

# [Dividend policy and share prices](https://assignbuster.com/dividend-policy-and-share-prices/)

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Introduction In this paper the impact of dividend policy of the companies on the firm’s share prices is analysed and different views in the context of the semi-strong form of the efficient market hypothesis are contrasted. The overview of the traditional and most recent empirical investigations of the stock market reaction to the dividend announcements is provided and different findings are discussed and compared. Three companies have been selected from the FTSE All share price index. These companies are Tesco, Burberry and Vodafone. These firms belong to different sectors of the economy.

Tesco is the largest retailer in the UK, Burberry is a fashion firm and Vodafone is the telecommunication services company. The dividends and accounts have been retrieved from annual reports of the companies (Tesco, 2011; Burberry, 2011; Vodafone, 2011). The share prices were sourced from YahooFinance(2012). The copies of the company accounts are provided in the appendices. Dividend Policies of Companies These three companies were chosen for the following reasons. Firstly, it was intended to choose large companies that have an established dividend policy and revenue of more than ? billion a year. Secondly, the companies from different industries had to be analysed. Thirdly, both services sector and goods sector were intended to be analysed. Finally, it was interesting to compare both pro-cyclical firms (e. g. Burberry) and counter-cyclical firms (e. g. Vodafone). The former are very sensitive to the effects of the economic recession whereas the latter are less sensitive because consumers would still have to use mobile phones and services regardless of their financial position.

The dividend payout ratio has been calculated for these companies for the period from 2007 to 2011. The following formula was used: Dividend payout ratio = dividends per share / earnings per share The results are summarised in the following figure. Figure 1 Dividend Payout Ratios Source: Annual Reports of Tesco (2011), Burberry (2011) and Vodafone (2011) The payout ratios indicate different dividend policies adopted by the three companies. Tesco’s policy is aimed at maintaining a constant dividend payout ratio, which is very common for mature industries such as retailing.

In these industries the majority of the large companies are “ cash cows” for the investors and therefore the dividend policy tends to show constant payout ratios, which inspires trust in the company and expectation of future stability. In contrast, the dividend policies of Vodafone and Burberry are not aimed at a constant payout ratio. In fact, as the following figure demonstrates, the policies of Vodafone and Burberry are aimed at dividend growth. Figure 2 Final Dividends

Source: Annual Reports of Tesco (2011), Burberry (2011) and Vodafone (2011) However, whereas Vodafone demonstrates a “ steady dividend growth strategy”, Burberry demonstrates the a strategy that does not show a specific pattern but can be interpreted as a signal to the market because in 2009 the company announced the dividends that were equal to the dividends announced in the previous year in spite of the accounting losses suffered by the firm which were reflected in negative earnings per share (Appendix C).

This move can be interpreted as a sign that the management attempted to signal the market that the losses are temporary and the company was expected to recover quickly. It is interesting to note that the latter policy is inconsistent with the position that dividends should be paid out of earnings rather than accumulated capital or reserves. Furthermore, the companies could undertake an alternative dividend policy which would imply linking the dividend payout to the investment opportunities that could be managed by firms (Brealey and Myers, 2003).

If the company has many projects that offer positive net present value, then it would be recommended that dividends could be retained and reinvested in the firm. Only residual earnings, which are left after investments in all positive NPV projects could be distributed as dividends (Bodie et al, 2009). Dividend Announcements and Share Prices Dividend announcements and their impact on share prices can be explained by the semi strong form of the efficient market hypothesis (EMH).

Efficient market hypothesis implies that the only thing that may impact the stock prices is new information, since all other possibly influencing parameters are already included in the firm’s stock price (Palan, 2004). The efficient market hypothesis may be divided into three forms: the weak form, the semi-strong form, and the strong form. The weak form implies that share prices bear or reflect the past prices and trade volume information, the semi-strong form adds publicly available information to the weak form, and the strong form adds even insider information to the efficiency approach (Harder, 2008).

Empirical evidences show that successive changes in stock prices are independent and this independence is in line with the efficient market hypothesis, as markets promptly react to the new information (Fama et al. , 1969). In this context it may be assumed that dividend announcements convey particular positive information about the company and provide signals about future performance of the firm. The decision about paying dividends is made by the firm’s managers and often supported by shareholders’ voting.

Since dividend announcements bear useful information, from the efficient market hypothesis view point this information is reflected in the share price changes immediately after the public announcement (Bodie et al, 2009). The three companies that were chosen have been used to test the semi strong form of the EMH and whether the dividends announcements made by Tesco, Vodafone and Burberry had a significant impact on shareholder returns and share prices. So, the null hypotheses of the analysis are the following:

H0: Dividends have a positive and significant effect on the share prices H0: Dividends have a positive and significant effect on the weekly stock returns. The alternative hypotheses are the following: Halt: Dividends do not have a significant effect on the share prices Halt: Dividends do not have a significant effect on the weekly stock returns. According to EMH in its semi strong form, the information on dividends should be quickly absorbed into the stock prices during the first week and hence the acceptance of the null hypotheses will be consistent with the semi strong efficiency.

However, if abnormal returns persist in the longer run, e. g. three months, the EMH in the semi strong form can be rejected. Empirical evidences also provide support for the semi-strong efficient market hypothesis, implying that stock market efficiently and quickly adjusts to new information about dividends (Aharony and Swary, 1980). However, the research of Amihud and Li (2006) finds that the reaction of stock market to dividend announcement is not constant. It is concluded that cumulative abnormal returns promoted by dividend announcements decline to zero in due course.

