

3. Literature Review

3.1 Bonus issues

Many studies have been carried out in order to have a deeper understanding about bonus and rights issues. Bonus issues are similar to the stock split in the New York Stock Exchange and Australian Stock Exchange, as there is no change in the total shareholders' fund after the issues. Thus, studies on stock splits are also relevant for bonus issues. The areas of previous researches or studies include test of the semi strong form of market efficiency, hypothesizes for abnormal return, volatility or beta changes at announcement period and bid and ask spread as well as managerial motives and impact on managerial ownership.

3.1.a) Test of semi strong form of market efficiency

Mohamad and Annuar (1993) find that abnormal returns are significant as early as t-25, t-24, t-8, t-3 and t-2. This shows that there is anticipation of the bonus issues announcement as early as 25 days before announcement. This could be due to insider trading activities or any leakages of information. With the price increase during the announcement period, bonus issues are thus associated with good news and investors are expecting some windfall from the announcement. The decline in the cumulative abnormal return after the announcement suggests the profit taking activities and a consolidation phase where market correction takes place. They also found that post announcement abnormal return are randomly distributed at zero that is consistent with market efficiency.

Another studies by Bacha and Meera (1997) also find an abnormal price behavior around announcement date with the build up in prices before the announcement. They also find no change in daily price volatility, daily volume and any wealth effect. Furthermore, they find no evidence that differences in the

distribution ratios has any impact on the excess return. There suggest that there is no gain to the shareholders unless the shareholders sold the share immediately following the announcement.

Hemandas (1994) finds a positive abnormal return for all bonus issues by studying the stock from 1984 to September 1993 in the KLSE market. He also shows that the higher the ratio, the higher the abnormal returns. This is because the shareholders expect increase dividends, earnings and express their confidence in the companies. Previous researches by Ng (1984) and Neoh (1986) also obtained positive return although they used monthly data and weekly data in respective studies.

Another study by Wong and Lee (1990) on SES also observe abnormal return before bonus announcement for the bonus issues from 1975 to 1984. The studies observed a non random walk behavior of share prices after public announcement of the bonus issues and non-immediate price adjustment when stock went ex-bonus. As a result, they suggest that SES was not efficient in the semi-strong form during 1975 to 1984. Also, the surge in stock price before public announcement suggests leakages of news of the forthcoming bonus issues.

3.1.b) Hypothesis for abnormal return

By surveying managers of NYSE and AMEX firms that issues stock splits, Powell and Baker (1993) find that the main motives for stock splits is moving the stock price into a better trading range, followed by improving trading liquidity. Other motives include signaling optimistic managerial expectations and attracting investors. This is consistent with previous research by Lakonishok and Lev (1987) who find that splits are aimed to restore stock prices to a normal trading range and as a reflection to some signaling given by the firm. In addition, Brennan and Copeland (1988a) assume that the managers use stock split

announcement to communicate their private information about the firm's prospect to investors.

Powell and Baker (1994) find that the economics effects of stock splits is inconclusive because while stock splits results in a lower stock price, firm also spend for transaction cost. Besides, stock splits also resulted in a higher institutional ownership and may lessen individual ownership. Both the number and percentage of shares owned by institution increase although the number of shareholders for both splitting and non splitting firm does not have significant increases. Thus, they suggest that this could lessen information asymmetry between the firm and investors.

Grinblatt, Masulis and Titman (1984) also study the stock listed on New York Stock Exchange and American Stock Exchange and find that there is a positive reaction to stock splits announcement that are not contaminated by other contemporaneous firm specific events. Their analysis supports both the trading range and attention analysis. Ball and Torous (1988) later support their study by using a maximum likelihood method that incorporates the possibility of a random event date rather than the standard multiday approach.

Lamoureux and Poon (1987) argue that split announcement effects are due to the increase in the tax-option value of the split. Also, the splits increase both the number of transactions and shares traded which increases the volatility of the prices.

3.1.c) Volatility, beta behavior and bid and ask spread

In analyzing the volatility of the beta behavior following a stock split, Brennan and Copeland (1988b) find a temporary increase in stocks' beta on both the split announcement date and the effective date; moreover, they notice a permanent increase in the beta following the ex-date.

Foster and Scribner (1991) observe an announcement effect after controlling for beta non-stationarity. The violation of beta stationarity assumption is not a major concern in determining the abnormal return. Although there are some differences in the return behavior exhibited by different beta group, no statistically significant different is found.

In analyzing the role of information on stock prices around the time of stock split announcements, Arbel and Swanson (1993) show the degree of market anticipation of the split announcement is related directly to the amount of information available about the stock. Information-poor stock will have a greater announcement effect at the announcement time (events days 0 and +1) as compared to information rich firm. Moreover, information rich stock will have a rapid and complete adjustment at the post-announcement period.

