CORPORATE ANNOUNCEMENTS: WHAT THE 'INSIDERS' ARE SIGNALLING

By Doug Van Eaton

Researchers have found that many announcements act as signals from company insiders concerning what they think about the firm's earnings prospects. These types of announcements include: changes in stock dividends, stock splits, and share repurchases.

Have you ever wished that you knew what top management really thinks about their firm's future earnings prospects?

Some corporate announcements may tell you exactly that. Financial researchers have found that many announcements contain "signals" from corporate insiders about a firm's future earnings prospects. Among the announcements that may contain such signals are changes in stock dividends, stock splits, and share repurchases by the company.

When dividend, split, and repurchase announcements contain new information, stock prices adjust rapidly, just as we would expect. However, there is also a predictable longer-term price response after these announcements: The initial price reaction is followed by a lagged price adjustment that can continue for longer than a year and is, in many cases, larger on average than the announcement effect.

In this way, the stock price behavior after the announcements is similar to the stock's return patterns after earnings surprises and changes in analysts' estimates, both of which have been the subject of previous *AAII Journal* articles. The evidence of predictable stock price behavior after dividend, split, and repurchase announcements is strong enough that all investors should take note of it if they own, or are thinking about buying, shares of firms that have made these types of announcements.

FUTURE EARNINGS SIGNALS

In order to understand why some corporate announcements contain signals from management about future earnings prospects, consider the decision to increase the firm's dividend. When the managers and directors consider whether to increase the dividend, they must consider not only recent results (that may not have been released yet), but also their expectations about future earnings. If firm management believes that current earnings levels can be sustained or will continue to improve, they will be more likely to increase the dividend.

Managers of firms that will probably not continue their improved earnings performance might like to increase the dividend and enjoy the resulting increase in stock price. A one-time dividend increase may be a tempting way to increase the share price, since an increase of a few cents in the next dividend may be a cost the firm can easily afford. If future earnings are not sufficient to maintain the increased dividend, however, they will face a significant penalty in the future. Investors are quite unforgiving of firms that do not at least maintain their previous dividend payment over the coming quarters.

Firms that cut their dividend are punished with lower share price valuations that can persist for many quarters. Once investor faith in honesty or judgment of a firm's management is called into question, it can often be regained only after many years. Lower valuations can penalize managers and board members who own stock as well as those managers who have incentive stock options for future exercise. For this reason, a dividend increase is interpreted

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by investors as a believable signal that top management thinks future earnings prospects are as good.

MARKET REACTION

To the extent that dividend, stock split, and share buyback announcements are thought to contain signals about future earnings performance, stock prices will adjust rapidly to this new information. Researchers call this the "announcement effect." The direction and size of the average price move over a few days around each type of announcement provide an indication of how investors interpret the news. An unexpected dividend increase, for example, results in an average stock price increase of 2% to 3% at the time of the announcement.

Since these announcement effects generally are very rapid, the stock price changes don't present investment opportunities for most individual investors. Research has shown, however, that the announcement effect is not the only predictable price adjustment associated with dividend changes, stock splits, and repurchase announcements. For several of these announcements, abnormally good or poor stock performance continues for a year or longer after the announcement.

Table 1 presents a summary of the research results. However, care should be taken in interpreting the results. For one thing, results are averages for large groups of firms with similar announcements. In individual instances, however, other events may lead to significant differences in stock performance since research results only identify patterns and tendencies.

While Table 1 presents an overall picture of these patterns and tendencies and provides a convenient reference, what follows is a more detailed look at the market reaction to each type of announcement, and implications for stock investors.

CASH DIVIDEND INITIATIONS

The common Wall Street wisdom is that firms will start paying cash dividends to shareholders when they can no longer find profitable growth opportunities for all their income. According to this interpretation, an initial dividend is a sign that the firm is maturing and that future earnings growth may be slower than

