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Stock price reactions to stock dividend announcements: A case from a sluggish economic period

Aditya R. Khanal [a], Ashok K. Mishra [b,*]

[a] Department of Agricultural and Environmental Sciences, Tennessee State University, 202E Farrell-Westbrook Hall, Nashville, TN 37209, United States
[b] Kemper and Ethel Marley Foundation Chair, Morrison School of Agribusiness, W. P. Carey School of Business, Arizona State University, 7271 E Sonoran Arroyo Mall, Mesa, AZ 85212, United States

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ABSTRACT

The 2007 financial crisis and the Great Recession that followed resulted in a loss of confidence among investors, and regaining their full trust and confidence has been a challenge for companies. Although economic growth has been volatile throughout the postwar World War II period, recent growth (2008–2015) has been remarkably weaker than in the previous low-growth period (1974–1995). The 2006–2015 period is often characterized by sluggish economic growth. This study investigates stock price reactions to stock dividend announcements, 30 days before and after the announcement dates, of publicly traded companies in the period 2006–2012. We use an event study methodology for 460 events and daily stock price data for companies in the CRSP historical data set. The study shows a significant reaction in stock prices around the event date. On average, stock prices reacted positively to stock dividend announcements. However, compared to previous findings of abnormal returns (5.9%), results from this study show small abnormal returns (about 1.81%) attributable to stock dividend announcements that are cumulative of the announcement day and up to 3-day post-announcement days. Our estimates are even lower than the 2.01% stock price reaction obtained in the 1987–1996 period.

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1. Introduction

After the financial crisis that began in 2007, the United States experienced its longest and deepest recession since the Great Depression.[1] Although the recession ended in June 2009, the rate of growth in the GDP since the crisis has averaged one-quarter to one-half of the average, depending on the measure used, since World War II. This recent lower-than-average economic performance is partly attributable to the financial crisis, but it has persisted into the current expansion. When the whole stock market is declining, as it did during the 2007–2009 period, individual stocks decline as well, and investors might consider it prudent to liquidate all investments. The resulting large-scale shift of money out of stocks can cause further stock market declines. In fact, the 2006–2012 period is characterized by sluggish economic growth[2] (Keightley, Labonte, & Stupak, 2016). Reasons for sluggish economic growth include deleveraging and financial disruptions caused by the financial crisis;

* Corresponding author.
E-mail addresses: akkhanal@gmail.com (A.R. Khanal), Ashok.K.Mishra@Asu.edu (A.K. Mishra).

[1] During the Great Depression, unemployment spiked to 25%, and the country's output plummeted by nearly 50%.
[2] The Great Recession officially ended in June 2009 in the United States. GDP continued to grow at a slower-than-average pace of 1.7% between 2010 and 2015. In fact, the Great Recession is the only recession in U.S. history that has not had 4% or faster "catch-up" growth in GDP in any year of the subsequent expansion.

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hysteresis that may have resulted in a permanently lower level of GDP growth; and secular stagnation (when the percentage of a nation's savings exceeds the percentage of its longer-term investments[3]).

This peculiar period in the U.S. economy also had an impact on stock dividends[4] and stock dividend announcements. Stock dividends are a distribution of dividends in the form of stocks, resulting in stockholders receiving additional common shares. The response of a stock price to a dividend announcement indicates that the financial market is drawing inferences from managerial decisions. Stock dividend distributions are one of the corporate decisions that results in no direct change in cash flow due to the event *per se*. Unlike some other corporate decisions, such as cash dividends and capital structure changes that directly affect future cash flow, stock dividends do not incur direct costs and benefits, which also are referred to as "*cosmetic accounting changes*" (Adaoglu & Lasfer, 2011; Grinblatt, Masulis, & Titman, 1984). For the firm that declares a stock dividend, an amount equal to the market value of the distributed shares is transferred from retained earnings to the firm's capital account. In the absence of information asymmetries, the total market value should remain the same since it involves no change in the firm's capital structure, no direct enhancement in its earning power, and no expense reduction due to the event.

