CHAPTER 3:   LITERATURE REVIEW

Several recent studies have reported significant positive stock returns on stock dividend and bonus issues announcement dates, and these results are generally attributed to the information these announcements convey to investors concerning future firm prospects.

3.1   Previous Studies from the United States

Fama, Fisher, Jensen and Roll [1969] focused their study on the relationship between the impact of information contents of splits and their price behavior. To examine this relationship, they collected split data for all NYSE-listed stocks between 1927 and 1960 (total of 622 splits in all). They concluded that stocks in the dividend "increased" class had slightly positive returns following the split. This was consistent with the hypothesis that splits are interpreted as messages about dividend increase. On the other hand, stocks with poor dividend performance experienced declines in cumulative average residuals until about a year after the split by which time it must be clear that the anticipated dividend increase was not forthcoming.

Taken together, these results were consistent with the hypothesis that on the average the market made unbiased dividend forecasts for split-up securities and these forecasts were fully reflected in the price of the security by the end of the split month. Their results were consistent with the semi-strong form of the Efficient Market Hypothesis.

Chottiner and Young [1971] investigated stock price behaviour around the ex-dates of 945 stock splits and dividends declared by the NYSE firms over the 1963 − 1968 period. None of these splits or stock dividends were accompanied by cash distributions of any kind. They found, in effect, that the various classes of stock dividends (i.e. the 2, 3, 25, 50 and 100 percent classes) tend to produce positive unexpected returns on the ex-date.

Foster and Vickrey [1978] then analyzed stock price behaviour around announcement date and ex-date for 82 stock dividends on the NYSE over the 1972 – 1974 period. They also screened their data sample to ensure that other firm specific information and cash dividends were not announced around the ex-date. Foster and Vickrey hypotesised that the mean of the announcement day residuals would be greater than zero, due to the information content of stock dividends. They analyzed market model residuals and found that the announcement date residual to be significantly from zero and ex-date residual to be insignificantly from zero.

In the same study, Foster and Vickrey also analyzed whether small stock dividends almost always produce significant amounts of positive unexpected returns and that large stock dividends fail to generate such returns on the announcement date and ex-dates. The results showed that the market does not react positively to stock dividends of any size on the ex-date.

Woolridge [1983] did a similar study as Foster and Vickrey, He examined 317 stock dividends (less than 25 percent) post 1964 announcements and concluded that stock prices do not fully adjust for stock dividends and consequently stock dividend declarations increase the value of stockholdings.

Grinblatt, Masulis and Titman [1984] confirm earlier work on stock dividends by Foster and Vickrey [1978] and Woolridge [1983]. The announcement effects for stock dividends are large, 4.90% for a sample of 382 stock dividends and 5.89% for a smaller sample of 84 stock dividends with no other announcements in a three-day period around the stock dividend announcement. One possible reason for the larger announcement effect of a stock dividend is that retained earnings must be reduced by the dollar amount of the stock dividend. Only those companies that are confident they will not run afoul of debt restrictions that require the minimum levels of retained earnings will willingly announce a stock dividend. Another reason is that convertible debt and warrant holders are not protected against dilution caused by stock dividends. As with stock splits, there was a significant positive return

on the stock dividend ex-date and the day before. No explanation was offered for why the ex-date effect was observed.

Brennan and Copeland [1987] provided a signaling theory explanation for stock splits and showed that it is consistent with the data. The intuition can be explained as follows. Suppose that managers know the future prospects of their firm better than the market does. Furthermore, assume that there are two firms with a price of $60 per share which are alike in every way except that the managers of firm A know it has a bright future while the managers of firm B expect only average performance. Hence firm A will signal its bright future with a stock split and the signal will not be mimicked by firm B. As a result, firm A's price will rise at the time of the announcement so as to reflect the present value of its future prospects. Furthermore, the lower the target price to which the firm splits, the greater confidence management has, and the larger will be the announcement residual. Empirical results by Brennan and Copeland confirm this prediction.

