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Exploring the impact of strategic emphasis on advertising versus R&D during stock market downturns and upturns

Jin Kyung Sung[a], Jimi Park[b,*], Shijin Yoo[c]

[a] CS Consulting Center for Service Sector, Korea Productivity Center, 32, Saemunan-ro 5Ga gil, Jongno-gu, Seoul, Republic of Korea
[b] College of Business, Hawaii Pacific University, 900 Fort Street Mall Suite PL 600, Honolulu, HI 96813, United States of America
[c] Korea University Business School, LP 403, Seongbuk-gu, Seoul, 136-701, Republic of Korea

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ABSTRACT

A strategic emphasis on value appropriation to value creation framework has emerged as a growing area of research. However, whether such emphasis is effective in periods of different market trends remains an unexplored area of research. Among 287 firms in 17 industries listed on the New York Stock Exchange between 1980 and 2010, the authors found that strategic emphasis on advertising significantly decreases a firm's systematic risk when the stock market is experiencing a downturn (i.e., shielding stock returns in market downturns). Similarly, strategic emphasis on advertising significantly increases a firm's systematic risk when the market moves upwards (i.e., stimulating stock returns during market upturns). These results highlight that a strategic emphasis on value appropriation to value creation helps investor confidence recover during dark times and boosts it during good ones.

1. Introduction

Firms try to create sustainable competitive advantages by strategically allocating resources between two essential processes: (1) creating value from product innovation and (2) appropriating value from profit derivation (Mizik & Jacobson, 2003). We can label allocating a specific amount of support between these alternatives as a *strategic emphasis* (Edeling & Fischer, 2016; Mizik & Jacobson, 2003). To achieve a firm's current objectives, managers should adjust their strategic emphasis, given that internal and external environments are becoming more dynamic and hypercompetitive.

We often observe that firms fail to make profit only from value creation. For example, when TiVo innovated the digital video recorder (DVR), the company became a dinosaur almost overnight. DVRs were exclusive in 2006 (i.e., value creation), yet TiVo rarely made profit from the innovation and was unsuccessful in licensing its technology for wider appeal (i.e., value appropriation). Further, the inability to foresee competitive forces, such as streaming media, made TiVo obsolete in the marketplace. Investors saw the magnitude of future earnings when the TiVo launched the technology but when profit was not realized, investors left TiVo. Therefore, a change of strategic emphasis reflects how the firm will capture and lengthen the competitive advantage over time, which in turn, leads to superior financial performance.

Among the various strategic decisions, advertising expenditure has a greater connection with value appropriation, whereas research and development's (R&D) has greater association with value creation (Han, Mittal, & Zhang, 2017; Mizik & Jacobson, 2003). Investors can view an emphasis on advertising as facilitating a competitive structure for "lengthening" the acquired success, while relative emphasis on R&D can be interpreted by investors as "owning" potential earnings. This can be supported by the recent study (McAlister, Srinivasan, Jindal, & Cannella, 2016) that investigates how advertising influences firm value through brand equity for a differentiator because advertising can elaborate the firm's points of difference. However, advertising cannot build firm value for a cost leader because such a firm has no points of difference on which to build (McAlister et al., 2016).

The extensive marketing literature that has advocated the importance of marketing decisions in reducing financial risk can be used as a basis to confirm the "lengthening" role of acquired success through strategic emphasis on advertising over R&D. Accordingly, firm investments in advertising tend to be less risky than those in R&D. A marketing alliance represents an accessibility to new markets or a brand-equity-strengthening effect with risk-reducing effect (Thomaz & Swaminathan, 2015). For example, negative impact due to product recall diminishes when firms emphasize brand advertising (Liu, Shankar, & Yun, 2017). In contrast, the downside risk of value-creation activities is much stronger because a failure in R&D may trigger the loss of a potential customer and alienate current ones (Frohlich, 2014).

* Corresponding author.
E-mail addresses: jksung@kpc.or.kr (J.K. Sung), jipark@hpu.edu (J. Park), shijinyoo@korea.ac.kr (S. Yoo).

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Interestingly, Han et al. (2017) found that the risk-reducing effect of a strategic emphasis on advertising is weaker under large relative performance but stronger under demand instability. Taken together, these results indicate that firms can buffer themselves from broader financial market shocks and reduce the demand volatility by marketing investments. Following this argument, we next articulate how market trends may moderate the effect of strategic emphasis on financial risk.

Market trends can severely affect the financial performance of firms, as investors are sensitive to market conditions. Financial portfolio theory supports this idea by illustrating how investors can construct an optimal portfolio for maximizing returns under a given level of market change (Fama & French, 1992; Markowitz, 1999). Economic downturns have lowered investor confidence, prompting them to seek stability from risk-resistant stocks. A strong post-crisis growth often follows an economic crash, and firms successful in bringing back investor confidence become recipients of the growth. As such, a holistic understanding of a firm's capability and resilience must become a key aspect for investors across distinct market climates. Investors may highly value a firm's fundamental capability that facilitates a competitive structure under downturns and a capacity to build resilience that lengthens acquired success during upturns. As such, from investors' points of view, firms are required to play like a *libero*, a versatile sweeper in soccer. One role of this position is to play defensively to stop an opponent's attack (i.e., minimizing negative performance in market downturns), while the other is to play offensively in order to build a counter-attack (i.e., maximizing positive performance in market upturns). Thus, investors require constant attention not only to the fundamentals that how firms meet the consumers' evolving demands despite intense competition during downturns but also to the capacity to build resilience that quickens recovery, and furthers growth during upturns. Strategic emphasis is thus a key firm-level action that shows the relative importance of vulnerability assessment because it demonstrates the broad range of understandings pertaining to different market trends and the level of preparation for resilience to withstand each one.

