

Abstract

A stock split is simply a distribution of new shares to a firm's existing ordinary shareholders, where the number of the new shares is proportional to the number of shares already owned. There are two types of splits. A **forward split** is a subdivision of the outstanding stock units while a **reverse split** is a consolidation of those units. Both types of splits should have no impact on the issued equity. That is, except for the changes found in the number of shares outstanding and the par value according to the split factor, there should be no difference in the firm's capital and retained earning accounts before and after a split. However, it is more frequently to find a firm subdivide its outstanding common shares than consolidate the latter.

Although some people may think that forward (reverse) split will reduce (raise) the market price per ordinary share which, in turn, will make the firm's ordinary shares more attractive to small (institutional) investors, it is also widely believed that stock splits, no matter if they are the forward or reverse ones, are purely cosmetic. As mentioned above, the firm's issued equity (capital and retained earning account) as well as the cash flows will not be affected, each shareholder retains his original share of ownership and the claims of other classes of security holders of the firm are the same as before.

If a stock split were purely cosmetic, it would be surprising to find them associated with real effects which were usually associated both with the announcement and occurrence of the split. Findings on the effects on shareholders' wealth upon the announcement of a split had already been published in quite a large number of studies.

Stock splits have also been found to be followed by changes in stock risk (total volatility, systematic risk and/or diversifiable risk). Although there are not many plausible explanations for this, splits did associate with some risk changes.

Moreover, some other people also believe that a forward (reverse) split will increase the demand for a stock among small (institutional) investors, which will in turn improve the stock's liquidity and consequently raise its price.

The study of all these issues in the Hong Kong stock market should offer some value to the academics and practitioners. This is exactly the objective of this dissertation. In addition to this, the announcement effect of the splits will also be studied in order to check the degree of efficiency of the Hong Kong stock market in the semi-strong form.

The results show that the Hong Kong stock market had reacted favorably to forward splits but not to reverse split. Both types of splits do not induce any change in the risks on average. Conforming to most asset pricing models, any change in the diversifiable risk due to splits will not be priced. However, the findings seem to indicate that diversifiable risk is priced as those stocks which experienced higher level of this type of risk, exhibit negative abnormal returns. Liquidity in terms of number of transactions remain the same before and after the splitting/consolidating of the stocks. Using reactions of the market to the announcement of splits as a means of measuring the rapidity and accuracy of price adjustment to the arrival of new information, the Hong Kong stock market is found to be an efficient market in the semi-strong form.