Mispricing Firm-level Productivity

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Summary

This paper provides a mispricing-based explanation for the negative relation between firm-level productivity and stock returns. Investors appear to underprice unproductive firms and overprice productive firms. We find evidence consistent with the speculative overpricing of productive firms driven by investor sentiment and short sale constraints. Investors erroneously extrapolate past productivity growth and its associated operating performance and stock returns, despite their subsequent reversals. Such mispricing is perpetuated because of limits to arbitrage and is partially corrected around earnings announcements when investors are surprised by unexpected earnings news. Decomposition analysis indicates that extrapolative mispricing and limits to arbitrage explain most of the return predictability of firm-level productivity.