In our paper, *Institutional Investors and the Information Production Theory of Stock Splits*, forthcoming in the *Journal of Financial and Quantitative Analysis*, we analyze the incentives of analysts to produce information about a firm, by studying institutional trading and brokerage commissions around a specific corporate event, namely, a stock split. We make use of a large sample of transaction-level institutional trading data, which enables us to directly examine an extended version of the Brennan and Hughes’ (1991) information production theory of stock splits for the first time in the literature. We compare brokerage commissions paid by institutional investors before and after a split, and relate the informativeness of institutional trading to brokerage commissions paid. We also compute realized institutional trading profitability net of brokerage commissions and other trading costs.

First, we find that, both commissions paid and trading volume by institutional investors increase after a stock split. Second, institutional trading immediately after a split has predictive power for the firm’s subsequent long-term stock return performance. Further, this predictive power is concentrated in stocks that generate higher commission revenues for brokerage firms and is greater for institutions that pay higher brokerage commissions. Third, institutions make positive abnormal profits during the post-split period even after taking brokerage commissions and other trading costs into account. Further, institutions paying higher commissions significantly outperform those paying lower commissions. Fourth, the information asymmetry faced by firms decreases after stock splits: the greater the increase in brokerage commissions after a split, the greater the reduction in information asymmetry.

Overall, the results of our empirical analysis indicate that the incentives of outsiders to produce information about a firm are directly related to the compensation they receive for undertaking this task.
information production. The fact that the predictive power of institutional trading is concentrated in stocks which generate higher commission revenues and in institutions that pay higher brokerage commissions after a split and the absence of such predictive power for institutional trading prior to the split lend strong support to the above conclusion, since our results show that analysts increase the extent of information production about the firm after a stock split. Further, the fact that institutional investors are able to generate positive abnormal profits after a split, even after accounting for the higher brokerage commissions that they pay post-split, indicates that they are also made better off due to the above increase in information production. Finally, the decrease in information asymmetry facing firms in the equity market that we document after a split suggests that the above increase in information production benefits firms undertaking stock splits as well, since this will reduce their costs of raising external financing in the future.

Ikenberry and Ramnath (2002) find evidence consistent with the prediction that managers with favorable private information about their firms have an incentive to split their firms’ shares. In particular, they show that analyst forecasts for the splitting firms are revised upward post-split compared to those for matched non-splitting firms. They also show that splitting firms are less likely to experience a drop in future earnings compared to matched non-splitting firms. Desai and Jain (1997) as well as Ikenberry, Rankine, and Stice (1996) document significant abnormal returns post-split, suggesting that splitting firms are undervalued. Our empirical results, in conjunction with the results of the above papers, indicate that it is indeed firms that are undervalued that engage in stock splits in order to rectify mispricing by inducing information production.

The full paper is available for download here.