financial and stock data from PACAP and DataStream, we first document a pervasive negative relation between asset growth and stock returns in the Asian financial markets during the period from 1981 to 2007. When stocks are first ranked within each market and then the resulting portfolios are combined across the nine Asian markets, the annualized return spread between top and bottom asset growth deciles is −12.48%. This spread is however lower than that for the U.S., where the equal-weighted stock return spread between the top and bottom asset growth deciles is −23.64% per year. The weaker magnitude of the asset growth effect in Asia is interesting and somewhat puzzling if one

[1] Our analysis focuses on hypotheses developed under the overinvestment based explanation (Cooper et al., 2008), and therefore is silent on the rational asset pricing aspect of asset growth. We should point out, however, that there are rational explanations for the asset growth anomaly and other forms of anomalies related to firms' investment and financing activities; see, e.g., Cochrane (1991, 1996), Liu et al. (2009), Lyandres et al. (2008), Li and Zhang (2009), and Li et al. (2009). In particular, time-varying discount rate may explain a portion of the asset growth anomaly. If bank financing is associated with financing constraints, rational asset pricing theories may also predict an effect of bank financing on the asset growth anomaly. For example, Li and Zhang (2009) show that financial constraints may intensify the relation between investments and expected stock returns.