This study examines the relationship between strategic emphasis on advertising over R&D and stock-return risk in the presence of market trends (i.e., market upturns versus market downturns). We summarize the contributions of this study as follows. First, although various financial performance metrics (e.g., profitability, growth, and risks) have been the subject of academic research in marketing (Hanssens, Rust, & Srivastava, 2009), this is the first study that explores how market trends are entwined with the impact of a strategic emphasis on firm risks. We examine how the climate of financial markets moderates the relationship between strategic emphasis and firm risk. Second, in contrast to the prior literature that only focuses on the effect of marketing actions on downside risk (i.e., the protective role of marketing investment under downturns), we explore whether there is a firm's specific behavior that accounts for not only protective stock returns in times of difficulty, but also highly receptive stock returns in times of prosperity.

We begin by reviewing the literature on the concept of strategic emphasis, the relationship between strategic emphasis and stock-return risk, and the moderating role of market trends. We then detail the rationale for linking strategic emphasis to stock-return risks and develop hypotheses. Next, we explain our empirical analysis by introducing the data used in this study, measurements of key variables, and a proposed model. Finally, we present the results of the study with discussion on academic and managerial implications followed by directions for future research.

2. Literature review

2.1. Strategic emphasis between value appropriation and value creation

The future earnings of a firm can be created and/or strengthened by key intangible assets that are contributed by advertising and R&D (Erickson & Jacobson, 1992). Advertising enables a firm to have a price premium, reduces its vulnerability to competition (Keller, 1998), and serves as a market entry barrier (Aaker, 1996; Keller, 1998). Investment in R&D contributes to increasing production efficiencies, improving existing products, and creating competitive advantages (Rubera & Kirca, 2012).

Although advertising and R&D spending have been widely employed as a firm's important strategic investments in previous literature (e.g., McAlister, Srinivasan, & Kim, 2007; Steenkamp & Fang, 2011), the return on advertising apparently differs from that on R&D in the context of the risk-reward window. The benefits of R&D typically materialize over the long run (Chan, Lakonishok, & Sougiannis, 2001), thus R&D investment represents a high-risk and long-term strategic decision (Doukas, Pantzalis, & Kim, 1999). Mizik and Jacobson (2003) defined *value creation* as the process of creating value in order to widen the value gap between a firm and its competitors, whereas *value appropriation* as the process of extracting the profits of created value in the market and protecting it from competitors. Both capabilities are required for firms to sustain competitive advantage, and these capabilities are mutually supportive. Firms may allocate more resources to either R&D as a value-creation activity or advertising as a value-appropriation activity, depending on an area of emphasis. In fact, Mizik and Jacobson (2003) found significant differences in advertising spending compared to R&D spending according to industry, company, and time. For example, they classified industries into high-, stable-, and low-technology subsamples from 566 different firms covering the period 1980–1998 given that investor response might vary with the type of environment. They exhibited that the estimated mean value of strategic emphasis on advertising was negative for the entire sample, the high-technology group, and the stable-technology group. This indicates that firms, in general, show greater relative reliance on value creation over value appropriation capabilities in high-technology and stable markets. However, the mean of strategic emphasis on advertising was positive for low-technology groups such as food, which indicates relative emphasis on value appropriation over value creation capabilities. From the plot of strategic emphasis indicator for the Intel Corporation for the period 1982–1998, they found changes in strategic emphases over time. Although Intel maintained relative emphasis on value creation, the measure showed a shift in emphasis toward value appropriation over time.

2.2. Effects of strategic emphasis on stock-return risk

Stock-return risk and stock returns are the most important factors in stock trading (Luo & Bhattacharya, 2009). Stock-return risk may be divided into systematic and idiosyncratic risk. Systematic risk explains the portion of stock-return risk driven by the volatility of market returns. It indicates the sensitivity of an individual stock to market movements. Idiosyncratic risk is the portion of a stock's return attributable to internal factors unrelated to market movements. Systematic risk explains nearly 20% of stock risk, with the remaining 80% being explicated by idiosyncratic risks (Srinivasan & Hanssens, 2009).

Both R&D and advertising investment affect a firm's stock-return risk, although there exist conflicting results. For example, McAlister et al. (2007) suggested that both advertising and R&D investment have significant negative effects on systematic risk. However, Chen, Peng, and Wei (2012) found significant positive effects of R&D investment on systematic and idiosyncratic risk for firms facing mid- or high-level risk. However, the same study revealed significant negative effects from advertising investment on idiosyncratic risk for firms with a high level of idiosyncratic risk. In the service innovation literature, e-commerce initiatives (Dewan & Ren, 2007) and service innovativeness (Dotzel, Shankar, & Berry, 2013) increase idiosyncratic risks. Since innovations import a high level of uncertainty, the literature tends to suggest that a positive relationship exists between innovation and firm risks.

In general, a firm prioritizes R&D and advertising investment given limited resources and a competitive context. The strategic emphasis on

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