Chapter – 2
LITERATURE REVIEW

**Barker (1956)** presented one of the most popular theories to explain stock split behavior. Barker findings failed to consider the split action itself. Barker’s study concluded that price changes occurred because of the increase in cash dividends and not from the split action.

**Johnson.** According to the “signaling hypothesis”, managers use stock split announcements to convey positive information about the firm.

**Ikenberry, Rankine, Strice.** Investors see a stock split announcement as a positive thing, whereas a reverse split does not convey favorable information.

**Fama (1969)** suggests that the stock market is “efficient”, meaning that stock prices adjust very fast to new information. The theory of market efficiency is concerned with whether prices reflect all the public available information or not (Fama 1970). Efficiency implies that it is impossible for the investor to earn an above normal return from public information. Fama defined market efficiency in terms of how quick the stock market reacts to the information and suggested three kinds of
market efficiency: Weak form, semi-strong and strong form efficiency. If market is weak for efficient, then stock price reacts so fast to all past information that no investor can earn an above normal return (higher than the market or the return on the S&P 500 index). This study shows how investors will not earn a high return from acting on public information (stock split announcement), while investors having access to inside information will make an abnormal return. A second kind of market efficiency is semi-strong. It states that stock price reacts so fast to all public information that no investor can earn an above normal return (higher than the market or the return on the S&P 500 index) by acting on this type of information. (Fama 1970).

Splits usually result in high market valuations, but study done by Fama (1970), Dodd, Patell and Wolfson, found that there is no evidence of abnormal return after the release of public information. They concluded that the market assimilates and takes into consideration public information very fast, within 5 to 15 minutes after the disclosure (Malkiel). This supports the idea that an investor acting on public information will not earn an above normal return. When this happens the market is said to be semi-strong form efficient. If the market is strong form efficient, then stock price reacts so fast to all information (both public and private), that no investor can earn an above normal return (higher than the market or the return on the S&P 500 index) by acting on this kind of information. Studies made by
Friend, Brown concluded that profit can only be gained by having access to private or inside information, which is illegal. Fama presents evidence supporting that efficiency is not met in the strong form and that the semi-strong form is more accurate. This study agrees that stock split announcement are affected in a company stock price according to the semi strong form efficiency which states that stock prices reacts so fast to all public information that no investor can earn an above normal return after the announcement is made. An example would be information concerning a merger. If an investor would buy shares on the announcement day of the merger, the semi strong market efficiency believes that the investor would never be able to earn an above normal return, because adjustments had already been done in the stock price. The market has already been adjusted, so therefore the only way to outperform the market in this case would be by using inside information.

Fama (1969) observed that stock split announcements are often accompanied by or closely followed by dividend announcements. The evidence indicates that the market realizes this and uses the announcement of a split to revaluate the stream of expected income from shares. The results of the study lend considerable support to the conclusion that the stock market is “efficient” in the sense that the stock prices adjust very rapidly to new information. The evidence suggests that in reacting to a split the market reacts only to its dividend implications. In reacting to a split the market reacts only to its
dividend implications. That is split causes the share price adjustments only to the extent that it is associated with changes in the anticipated level of future dividends.

Copeland (1979) in his Optimal Trading Range Hypothesis/Liquidity Hypothesis hypothesis suggested that bonus announcements changes price to a more optimal trading range and makes it more affordable for more investors to trade, which leads to the increase in demand and thus generates abnormal positive return.

Grinblatt, (1984) Doran and Natchmann, (1988) and Arbel and Swanson, (1993) found that Stock split and bonus offer announcements are some of the ways of catching the attention of the market by the firms, which feel that their share price are undervalued in the market due to the negligence of market participants, which suggests that shares of little known firms trade at discount. Therefore, firms use bonus issue to raw attention to ensure that information about the company is widely recognized before.

Lakonishok and Lev (1987) and Han (1995), provided some empirical evidences on the existence of an optimal trading range in US. They found an increase in the liquidity of the stock after the announcement of stock dividend because creation of more shares leads to more trading and dispersion of ownership. They also found a positive relation between equity value and liquidity.
Baker and Powell (1993) and Muscarella and Vetusuypens (1996) suggested a model that describes rational investors discount liquid securities heavier than liquid ones due to the higher transaction costs and greater frictions they face. According to the above hypothesis, stock splits are used as tools to realign the share price to a desired share price range so that it is more affordable for small investors to buy round lots of shares. If the pre-spilt share price is at a high level, then a stock split is justified for improving the marketability of the shares. The reduction in trading price through stock split enables the post – split shares to become more attractive to a previously wealth constrained investors.

Rao (1994) found significant positive effect just after the announcement date with cumulative abnormal return of 6.31% surrounding three days of announcement date and found evidence of semi strong form of market efficiency in the Indian markets.

Obidullah (1992) found positive wealth effect associated with bonus issue. He also found evidence of semi-strong form of efficient market hypothesis for Indian markets.

Ramchandran (1995) studied the bonus effect on stock prices and found mixed evidence of semi-strong form of market efficiency.
Rao and Geetha (1996) studied bonus announcements and concluded the identification of past abnormal returns pattern associated with an event doest not lead to any future gains.

Angel (1997) and Schultz (2000) in his Market Maker Hypothesis found that stock splits and bonus announcements lead to an increase in relative bid-ask spread and makes the market more active in promoting stock an hence leads to positive stock market effect.

Mishra (2005) found positive abnormal return on and around the announcement day associated with bonus announcement and observed that the positive abnormal returns starts appearing about eight days before the formal announcement and hence provided the important evidence of leakage of information a few day prior to formal announcement. He found -0.10% abnormal returns on the announcement day, which is statistically not significant and supports the hypothesis that Indian stock markets are semi-strong efficient. He also found for signaling hypothesis, which is in line with the evidence found from the US and other countries.

Mayank Joshipura (2007) founded that price effect associated with stock split is not significant and though there is a significant positive abnormal return of 1.08% and 1.66% found on announcement and effective day respectively. It did not sustain and got reversed in less than a week’s time; hence
there is no clear evidence about positive wealth effect associated with stock split available from Indian markets. However, there is a clear evidence of significant improvement in traded volume associated with stock split both surrounding announcement and effective day.