The findings suggest that dividend announcement are less informative over time, and this may be related to the reluctance of managers to pay extra expenses related to dividends (Amihud and Li, 2006). Moreover, the recent decrease in propensity of companies to pay dividends is sometimes related to the lower informational contend of dividend announcements. Since institutional investors are normally better informed and tend to play key roles in public firms, the costly dividends have become a less popular way to provide information (Baker, 2009).

The study of Asquth and Mullins (1983) also suggests that stock prices and shareholders’ wealth are impacted by initiation and increase of dividends. Moreover, the effect of dividend increase is stronger than the influence of dividend initiation. The results are in line with assumption that dividend announcements bear valuable information for investors. Dividend policy may be used as a simple way to signal managers’ view of the company’s recent and future performance (Asquth and Mullins, 1983). However, it must be stated that dividend policies are not directly influencing share prices and lead to their changes.

Instead, dividend policies are changed by managers when some fundamental developments in company’s performance are expected, and these developments cause the change of the share prices. Thus, dividend announcement is only the way for investors to obtain information about these fundamental developments. Similarly, there are no evidences that a company value may be increased through increase of dividends, since dividends only convey signals about fundamental changes in the company and are viewed as only by-products of the changes (Moles et al. 2011). Nevertheless, the study of Shiller (1981) challenges the efficient market hypothesis suggesting that the volatility of stock prices are too high to be explained by the future dividends. A more recent investigation of Mehnidiratta and Gupta (2010) supports the semi-strong form of efficient market hypothesis concluding that stock prices promptly and accurately react to the publicly available information, particularly to dividend announcements. The two-stage study tests the share prices response to dividend announcement.

The first stage included the evaluation of beta based on post facto returns on stock and market index and predicted returns on every of the stocks. The second stage these values were used to calculate abnormal returns around the day of announcement. The results provide information that though investors do not obtain significant value prior to the dividend announcement day or on the event day, they do gain value after the announcement. Investors move their security positions on the announcement day which implies that after the event day there is informational value in dividend announcement.

The evidences prove that the increases in dividends imply more positive abnormal stock returns, and this supports the efficient market hypothesis (Mehnidiratta and Gupta, 2010). But there are also empirical evidences of little stock market reaction to dividend announcements at some periods (Hasan et al. , 2012). The event study methodology was used to evaluate the effect of cash dividend announcements on the share prices. The data about abnormal returns around the event day was analysed and the events before, on, or after the announcement day were pooled.

The tested assumption states that payment of cash dividends is the most significant factor that impacts all prices around the event days (Hasan et al. , 2012). In the following figures the results of the regression analysis and statistical tests applied to the regressions are presented. Table 1 Effects of Dividends on Investor Weekly Return Coefficientsa Model Unstandardized Coefficients Standardized Coefficients t Sig. B Std. Error Beta 1 (Constant) . 012 . 009 1. 375 . 175 Dividend -. 002 . 002 -. 143 -1. 030 . 308 Model R R Square Adjusted R Square Std. Error of the Estimate imension0 1 . 143a . 020 . 001 . 03489 a. Predictors: (Constant), Dividend According to the first regression, dividends do not have a significant impact on the weekly stock returns and hence the null hypothesis related to stock returns is rejected. However, the output from the regression of share prices on dividends demonstrates that the former have a statistically significant positive influence on the share price performance. This was evidenced with the t-test. Table 2 Effects of Dividends on Share Prices Coefficientsa Model Unstandardized Coefficients Standardized Coefficients Sig. B Std. Error Beta 1 (Constant) 151. 362 47. 949 3. 157 . 003 Dividend 45. 955 9. 186 . 574 5. 003 . 000 Model R R Square Adjusted R Square Std. Error of the Estimate dimension0 1 . 574a . 329 . 316 191. 66266 a. Predictors: (Constant), Dividend Thus, the null hypothesis related to the effects of dividends on the share prices is accepted. R-squared test has revealed that the second regression had a better fit. Conclusion As the semi-strong efficient market hypothesis suggests, new information including dividend announcement is quickly reflected in the company’s stock prices.

Some empirical evidences support the hypothesis (Fama et al. , 1969; Aharony and Swary, 1980). Other findings suggest that the impact of the announcements may decline in the course of time (Amihud and Li, 2006). The recent empirical studies that were reviewed support the semi-strong efficient market hypothesis and find that dividend announcements produce abnormal returns and are positively related to the share prices (Mehnidiratta and Gupta, 2010). But another event study displays different reaction of stock prices to dividend announcement in different years (Hasan et al. , 2012).

The analysis in the paper was conducted in the context of three UK based companies from different sectors. The dividend policies of these companies have been analysed. Furthermore, the relationships between the share prices and the dividends were tested. It was found that the dividends produced a positive and statistically significant effect on the share prices but no significant effect on weekly returns. References Aharyny, J. and Swary, I. (1980) “ Quarterly Dividend and Earnings Announcements and Stockholders’ Returns: An Empirical Analysis”, The Journal of Finance, 31 (1), pp. 1-12. Amihud, Y. nd Li, K. (2006) “ The Declining Information Content of Dividend Announcements and the Effects of Institutional Holdings”, Journal of Financial and Quantitative Analysis, 41, pp. 637-660. Asquith, P. and Mullins, D. W. Jr. (1983) “ The Impact of Initiating Dividend Payments on Shareholders’ Wealth”, The Journal of Business, 56 (1), pp. 77-96. Baker, H. K. (2009) Dividends and dividend policy. New Jersey: John Wiley & Sons, Inc. Bodie, Z. , Kane, A. and Marcus, A. (2009) Investments, Hoboken: McGraw Hill Professional. Brealey, R. and Myers, S. (2003) Principles of Corporate Finance, New York: McGraw Hill.

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