

Ideas @ Edelweiss Multi Strategy Funds – Bonus Stripping



Bonus stripping is a popular tax-loss harvesting strategy run by high networth individuals in India. The modus operandi of the strategy is to buy shares of a company that has declared or is about to declare a bonus and to subsequently sell the same shares immediately after the ex-date. The investor is able to book a short-term capital loss, because the price of the stock falls by the amount of the bonus, even though there is no financial loss. The bonus units with zero cost basis can be held for a year and then sold tax-free. In this month's Ideas @ Edelweiss Multi Strategy Funds, we examine the impact of bonus stripping activity on stock prices.

We studied bonus announcements over the last 15 years to get a sense of the dataset. We narrowed, the sample down to the 87 opportunities that were in the FNO universe at the time of the bonus. In our experience, this is representative of 90+% of the bonus stripping activity because the FNO stocks are the largest, most liquid and have a natural hedge in the futures market for risk-averse investors who do not want to take a fundamental view on the stock. To do our analysis, we conducted an event study on both the stock and the Nifty and did so in the lead-up and the aftermath of the issue.

We found that the stocks returned on average 1.48% in the month leading up to the ex-date, whereas the Nifty returned 1.44%. The difference between the returns on the stocks and the index is immaterial regardless of whether you look at the preceding month, week or day. However, once the bonus issue goes ex, the stocks underperform the Nifty over the next month, quarter and year by -2.00%, -5.07% and -5.68% respectively. There is no underperformance in the week after the ex-date. Likewise, we found no material impact on cash-futures arbitrage spreads either before or after the ex-date

This means that bonus stripping activity by itself does not exert any pressure on stock prices either before or after the ex-date. However, the announcement of a bonus may be a signal from management that the stock has run up significantly and is now overvalued.