Generally accepted accounting principle suggests that stock distributions of more than 25% are treated as splits and thus do not affect retained earnings (Grinblatt et al., 1984) and distributions of less than 25% are considered stock dividends. A stock dividend announcement would have a pure effect on a stock price if, for example, the stock price shows a sensitivity or reaction regardless of how much or how little stock is distributed as dividends. Several empirical studies in the international arena have shown significant market reactions to stock dividend distribution announcements (for recent literature see Adaoglu & Lasfer, 2011; Al-Yahyaee, 2014; Bechmann & Raaballe, 2007; Nguyen & Wang, 2013). These studies may indicate that the market values the information content of stock dividend distributions and forms some expectation about the firm's prospects. Note that only few studies (e.g., Crawford, Franz, & Lobo, 2005; Grinblatt et al., 1984) have analyzed the effect of pure stock dividend distribution announcements on stock prices in the United States. These studies have low sample sizes and/or are quite dated, and most of the previous studies on stock dividend announcements presented the results of market reactions during the 1980s. To best of our knowledge, no study has analyzed the effect of pure stock dividend announcements on stock price reactions in recent years, especially during the sluggish economic growth period of 2006–2015. One would expect that factors such as significant economic changes, information technology, improved digital trading processes, increased scrutiny of banks and financial regulations, and Americans' lower wealth may have affected the magnitude of stock price reactions.

Therefore, the objective of this study is to evaluate stock price reactions around stock dividend announcement dates during the 2006–2012 period. Unlike the 1980s, a period marked by high inflation and tax reforms that led to changes in Americans' investment and wealth accumulation behavior, the 2006–2012 period was characterized by sluggish economic growth and included the Great Recession of 2007–2009. The response of stock prices to stock dividend announcements during this sluggish economic period allows us to explore unique research questions such as: (1) *Do companies that distribute stock dividends during sluggish periods experience higher stock price reactions?* (2) *How do stock price reactions during the recent period of sluggish economic growth compare to stock price reactions during the growth period of the 1980s and 1990s?* We use data from 460 pure stock dividend announcement events for companies listed in Center for Research in Security Prices (CRSP) from the 2006 to 2012 period.

The rest of this paper is organized as follows. Section 2 presents the background, literature review and a discussion of underlying hypotheses. Section 3 presents event study methodology, and Section 4 discusses data used in the study. Section 5 presents results and discussion. We provide summary and conclusions in Section 6.

2. Background and literature review

Several studies have found significantly positive market reactions to stock dividend announcements around the event dates. For example, Foster and Vickrey (1978) tested for information content on 82 stock dividend events from 1972 to 1974, evaluating both declaration date abnormal returns and ex-date abnormal returns. The authors found evidence for small significant positive abnormal returns around the declaration date, but no abnormal returns on ex-date. Further, the authors found no significant ex-date effects on stock dividends. In a similar vein, Woolridge (1983) evaluated ex-date stock price adjustments for 317 stock dividend events from 1964 to 1972 and concluded a presence of market inefficiency in adjusting stock prices on the ex-date. A year later, Grinblatt et al. (1984), using 82 pure stock dividend events, studied the effect of stock dividend announcements on stock prices from 1967 to 1976[5] and found significantly positive abnormal returns on Day 0 and Day 1, respectively; the average returns on stock dividends announcement was about 4.90%. Finally, Crawford et al. (2005), using data from 1967 to 1996, investigated reactions to stock dividend announcements for the 1967–1976, 1977–1986, and 1987–1996 periods and found the impact on stock prices to be significantly positive but decreasing in magnitude, 4.88%, 3.24%, and 2.01%, respectively, over the sampled periods.

It is interesting to analyze underlying explanations for such market responses, and previous studies have proposed some hypotheses. The most common explanations are based on a market-signaling hypothesis (MSH) and a retained-earnings

[3] An example of secular stagnation includes lower long-term investments in infrastructure and education that are necessary to sustain future economic growth.

[4] Dividends from a company to shareholders are one of the tools executives use to communicate with shareholders.

[5] It should be noted that Grinblatt et al. (1984) also investigated the effect of stock splits on stock prices and found that a stock dividend has a higher effect on stock prices compared to a stock split.

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