TABLE 1. CORPORATE ANNOUNCEMENTS AND STOCK PRICE REACTIONS

Announcement	Reaction (on average)*	Lagged Reaction (on average)*
Initial Cash Dividend	Stock prices rise; 3% on average	Outperform similar firms by 5% over next year
Cash Dividend Increases	Stock prices rise; 2%–3% on average	Not much—if there is upward drift, it is not large
Cash Dividend Decreases	Stock prices drop; –6% on average	Underperform 10% to 15% on average over a year
Cash Dividend Omissions	Stock prices drop; –7% on average	Underperform 13% to 15% in first year; underperform 7% in second year
Initial Stock Dividend:		
No Decrease in Cash Dividend	Stock prices rise; 5%–6% on average	Prices rise 2% at split date; then 3.5% over 6 months
Cash Dividend Cut or Omitted	Reduces negative reaction to cut or omission	Lagged decrease tends to be even larger than after cash dividend cuts or omissions
Stock Dividend Suspended:		
Cash Dividend Increased	Stock prices rise; 2% on average	Little or no difference from similar firms
Cash Dividend Decreased or Unchanged	Stock prices drop; –3.5% on average	Underperform 2% on average over 50 trading days
Stock Split 5/4 or Larger	Stock prices rise; 3%–4.5% on average	Outperform market 7% in first year; 12% over 2 years
Reverse Split	Stock prices drop; –4% to –5% on average at announcement	Underperform similar firms by 10% over 1 year; as much as 30% over 3 years
Share Repurchases: **Self Tender**	Stock prices rise; 13% on average in announcement month	Outperform by 8%–12% over 2 years
Share Repurchase in Market:		
Lowest Valuation Stocks**	Prices rise; 3.5% on average	Outperform similar firms by 6% over 2 years; 30% over 3 years
Midrange Valuation Stocks**	Prices rise; 3.5% on average	Outperform 6% to 12% over 2 years
High Valuation Stocks**	Prices rise; 3.5% on average	Average performers over 2 years; –2% over 3 years

** Price adjustments are average for many stocks.*
*** As measured by price-to-book-value ratios*

in the past.

Research results tell a different story, however. The announcement of a first dividend produces an average stock price increase of just over 3%; investors react as if such a change signals good news. There is evidence that relatively good returns continue over the year after the announcement. These stocks, on average, outperform shares of similar size firms by about 5%. Since no research has found evidence of relatively poor subsequent performance, an initial dividend announcement does not signal the beginning of the end of rapid growth, and it certainly is not a reason by itself to sell a stock from your portfolio.

DIVIDEND INCREASES

Dividend increases are generally greeted by the market as good news and stock prices increase 2% to 3% on average.

After this initial reaction, however, researchers have found very little evidence of a predictable lagged reaction. The market seems to adjust to these changes quickly without bias.

DECREASES AND OMISSIONS

None of the announcements discussed here has a stronger initial and lagged effect on stock prices than a dividend cut or omission. In the days around such an announcement, stock prices fall 6% to 7% on average.

But an investor who believed this represented the full extent of the damage would be mistaken. These firms continue to underperform for up to three years after dividend cut and omission announcements.

Dividend decrease firms underperform similar firms by about 15% on average over two years after the announcement. Samples of dividend omission firms fare even worse over the years after the announcement—they underperform samples of similar firms without dividend omissions by 20% on average.

STOCK DIVIDENDS

It is often suggested that stock dividends are a purely cosmetic change with no real value implications. Because of the signaling effect, however, there are significant announcement effects when stock dividends are initially declared. The overall effect depends, however, on the reason for the introduction. If the firm has had no cash dividend or will maintain an existing cash dividend, there is likely to be a stock price increase at the time of the announcement. These increases average just over 5%. There is a positive effect on stock prices over the period after the announcement as well. Stock prices for these firms increase 3.5%, on average, over six months after the announcement. About 2% of this increase comes around the ex-dividend date for the stock dividend.

A situation where the initiation of a stock dividend is not greeted as good news by investors is when the stock dividend *replaces* a cash dividend or is accompanied by a cash dividend decrease. These firms tend to experience a smaller decrease in stock price at announcement than firms that do not replace omitted cash dividends with stock dividends. Over the subsequent two years, however, the stock of these firms tend to perform even worse than that of dividend decrease firms. A firm that omits or cuts its cash dividend is a very poor performer, on average, even when it offers a stock dividend as a replacement.

STOCK SPLITS

Firms that announce stock splits generally have a positive price reaction at the time of the announcement. The average announcement effect ranges from an increase of between 3.5% to 4.5% for firms with stock splits of 5-for-4 or greater. The market seems to interpret a split announcement as a positive signal about management's earnings expectations.

Two recent studies examined the behavior of stock prices over the year after a split announcement. Surprisingly, stock prices tend to jump up (on a split-adjusted basis) at the split date, even though the split date is announced in advance. Overall, the stock of firms splitting their shares outperforms that of similar (non-splitting) firms by an average of 7% over the post-announcement year.

REVERSE SPLITS

In a reverse split, the number of outstanding shares is decreased. In a 1-for-3 split a holder of 300 "old" shares will receive 100 "new" shares. Such a move is generally made to increase a stock price that has reached a level that is unacceptably low to management. The signal is that managers do not expect the stock price to rise to a more desirable level from near-term earnings growth.

