Market reaction to stock splits

Abstract:

There are several theories that have been advanced to explain why companies split their stock. The most common ones are to achieve an optimal price range for liquidity, to achieve an optimal tick size and to signal managements' confidence in the future stock price. This paper examined the effect of stock splits at the Nairobi Stock Exchange. This was achieved by studying nine companies that had undergone stock splits in the period 2002 to 2008. The study made use of the trading activity ratio to determine whether stock splits elicit any reaction in the Kenyan market. The study made use of daily adjusted prices for sample stock for the event window of 101 days, consisting of 50 days before and 50 days after the stock split. The event study methodology was employed in the determination of the effects of the split. Abnormal returns were calculated by use of the market model and t-tests are conducted to test the significance. The study found out that the Kenyan market reacts positively to stock splits, as shown by a general increase in volumes of shares traded around the stock split. There is also an increase in trading activity after the stock split as compared to that before the stock split. This is consistent with the signaling hypothesis, which states that managers of companies split their stock to act as a means of passing information to stock holders and potential investors. The study equally found out that on the split date and on days around the stock split, there was a positive average abnormal return that was very significant at 0.05% significance level. Results of the cumulative abnormal return indicated that there is a positive cumulative abnormal return across the different event windows.