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## Shareholder wealth effects of stock dividends in a unique environment



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### ABSTRACT

We investigate shareholder wealth effects of stock dividends using a unique dataset from Oman in which many market frictions that are used to explain the stock dividend announcement effect are either absent or limited. We find a positive stock market reaction to stock dividend distributions. We also find that firms that distribute stock dividends experience favorable changes in operating performance during the seven-year period around the stock dividend distribution. Our results suggest that stock dividends are used primarily to signal future operating performance and to a lesser extent to reduce stock prices to an optimal trading range.

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## 1. Introduction

Researchers have long puzzled over the role of stock dividends. A stock dividend increases the number of equity shares outstanding but has no influence on shareholders' proportional ownership of shares. It is therefore puzzling that firms engage in these transactions and even more so that there is a positive market reaction when these transactions are announced (McNichols and Dravid, 1990).

Practitioners have long contended that the purpose of stock distributions<sup>1</sup> such as stock splits and stock dividends is to move a firm's stock price into an "optimal trading range". Realignment stock price

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<sup>1</sup> Henceforth, stock distributions refer to stock splits and stock dividends.

could attract more attention to a stock (Grinblatt et al., 1984), which may lead to an increase in the liquidity of the stock (Muscarella and Vetsuypens, 1996). In fact, Baker and Powell (1992) find that moving the stock price into a better trading range and improving the stock's liquidity are the primary motives for managers to split their firms' stocks. Nonetheless, the empirical evidence from previous studies on improved liquidity following stock splits and stock dividends is mixed. Whereas several empirical studies document an enlarged ownership base after a stock distribution (e.g., Schultz, 2000; Dhar et al., 2004) as well as improved trading liquidity (e.g., Anshuman and Kalay, 2002; Dhar et al., 2004; Nguyen and Wang, 2013), other empirical studies (e.g., Conroy et al., 1990; Desai et al., 1998) find an increase in relative spread after the effective stock split date, indicating that split stocks become less liquid after the stock split.

Lakonishok and Lev (1987) postulated the signaling hypothesis as a possible explanation for stock dividends. This theory suggests that managers announce stock dividends to communicate favorable private information about their future profitability (Brennan and Copeland, 1988). According to the signaling hypothesis, stock dividends are associated with positive announcement excess returns because managers use stock dividends to convey favorable private information about their firms' future prospects. On the other hand, previous empirical studies (e.g., Lakonishok and Lev, 1987; McNichols and Dravid, 1990; Kadiyala and Vetsuypens, 2002) find little evidence to support the claim that stock distributions convey favorable information about future profitability in the long run.

Woolridge (1983) proposed an alternative explanation for positive market reaction to the announcement of stock dividends based on market frictions. Specifically, he suggests that because U.S. stock prices change in multiples of \$0.125, stock dividends cannot fully adjust to the payment on the stock dividend announcement day. He reports evidence that small stock dividends have a stronger announcement effect than larger stock dividends. Woolridge's results indicate that in addition to discrete price changes, transaction costs and taxes contribute to the stock dividend effect. Woolridge (1983) documents that small stock dividends have more odd lots compared to large stock dividends, resulting in higher transaction costs for small lots. Furthermore, small stock dividends have more fractional shares that are paid in cash and are taxable.

Dubofsky (1992) suggests another market microstructure explanation for the stock dividends effect. He argues that abnormal returns on the ex-day arise from stock exchange rules requiring specialists to adjust outstanding limit buy orders, but not limit sell orders, for stock dividends on the ex-day. He suggests that reduced limit buy order prices that are not multiples of \$0.125 are rounded down, resulting in an unusually wide bid-ask spread on the ex-day, which causes the stock dividend effect.

Angel (1997) proposes another motive for stock distributions known in the literature as the market maker hypothesis. He claims that the motive for stock distributions is to move tick sizes relative to the stock price to desired levels. The idea is that a large tick size may provide market makers additional incentives to promote stock to small investors. Schultz (2000) shows that there are many small orders, but not large orders, subsequent to stock distributions, which is in line with the notion that stock distributions act to promote stock trading.

This paper examines stock dividends in Oman, which is of interest for several reasons. First, the Omani stock market is organized in such a way that the market microstructure explanations given for the stock dividends in the U.S. can be ruled out. For example, there is an additional fee for odd lot transactions in the U.S., resulting in odd lots having higher transaction costs compared to round lots. In Oman, there is no odd lot fee and transaction costs are the same for odd and round lots. In the U.S., fractional shares are distributed in cash and are taxable. In Oman, there are no taxes on fractional shares. Furthermore, specialists determine the bid-ask spreads for the stocks that trade in U.S. stock exchanges. Oman does not have any market makers setting bid-ask spreads. In Oman, individual orders are executed through price auctions and preferences are given to higher bids and lower offers.<sup>2</sup> Moreover, in the US, outstanding limit buy orders are automatically adjusted downward by the dividend amount rounded to the next lower tick size. In Oman, the MSM does not have an ex-dividend day limit order adjustment mechanism like that in U.S. markets. Specifically, limit orders

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<sup>2</sup> For further information on how transactions occur in Oman, see Al-Yahyaee (2013).

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