Brown and Warner [1980] did a study to examine various methodologies which are used in event studies to measure security price performance. Event studies focus on the impact of particular types of firm-specific events on the prices of the affected firms' securities. Observed stock return data were employed and abnormal performance is introduced into this data. Brown and Warner found that a simple methodology based on the market model performs well under a wide variety of conditions. In many situations, even simpler methods which do not explicitly adjust for marketwide factors or for risk perform no worse than the market model.

3.2   Previous Studies from Malaysia and Singapore

Tang [1976] studied 67 bonus issues on the Singapore Stock Exchange between January 1970 and December 1975, and for periods ranging from 12 months prior to announcement and 24 months after the announcement. In all, for every given bonus issue declared, stock prices and their corresponding STI index values were found for the 12-months, 6-months, 1-month and 1-week before the announcement date as well as 3-months, 6-months, 12-months and 24-months after the announcement date, and the rate of returns were calculated over these periods.

Tang concluded that stock prices of declared bonus issues tend to out-perform the market up to 6 months prior to the announcement of the bonus issue, and continued to do so for 3 months after the announcements. Tang concluded that the best trading strategy is to buy into a particular stock when an official announcement of a bonus issue is made and then sell out not longer than three months after the announcement.

For the research methodology, Tang also used the simpler method developed by Brown and Warner [1980] which do not explicitly adjust for marketwide factors as in the market model. Tang compares the returns for the security to the return of the corresponding STI index values.

Ariff [1990] studied the price response to capitalization changes in the Singapore Stock Market including 371 bonus issues in the period January 1973 to December 1982. Using monthly price data, his study showed that the Cumulative Abnormal Return (CAR) up to and including the announcement month is large, positive and significant. Excess returns after the announcement month are insignificant and random, consistent with the semistrong form efficiency of the EMH.

Ku Nor Izah [1990] studied the effect of bonus issue announcements on share prices listed on the KLSE. The results indicated that KLSE displayed the

semistrong form efficiency with regards to bonus issue announcements. However, Ku Nor Izah's study was only confined to announcements made between January 1985 and December 1987 (3 years only). Furthermore, monthly stock prices were taken to calculate the returns.

In another study by Annuar and Shamser [1993], they attempted to determine the price effect and efficiency of the KLSE with respect to rights issues announcements. A total of 29 samples were chosen from the year 1980 to 1991. The New Straits Times Industrial Index was used to estimate the daily residual behavior of the sampled firms in the analysis period.

Their findings suggest that an optimal trading strategy is to sell shares of firms expected to announce rights one month before the announcement and buy back the shares 10 days after the announcement. Based on their findings, the Malaysian stock market does not seem to conform to the semi-strong version of Efficient Market Hypothesis.

Neoh [1986] did a study on bonus issues of companies on the KLSE using price movement of 78 stocks which gave a bonus of 1 for 5 or greater from 1968 to 1983. The price movements were recorded in respect of the 50 weeks before and 50 weeks after the bonus announcements.

Neoh's findings showed that there was a strong Cumulative Abnormal Return (CAR) movement upwards from about 15 weeks before the announcement until about 4 weeks after the announcement. There was a very sharp decline from about 4 weeks after the announcement. Such downward movement seemed to continue beyond the end of the event period.

Neoh then concluded that in order to gain from bonus issues, an investor has to buy the stocks 20 weeks before announcement and sell almost immediately to within 4 weeks after the announcement.

Ng [1984] did a study on the impact of bonus and rights issues on stock prices in the Malaysian Market. Ng used monthly data collected between 1977 to

1981, and the event study period ranging from -11 months to +12 months about the event month.

The study indicated that, on the average, the market judgements concerning the information implications of a bonus issue were fully reflected in the price of a share at least by the ex-bonus month but most probably almost immediately after the announcement date. It also indicated that the largest positive average residual occur in the three months before bonus issue announcement, but after announcement, its average residuals are randomly distributed about zero.

Ng then concluded that the Malaysian stock market showed semistrong form efficiency in the sense that stock prices adjust very quickly to new information. In other words, the bonus issue causes price adjustments only to the extent that it is associated with the changes in the anticipated level of future dividends.