2. Theoretical Framework

2.1 Bonus issues

Bonus issue is the additional shares issued to shareholders for free. There is no change in total shareholder's fund after the bonus issues. It is just a capital accounts rearrangement in the balance sheet whereby reserves is deducted to add to issued and paid up capital section of the shareholders fund. Thus, total value of the firm remains unchanged. Since there is no direct cash flow implication for valuation, it should be no effect on share price.

Bonus issue is similar to stock split in the New York Stock Exchange (NYSE) and Australia Stock Exchange (ASE). It is normally followed by favorable news of revaluation of assets or forecast for higher dividend. It serves to remind investors of firm's inability to pay cash dividend. Research suggests that these announcements contain information relevant to market participants for reassessing share prices of the announcing firm.

Bonus issues are normally quoted as a ratio. For example, a 3:1 bonus issue means for every one existing share held, shareholders are entitled to three free, newly issued shares. As a result, the investor ends up with four shares.

There are a few hypotheses to explain the abnormal return generated when bonus issues or stock splits are announced. The hypotheses include:

2.1.a) Signaling or information asymmetry hypothesis

According to information asymmetry hypothesis, managers of undervalued firms use stock splits to signal information about their future prospects to investors. Pessimistic managers are less likely to undertake a split because a future decline in the firm's share could result in the price falling below an acceptable range. Thus, stock split could be interpreted by the market as a signal that managers are optimistic about future prospects of the firm.

2.1 b) Liquidity or optimal trading range hypothesis

Bonus issues can increase liquidity of the stocks and widen distribution of shares because of the drop price after the ex-bonus date. It provides better trading range and attracts investors and enhances trading liquidity (Baker and Gallagher, 1980). Managers use stock splits to broaden the ownership mix of the firm, increase the number of shareholders and decrease the institutional ownership of the firm. This is because lower post split share price make it easier for retail investors to buy shares in round lot while it increases the transaction cost of a fix dollar transaction for institutional investors (Powell and Baker, 1994).

2.1.c) Getting Attention

This hypothesis is first proposed by Grinblatt, Masulis and Titman (1984). It is a special version of signaling theories. When a firm split its stock, more analysts begin to study the stock and reassess the true value of the stock. This leads to a revaluation of the stock and the stock price become more informative. For under-priced firm, analyst will upgrade the stock rating to reflect the better prospects. As a result, under-priced firm finds it favorable to have a stock split but not the over-priced firm.

2.2 Rights Issue

Rights issues are additional shares issued to existing shareholders in order to raise additional capital. The numbers of new shares offered are in proportion to the shares an investor owned and the subscription price is below the market price of the firm's existing shares. Shareholders could either buy the rights or sell the rights in the market and thus there is an impact on firm future value, risk and cash flows.

Since rights issue gives existing shareholders a privileged to subscribe any new shares issued by the company, it protects shareholders against any involuntary dilution of their shares and minimizes wealth transfer between shareholders and outside investors. As compared to public offering that causes greater dispersion in share ownership, rights offering leads to a more concentrated ownership.

When a rights issue is announced, shareholders will be informed and they could either subscribe or sell the rights in the market. Their decisions will depend on their valuation of the stock and the rational of the rights issues. The value of the rights is the different between the average price of a share without the rights issues and with the rights issues. In technical jargon, it is the price per share just before the rights issues or the rights-on price less the price per share after the rights issues or the ex-rights price (Sivalingam, 1993). The higher the value of the right, the more attractive the rights issue will be.
An investor would consider a few factors in deciding whether should subscribe for the rights issue. These factors include:

a) The shareholder may not have sufficient funds to subscribe for the rights issue and therefore choose to forfeit them to sell the rights in the market to others.

b) A number of days allowance is given between the day when the shares go ex-rights and the final day for payment for the rights. Over this period, it is possible for the market to be depressed such that it is cheaper to buy the ex-rights shares in the open market rather than to subscribe for them. Under such situation, the rights issue would have been a failure and the underwriters would have to absorb a large proportion of the rights issues. However, if the market improves, subscription for the rights would have become more attractive.

c) Another factor is the purpose for which the company intends to utilize the cash proceeds realized from the rights issue. If the earning on the capital employed is likely to be maintained or increased, then the new shares offer the prospect of increase participation in the company's prosperity.

d) If the shareholder chooses to subscribe for the new shares, he would lose the opportunity of using his money for other investment. The shareholder should also consider the question of opportunity cost (Investors Digest, Jan 1994).

Similar to bonus issue, rights issue is also quoted as a ratio. For instance, a 2:5 rights issue means exiting shareholders will be eligible to buy two shares for every five shares already owned. The investor will end up with seven shares after the rights issue.

Unlike bonus issues, rights issue is observed to experience a drop in share price on the announcement date. One of the explanations for the behavior is the price pressure hypothesis which states that firm face downward sloping demand curve for their stocks. When more shares are offered in the market through rights issues, this will depress the share price. Meanwhile, wealth redistribution hypothesis suggests that bondholders gain from the leverage reduction associated with the new issue of equity, and their gains are at the expense of the stockholders. Another hypothesis, information release hypothesis states that insiders having superior information, issue equity when they perceive it to be overvalued by the market. Thus, when the rights issues are announced, shareholders will sell the stocks that are overpriced and this depresses the share prices (Kalay and Shimrat, 1987).

2.3 Efficient market hypothesis

A perfectly efficient market is a market in which price always reflect all known information (past information). Price adjusts instantaneously to any new information released and speculative profit is just a matter of luck. Since prices adjust immediately to new information, nobody is able to constantly beat the market and earn above market return for a long time.

In a perfectly efficient market, demand curve for a security should be perfectly elastic, that is horizontal at a price level. This is because all investors hold the same information and thus they will agree on the same fair market price. Nobody is willing to pay a higher price for a securities and nobody is willing to sell at anything less than the fair price.

There are a few conditions necessary for a perfectly efficient market. These conditions includes information must be freely and instantly available to all markets participants, no trading cost, individual cannot affect price level and people maximize expected utility.

There are three level of market efficiency distinguished by the degree of information contained in the price level. Weak form of market efficiency, semi-strong form of market efficiency and strong form of market efficiency are the three form of market efficiency.

2.3.a) Weak of market efficiency

In a weak form of market efficiency context, price reflects the information contained in the record of past prices and it will react to new information. Since new information arrives at random, next price movement is also at random. Thus, share price movement is a random walk. As a result, it is impossible to make consistently superior profit by studying past return. Technicians use past data on variable such as stock price and trading volume in order to identify predictable patterns and identify any support and resistant level for the stock price. Return predictability will verify this form of efficiency.

2.3.b) Semi-strong form of market efficiency

Price reflects not just past prices but all other published information in semi-strong form of market efficiency. Price will adjust immediately to new information or information that is different from what is expected and there will be no consistent under or over reaction. The implication of this form of efficiency is that price adjusts immediately to public information such as announcement of bonus and rights issues, merger and acquisition, or earning announcement. The observations on how prices react to new information can provide evidences on semi strong form of market efficiency.

2.3.c) Strong form of efficiency

In this situation, price reflects all information that could be acquired by any analyst. This suggests that no one could consistently beat the market, even with an active investment strategy. The test that could be applied to test this form of market efficiency is whether investors have private information.