McCorry (1995) tests for the bid-ask spread reaction to announcement of stock splits. He finds reductions in percentage bid and ask spreads in responds to splits announcement. By using stock split as signaling devices to inform market participants of stock under valuation, information asymmetry is reduced after the announcements. Consequently, stock prices reflect the true value more accurately and thus reduces adverse selection risk by the security dealers. Thus, the bid and ask spread become narrower and the liquidity increases.

McCorry's finding is contradicts to previous research by Copeland (1979) who reveal a drop in liquidity after stock split. Copeland's study also shows an increased in brokerage fees and wider bid-ask spreads after the stock split.

3.1.d) Managerial motives and impact on managerial ownership

Szewczyk and Tsetsekos (1993) study the impact of managerial ownership on stock split induced abnormal return. They find a significant difference in share

prices reaction to stock split depending on the degree of managerial ownership. The magnitude of announcement period abnormal return is inversely related to the percentage of firm's common stock owned by its managers and director. They also notice that splitting firm tend to have a lower managerial ownership than non-splitting firms.

In analyzing the impact of ownership and information asymmetry on investor response to stock split announcement, Han and Suk (1998) show that a significantly positive link between returns at stock splits announcement and insider ownership for small firm. They find that firm with a higher level of insider ownership are more credible and there is greater likelihood of receiving a more positive market response. As management stake in the firm increases, its costs increase if it sends false signal. Thus, the credibility of the signal is enhanced as the level of ownership increases. Also, they find that investors evaluate stock splits decisions by considering both the insider ownership and information asymmetry.

3.2 Rights issues

Kananathan (1994) finds that cumulative abnormal return increases prior to announcement but decreases after the announcement. The drop in return after the announcement is a signal that market does not respond favorably to announcement of rights issues and consider it as a signal of financial distress. He also finds that the distribution ratio is inversely related to abnormal return. The higher the distribution ratio, the lower the abnormal return.

Similar observation is obtained by Isa and Tan (1997) who find that there is a positive price reaction prior to rights issues followed by an immediate drop after the announcement. They further conclude that the market reacts also to the information content of the rights announcement. As for bonus announcement, there is a strong and positive market reaction.

Abdullah (1997) also find similar pattern of abnormal return as suggested by Kananathan, Isa and Tan when he studied the rights issues from 1987 to 1996 for the Malaysian listed companies. There is a rising trend in stock prices before the rights issues. Based on the observation, rights issue announcements are welcome in the Malaysian stock exchange and this is deviating from the semi-strong form of efficient market hypothesis. Furthermore, it is also found that the cumulative abnormal return is statistically influenced by the debt/equity ratio, relative size of issues, company's size, subscriptions price discount and book to market equity ratio.

Unlike the above three researches, Ariff (1998) observes that rights issue announcement are perceived to be unfavorable news. By using daily closing price of selected stocks and daily KLSE Industrial index as market return from 1980 to 1991, he finds that there is a negative price impact toward the rights issue announcement, the announcements are anticipated, and price changes are efficient to such announcement. The findings also suggest that investors can earn abnormal gains if they sell the share a month before the announcement and buy back the shares 10 days after the announcement.

Similarly, Srinivasan and See (1990) observes that rights issues of SES from 1976 to 1984 do not respond favorably to the announcement. There is a drop in price during the announcement period although the drop is not significant. However, the anticipation of investors and possible leakages of information had push up the prices prior to the announcement. Nevertheless, the increase in price before the announcement is not significant and investors are only earning a rate of return that commensurate with systematic or market risk.

Cai (1998) finds that 260 rights issues in the Tokyo Stock Exchange between 1971 and 1986 performed poorly. This trend is similar to other studies on initial

public offering and seasoned equity offering that accompanied by the post issues deterioration of accounting profitability.

White and Lusztig (1980) obtain a conflicting conclusion on their studies. Although they find a drop in market price that is associate with the rights offering announcement, three factors unable them to conclude the finding. These factors are the announcement effects of other events such as dividends or earning, the lag between announcement dates and date of record and selected dates prior and subsequent to that date, and the assumption that each security is homogeneous to other securities and the market.

Tsangarakis (1996) studies the announcement effects in Greece for the period of 1981 – 1990 and suggests that rights issues by Greek convey positive information about their prospects. As explained by Tsangarakis, the lack of an active secondary market for rights issues suggests large current shareholder participation in the issue, thus reducing the adverse selection costs. Furthermore, large and concentrated shareholders own shares. This reduces the agency and adverse information costs. Thus, rights offering announcements are considered as good news. The positive return is similar to the previous finding by Kang (1990) with the study carried out in Korea.