



A REVIEW OF THE EMPIRICAL LITERATURE ON STOCK SPLITS

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Abstract

Efficient Market Hypothesis (EMH) postulates that no investors/expert can beat the stock market in the long-run. In other words, the investors can earn only normal/equilibrium returns in the stock market. Yet there are ample evidences of abnormal returns associated with certain event across the stock markets of developed and developing nations. Out of these events the stock splits are the ones which are associated with positive abnormal returns around the announcement and the execution day and in addition with an increase in variance following the ex-day across the world. The present paper examines the empirical evidence on stock splits since these seem to be purely cosmetic corporate events. Various hypotheses have been proposed by the researchers to explain effect surrounding split announcement. These hypotheses are the signaling hypothesis, the trading range hypothesis, the liquidity hypothesis, and the neglected firm hypothesis. The proponents of the liquidity hypothesis discover a significant improvement in liquidity surrounding announcement and effective day of stock split while signaling hypothesis exhibited that announcement returns were significantly correlated with split factors after controlling for earnings forecast errors. Furthermore, it also appeared that stock splits done by low priced companies were due to the neglected firm hypothesis. On the whole most of the studies indicated abnormal returns associated with stock splits.

Introduction

In an informational efficient market the incorporation of new information in stock prices is so swift that no investor can expect abnormal returns associated with the information. Still there exists ample empirical evidence that the stock splits are associated with positive abnormal returns around the announcement and the execution day and in addition with an increase in variance following the ex-day across the world. Since stock splits seem to be purely cosmetic corporate events these findings are puzzling. Several hypotheses have been presented to explain effect surrounding split announcement.

The prime concern of the study is to review the empirical literature on the announcement effects of stock splits on stock return behaviour across the globe. There is voluminous literature available on stock returns behavior around stock splits across the globe. Most of the studies were focused on testing four hypotheses- (I) the signaling hypothesis, (II) the trading range hypothesis (III) the liquidity hypothesis, and (IV) the neglected firm hypothesis to explain the abnormal stocks returns around stock splits. In the following sections, studies are categorized according to their explanations of stock splits.

The Liquidity Hypothesis

Shares can split to improve the liquidity of the stock by expanding the investor base due to reduced share price, is the central notion of the liquidity hypothesis. Lamoureux and Poon (1987) argued that the announcement of a split recognized that, subsequent to the (reverse) split ex-day, the daily number of transactions along with the raw volume of shares traded increased (decreased) and resulted in an increase in the noisiness of the security's return process. Muscarella and Vetsuypens (1994) investigated splits of American Deposit Receipt (ADR) securities which were not associated with splits in the home country stock. They argued that these splits were likely to be motivated by the desire for liquidity improvements only. Angel (1997) argued that the firm split shares to improve their liquidity because the splits generate an optimal tick size relative to stock price. Mishra (2007) confirmed a negative effect on price and return of stock splits. The results suggested that stock splits had induced the market to revise its optimistic valuation about future firm performance, rejecting signaling hypothesis to which splits conveyed positive information to markets. The results also showed that split events enhanced liquidity. Joshipura (2008) suggested that though there was some positive abnormal return associated surrounding announcement and effective day of the stock split but it reversed in just a few days after the event day and ultimately generated significant negative abnormal return in slightly longer post effective window. However, there was a significant improvement seen in liquidity surrounding announcement and effective day of stock split.

The Neglected Firm Hypothesis

Arbel and Swanson (1993) proposed the neglected firm hypothesis for stock splits. It suggested that if there is little information about a firm, its shares could trade at a discount so firms exercise splits to draw attention of investors. Wulff (1999) investigated the market reaction to stock splits using a set of German firms. Consistent with the U.S. findings, similar effects were observed for the sample of German stock splits but abnormal returns around the announcement day are much lower in Germany than in the U.S. It also documented that the announcement effect to German stock splits was best



explained by a neglected firm effect and the observed market reaction could not be attributed to measurement problems caused by thin trading. Gupta (2007) exhibited the evidences that there was no announcement effect associated with stock splits in Indian capital market though there was existence of ex-split day effect and improvement in trading volume. Further it appeared that reasons for stock split by low priced companies could be the neglected firm hypothesis.

The Signaling Hypothesis

According to the theory of signaling, splits are a means of passing information from managers to stockholders. By announcing a stock split, a company can reduce any information asymmetries that might exist between stockholders and management. The stock price reduction resulting from a stock split conveys management's conviction of rising future earnings (see Fama et al. (1969)). Grinblatt et al (1984) presented evidence which indicated that stock prices, on average, reacted positively to stock dividend and stock split announcements that were uncontaminated by other contemporaneous firm-specific announcements. In addition, it documented significantly positive excess returns on and around the ex-dates of stock dividends and splits and offered several signaling based explanations for them. Lakonishok and Lev (1987) suggested that stock splits were mainly aimed at restoring stock prices to a "normal range." The evidences also supported the oft-mentioned signaling motive of stock splits. McNichols and Dravid (1990) suggested that management's choice of split factor signaled private information about future earnings and the investors revised their beliefs about firm value accordingly. The analysis also exhibited that announcement returns were significantly correlated with split factors after controlling for earnings forecast errors.

The Trading Range Hypothesis

The hypothesis of the optimal price range states that there is a price range in which trading is most liquid for the stocks of a company. Consequently, when a stock becomes too expensive, a split will bring its price back into the optimal price range. Copeland (1979) postulated the trading range hypothesis as a possible explanation for the stock splits. The study suggested that firm may prefer their shares to be traded within a particular price range when prices are too high.

Besides these explanations to stock splits various studies documented the splits effects across the world. Dhar and Chhaochharia (2007) analyzed the 90 stock splits during the April 2001 to March 2007 and exhibited the presence of significant abnormal returns on ex-split day. Desai and Jain (1997) found that, in the period from 1976 to 1991, their sample of stocks realized an excess return of 7.05 percent after a holding period of one year following the stock split. Ikenberry et al. (1996), examining 1275 stock splits and observed excess returns of 7.93 percent in the first year after a stock split and 12.15 percent in the first three years following a split. The findings of positive excess returns are not confined to the American market. Wu and Chang (1997) found excess returns over the three days surrounding a split announcement amounted to an astounding 18.2 percent on the Hong Kong stock exchange by examining 67 splits in the period from 1986 to 1992. On the whole most of the studies indicated abnormal returns associated with stock splits.

Conclusions

Efficient Market Hypothesis (EMH) postulates that no investors/expert can beat the stock market in the long-run. In other words, the investors can earn only normal/equilibrium returns in the stock market. Yet there are ample evidences of abnormal returns associated with certain event across the stock markets of developed and developing nations. Out of these events the stock splits are the ones which are associated with positive abnormal returns around the announcement and the execution day and in addition with an increase in variance following the ex-day across the world. The present paper examines the empirical evidence on stock splits since these seem to be purely cosmetic corporate events. Various hypotheses have been proposed by the researchers to explain effect surrounding split announcement. These hypotheses are the signaling hypothesis, the trading range hypothesis, the liquidity hypothesis, and the neglected firm hypothesis. The proponents of the liquidity hypothesis discover a significant improvement in liquidity surrounding announcement and effective day of stock split while signaling hypothesis exhibited that announcement returns were significantly correlated with split factors after controlling for earnings forecast errors. Furthermore, it also appeared that stock splits done by low priced companies were due to the neglected firm hypothesis. On the whole most of the studies indicated abnormal returns associated with stock splits.

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