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Ex-Date Stock Price Adjustment to Stock Dividends: A Note

J. RANDALL WOOLRIDGE*

I. Stock Dividends and Share Prices

EISEMANN AND MOSES [6] RECENTLY surveyed the chief financial officers of over 30 firms which had paid stock dividends in 1974.[1] The officers overwhelmingly expressed the belief that stock prices do not fully adjust for stock dividends and that therefore the total value of stockholdings increases.[2] Twenty years ago, the Committee on Accounting Procedure made the same observation [2, p. 51]:

> Many recipients of stock dividends look upon them as distributions of corporate earnings and usually in an amount equivalent to the fair value of the additional shares received. Furthermore, it is to be presumed that such views of recipients are materially strengthened in those instances, which are by far the most numerous, where the issuances are so small in comparison with the shares previously outstanding that they do not have any apparent effect upon the share market price and, consequently, the market value of the shares previously held remains substantially unchanged.

This phenomenon suggests inefficient market behavior. In a perfect markets environment with perfectly divisible financial assets, homogeneous investor expectations, and no taxes or transactions cost, the expected price adjustment as of the ex-dividend day is the last closing price prior to the ex-date divided by one plus the stock dividend. If ex-date stock price declines tended to be less than (greater than) the expected price adjustment, investors would buy (short sell) the stock the day prior to the ex-date and reverse the transaction the following day. In this manner arbitragers would eliminate abnormal price behavior around the ex-day.

However, market imperfections prohibit full price adjustment on the ex-date. If the stock dividend is not divisible by ⅛ (.125), then the price cannot adjust fully since trading only occurs at $.125 intervals on organized stock exchanges.[3]

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