1. INTRODUCTION

1.1 Background

A stock split (also known as a sub-division) is a decision by the company's board of directors to increase[1] the number of shares outstanding[2] to its current shareholders. This is considered purely a cosmetic event not having a direct impact on the company's valuation as it does not change the company's financial performance by altering the future cash flows. However, Fama, Fisher, Jensen and Roll (1969), Grinblatt, Masulis, and Titman (1984) and more recently Li, Stork, and Zou (2011) have observed short-term abnormal returns around the announcement day and ex-date[3] of the stock split. Hence it is hypothesized that there is informational content in the announcement of stock splits. This has been attributed to various hypotheses such as the signaling hypothesis, liquidity hypothesis, neglected firm hypothesis and the managerial entrenchment hypothesis. These are discussed in detail in the second chapter.

In Sri Lanka, the Companies Act No. 07 of 2007, which was effective from May 2007, brought in provisions for splitting of shares. Following this there have been 80 stock split announcements in the Colombo Stock Exchange (CSE). With the end of the armed conflict in Sri Lanka in May 2009, the CSE experienced a rapid boom and was dubbed as one of the best performing[4] stock markets in the world. However, this stint was not long lived and the CSE witnessed a considerable drop, which continues to this date. Gunathilaka and Kongahawatte (2011) and Ratnayake and Yapa (2011) have studied this relatively new phenomena of stock splits on the CSE and have concluded that there are abnormal returns associated with stock split announcements. However, these studies have mainly confined their sample to the post-conflict boom period. In contrast, the current study attempts to identify the information content of stock split announcements in both the boom and bust periods. Other methodological

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[1] A reverse split will reduce the number of shares outstanding.

[2] A stock split does not change the market capitalization of the firm (market capitalization = price per share × number of shares outstanding)

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[3] The ex-date is the day on which the number of shares outstanding actually increases.

[4] http://in.reuters.com/article/2010/01/04/market-srilanka-idINSGE6030DU20100104?sp=true

differences between the current study and previous studies are highlighted in section 1.5.

1.2 Problem statement

Is there information content in the announcement of stock splits by companies listed on the Colombo Stock Exchange (CSE) and if so what is the impact of such announcements on the shareholder return and how efficient is the CSE in incorporating such information into the stock prices?

1.3 Objectives of the study

The objectives of the study are as follows:

1. To examine the information content of stock split announcements and its nature – i.e. if there are statistically significant positive or negative abnormal returns. This in turn will provide a test of the semi-strong form efficiency of the Colombo Stock Exchange. The study also attempts to find if these abnormal returns are present by using a number of return generating models to model the normal returns and to provide a methodological triangulation of results.
2. To find if it is possible to make arbitrage profits based on stock split announcements. This would involve a trading strategy depending on the findings of the study.

1.4 Significance of the study

The informational efficiency[5] (i.e. how information is reflected in the pricing of assets) of a stock market is of utmost importance to all market participants, investors and listed companies alike. The Colombo Stock Exchange witnessed rapid growth after the end of the 30 year conflict in 2009. The number of listed companies increased from 235 in 2007 to 272 in 2011. The number of new Central Depository System accounts opened increased from 15,020 to 112,473 over the same period.

[5] Discussed in Chapter 2 under the Efficient Market Hypothesis

Given this backdrop, the importance of informational efficiency of the Colombo Stock Exchange is, arguably, greater than ever.

1.5 Scope and limitations

The current study is confined to the announcement day effect of stock splits and does not consider the ex-date effect. To identify any liquidity related impact (i.e. if the number of shares trading changes) trading volumes have to be analyzed. This is outside the scope of this study.

1.6 How this study differs from previous studies

Two studies have been previously conducted on the informational content of stock split announcements in the Colombo Stock Exchange. They are Gunathilaka and Kongahawatte (2011) and Ratnayake and Yapa (2011). The current study attempts to improve upon the methodology followed and differs from previous studies in the following ways;

1.6.1 Differences in modeling normal returns

Gunathilaka and Kongahawatte (2011) have used the market model in modeling normal returns. However, other models such as the market-adjusted return model and the mean-adjusted return model have also been widely used. A discussion of these models is presented in Chapter 4. According to Fernando and Guneratne (2009), no particular model can be judged as superior to others in absolute terms. Hence using all three models, namely the market model, market-adjusted model and the mean-adjusted model, will provide a methodological triangulation of results. Fernando and Guneratne (2009) and Pathirawasam (2009) are examples of such an approach. The current study also uses all three above mentioned models to model the normal returns.

1.6.2 Controlling for other announcements

There could be contemporaneous firm-specific announcements such as rights issues, cash dividends and bonus issues along with the stock split announcement. Such events could contain information in their own right. This could distort the information contained in the pure stock split announcement. The current study attempts to isolate the impact of stock split announcements by dividing the sample into contaminated data – events containing other announcements over the event window and uncontaminated data – purely stock split announcements. There is no indication of such segregation in the previous studies.

1.6.3 Differences in the sample set

Gunathilaka and Kongahawatte (2011) consider 40 stock splits over the period 2008 to 2010. Ratnayake and Yapa (2011) confine their study to 26 announcements that were made in 2010. The current study considers a total of 80 stock split announcements from 2008 to 2012 – which covers the entirety of stock split announcements up to November 2012.

The structure of the study is as follows. The second section presents a review of relevant literature. This includes theoretical background and empirical evidence relating to the announcement day effect of stock splits and empirical evidence of semi strong form efficiency of the Colombo Stock Exchange. The third section describes the research design, the sample and methodology. The fourth section presents the results of the study. The final section concludes the findings of this study.