

Session 26

Information Trading: Public Information – Other than Earnings

Test

1. Which of the following statements best describes the stock price behavior of target firms around acquisition announcements?
 - a. The target firm's stock price starts drifting down before the acquisition announcement and jumps up on the acquisition announcement.
 - b. The target firm's stock price is flat before the acquisition announcement and jumps further up on the acquisition announcement.
 - c. The target firm's stock price starts drifting up before the acquisition announcement and jumps further up on the acquisition announcement.
2. Which of the following statements best describes the returns earned by target and acquiring company stockholders from acquisitions?
 - a. Both target and acquiring company stockholders make significant positive returns.
 - b. Both target and acquiring company stockholders make significant negative returns.
 - c. Target company stockholders lose money a significant proportion of the time but acquiring company stockholders make significant positive returns.
 - d. Acquiring company stockholders lose money a significant proportion of the time but target company stockholders make significant positive returns.
3. Many mergers/acquisitions are justified on the basis of synergy, where the combined firm is more valuable than the individual firms. Looking at the studies of post-merger performance, which of the following conclusions would you draw about synergy in mergers?
 - a. There is substantial synergy and acquiring companies pay too little for the synergy.
 - b. There is substantial synergy but acquiring companies pay too much for the synergy.
 - c. There is little, no or reverse synergy and acquiring companies pay too little for the synergy.
 - d. There is little, no or reverse synergy and acquiring companies pay too much for the synergy.
4. Which of the following best characterizes the findings from studies of dividend announcements across all companies?
 - a. Dividend increases or decreases have no effect on stock prices.
 - b. Stock prices go up a lot when dividends are increased and go down a little when dividends are decreased /suspended.
 - c. Stock prices go up a little when dividends are increased and go down by a larger amount, when dividends are decreased /suspended.

- d. Stock prices go up a lot when dividends are increased and go down by less, when dividends are decreased /suspended.
5. Studies also seem to indicate that the market reaction to dividend announcements has decreased over time. Which of the following may explain this phenomenon?
- a. Fewer companies pay dividends, and these companies tend to be larger and more widely followed by analysts.
 - b. Companies collectively return more cash to stockholders in the form of stock buybacks than dividends.
 - c. Investors are less likely to follow dividend-based investment strategies.
 - d. The proportion of stock held by institutions has increased.
 - e. All of the above.

Solution

1. Which of the following statements best describes the stock price behavior of target firms around acquisition announcements?
 - a. The target firm's stock price starts drifting down before the acquisition announcement and jumps up on the acquisition announcement.
 - b. The target firm's stock price is flat before the acquisition announcement and jumps further up on the acquisition announcement.
 - c. **The target firm's stock price starts drifting up before the acquisition announcement and jumps further up on the acquisition announcement.**

Explanation: Insiders (or someone in the know) start trading before the acquisition announcement but the announcement is still a surprise to most of the market.

2. Which of the following statements best describes the returns earned by target and acquiring company stockholders from acquisitions?
 - a. Both target and acquiring company stockholders make significant positive returns.
 - b. Both target and acquiring company stockholders make significant negative returns.
 - c. Target company stockholders lose money a significant proportion of the time but acquiring company stockholders make significant positive returns.
 - d. **Acquiring company stockholders lose money a significant proportion of the time but target company stockholders make significant positive returns.**

Explanation: Target company stockholders almost always win (with target company stock prices jumping) but acquiring company stockholders see stock prices drop in about half of all acquisitions.

3. Many mergers/acquisitions are justified on the basis of synergy, where the combined firm is more valuable than the individual firms. Looking at the studies of post-merger performance, which of the following conclusions would you draw about synergy in mergers?
 - a. There is substantial synergy and acquiring companies pay too little for the synergy.
 - b. There is substantial synergy but acquiring companies pay too much for the synergy.
 - c. There is little, no or reverse synergy and acquiring companies pay too little for the synergy.
 - d. **There is little, no or reverse synergy and acquiring companies pay too much for the synergy.**

Explanation: There seems to be little improvement in operating performance, relative to the peer group, in the years after mergers suggesting little or no synergy and the

fact that acquiring company stock prices decline in so many acquisitions suggests that over payment is the norm.

4. Which of the following best characterizes the findings from studies of dividend announcements across all companies?
 - a. Dividend increases or decreases have no effect on stock prices.
 - b. Stock prices go up a lot when dividends are increased and go down a little when dividends are decreased /suspended.
 - c. Stock prices go up a little when dividends are increased and go down by a larger amount, when dividends are decreased /suspended.**
 - d. Stock prices go up a lot when dividends are increased and go down by less, when dividends are decreased /suspended.

Explanation: Dividend cuts are much more uncommon than dividend increases. So, the price impact when dividends are cut tends to be higher than the price impact when dividends are increased.

5. Studies also seem to indicate that the market reaction to dividend announcements has decreased over time. Which of the following may explain this phenomenon?
 - a. Fewer companies pay dividends, and these companies tend to be larger and more widely followed by analysts.
 - b. Companies collectively return more cash to stockholders in the form of stock buybacks than dividends.
 - c. Investors are less likely to follow dividend-based investment strategies.
 - d. The proportion of stock held by institutions has increased.
 - e. All of the above.**

Explanation: Dividends are no longer the primary signal used by companies to signal future prospects. Stock buybacks are used by far more firms and investors are less likely to invest purely based on dividend yield. The rise in institutional trading may feed into this shift away from dividends (both as a mechanism to return cash and to signal to markets).