As might be expected, an announcement of a reverse split is associated with a predominately negative price reaction—stock prices decrease 5.5%, on average, over a few days around the announcement. Compared to similar firms without stock splits, stocks with reverse splits do very poorly for up to three years after the announcement. One researcher has estimated that those stocks with reverse splits underperform by 10% in the first year after the announcement and by about 30% during the three years after the announcement.

STOCK REPURCHASES

There are basically two ways that firms buy back their own shares. The less frequent one is a tender offer (a self-tender). More frequently, firms simply buy their own shares in

the open market.

In a tender offer, the firm sets a price and the number of shares it is willing to buy. If more than this number of shares are offered by existing shareholders by the expiration date, the firm usually buys a percentage of each of the offers to equal the total number to be purchased.

Since the tender offer price is (necessarily) above the market price, such an offer is associated with an average share price increase of 13% around the time of the announcement. It seems that this is a clear signal that the firm's managers believe their stock is undervalued, since the shares of firms with such offers outperform shares of similar firms by an additional 8% to 12%, on average, over the next two years.

Among firms announcing open market share repurchases, there is a similar pattern, although the price move at the time of the announcement is less. On average, shares of firms announcing share repurchases increase 3.5% at the time of the announcement. Over four years after the announcement, shares of these firms tend to outperform shares of similar firms by about 12% on average.

A closer look at these firms reveals a slightly more complicated story, however. When the samples of repurchase firms are divided into those with low valuations (low market value to book value ratio) and those with high valuations, the results over the years after the announcement of the repurchase differ significantly. Most of the good stock performance after repurchase announcements is due to the performance of "*value stocks*"—stocks that have relatively low price-to-book-value ratios. These stocks outperform by 6% over two years, on average, and by a surprising 30% over the three years after the repurchase announcement.

Shares with average price-to-book-value ratios return 6% to 12% more than similar shares without repurchase announcements over two years after stock repurchase announcements.

High valuation shares (high price-to-book-value ratios) do not outperform after repurchase announcements and show some tendency to underperform over longer periods. In other words, for high valuation stocks, share repurchase announcements are not followed by unusually good stock returns on average; the probability that these shares are truly "undervalued" appears to be quite low.

One place that investors can find estimates of the average valuation in the market is in Barron's. In the "Market Laboratory" section of Barron's, the price-to-book-value ratios are available for several popular stock indexes. Currently the ratio is 6.29 for the Dow Jones industrials and 8.51 for the S&P 500. Stocks with valuations higher than that are less likely to be temporarily undervalued. In short, stocks with valuations at or below the average level will likely outperform after share repurchase announcements. Stocks with historically low valuations (ratios around two or less) can be expected to perform the best of those firms announcing repurchases.

SUMMARY

The accumulated research about stock price reactions to various corporate announcements should not be ignored in making stock selection decisions:

- With respect to cash dividend changes, investors should not be overly encouraged by dividend increases. If firms in your portfolio unexpectedly increase their dividends, that's good news, but in general, not good enough to recommend these shares for purchase.
- Dividend initiations do not signal slower growth rates in the future and, in fact, they can be a good indication of good future performance.
- News of dividend cuts or omissions seems to come in the middle of poor performance over a period of years. In general it is a good time to sell (and quickly) and certainly not an opportunity for "bottom fishing." This remains true, and perhaps especially so, if the firm offers up a stock dividend to "replace" a cash dividend.
- Changes in stock dividends should be interpreted in relation to their effect on the cash payout per share. If cash dividends per share are maintained or increased, it can be a buying opportunity if you purchase before the ex-dividend date for the stock dividend. If cash dividends decrease (regardless of any increase or decrease in stock dividends), future stock performance is generally very poor. The suspension of a stock dividend is not bad news if it is accompanied by an increase in the cash payout; otherwise, it is usually followed by poor performance.
- Stock splits are associated with continued good share performance. Buying at the announcement has been a profitable strategy in the past, especially if an investor acts quickly before the actual split takes place. Reverse splits generally come after poor performance and, as with cash dividend decreases, are followed by very poor performance, on average.
- Share repurchase announcements are usually a signal of good future earnings and are generally followed by good stock performance. This is especially true for self-tender offers and for stocks that we would normally consider "value" stocks. For high growth stocks with relatively high valuations, open-market share repurchases are much less likely to be a signal that shares are undervalued and seem to have little value past the initial price reaction to the news. ✦