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Research paper

The Effect of Dividend Policy on Share Price: A Conceptual Review

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Abstract

In modern corporate world, dividend policy is one of the most debatable issues in corporate finance. The academic literature related to effect of dividend policy on share price has grown rapidly over the previous decade, due to its puzzling phenomena. The present study intends to conduct a non-systematic review of literature on the empirical and theoretical studies on corporate dividend policy in order to understand its nature and dimensions. In this concern, an extensive review of existing literature has been performed and it is found that there are three different approaches or schools of thought. First school of thought is that a rise in dividend payout will increase the firm value (share price). Second, thinks that a rise in dividend payout will reduce the firm value (share price) and third supports Miller and Modigliani (1) argument that firm value or share price are not affected by dividend policy. Till to date no consensus has appeared and results are inconclusive. This article also attempts to cover key empirical studies on dividend policy across countries, which shows that the phenomena of dividend policy differ from one country to another. The continuing nature and wide array of discussion on dividend policy has formulated a massive volume of literature that increase day by day. Therefore, it not feasible to do a full-fledge review of all debates.

Keywords: *Share Price; Dividend Policy; Non-systematic Review; Firm Value; Dividend Policy Theories*.

1. Introduction

Dividend policy has always been questionable and there has been a continuous debate regarding this issue since the studies published by (Lintner (2), Lintner (3)) and Gordon (4). As dividend policy is one of the most controversial / complex issue and also primary element of corporate finance (5). This is an important topic not only because of amount of money involved, but the recurring nature of dividend payout. The dividend payout policy has a close relationship with the majority of the company's investments and other financial regulations (6). After the discovery of Miller and Modigliani (1) theory of dividend irrelevance, many studies have been carried out in the field of dividend payout determinants around the globe. The theory of dividend irrelevance asserts that in an efficient and perfect market where there are no information asymmetry or taxes and transaction costs, the company's dividend policy has no influence on its market value reflected through company's share price and that the company has no appropriate dividend policy. Though in a perfect market where investor can get all information immediately free of cost and there are no costs of transaction or taxes included (7) is far out of range. On the other hand, the theory identified that investment is an important and main issue. The framework, which was proposed by Miller and Modigliani is the foundation for all the studies been conducted usually on payout policy of dividend. Allen and Michaely (8) also supported that their structure was sufficient enough that it included both repurchase and dividends, while the value of company is determined by its investment strategy. It is debatably assumed that a firm's prime goal is maximization of shareholder wealth (9, 10), but according to Block, Hirt (9) this perception is not an easy task because the share price cannot be directly influenced by the management but the only way in which the share price can act is consistent with the investors willingness. As cited by Priya and Mohanasundari (11), Barman states that "if dividends are the key indicator of share price and share price are the key indicator of firm value, it is imperative that to maximize the shareholders wealth, the company should adopt a dividend policy that will increase the share price". Therefore, the wealth of shareholder is usually recognized as the total worth of the ordinary shares that is considered as the cash flows present value that will accrue to stockholders and equity requisite rate of return is used for discounting purpose. These cash flows comprise of capital appreciation and dividend (12). Therefore, companies must take significant decision about what amount of money company should retain for growth prospects and also distribute to its shareholders, perhaps in which form and how frequently (13). The different ways or forms in which dividends can be paid include cash dividends (annual or semi-annual) or bonus shares declared.

The key objective of this paper is to provide a brief literature review that focuses on the effect of dividend policy on share price by reviewing the prevailing theories related to dividend policy and their empirical outcomes. Moreover, this paper inspects the empirical studies conducted on finding out the linkage between dividend policy and share prices across different countries. This study is not comprehensive at all but established on the seminal researches contributed in the field of dividend policy literature.

2. Rationale Behind Companies Paying Dividend

In corporate finance, the most thoroughly researched topics focus by the academics is dividend policy. Numerous authors and re-

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searchers have described the concept of dividend, as it is a reward for the shareholders since they are the equity finance provider to a corporation. According to Bierman (14), dividend is usually a seizure of profits distributed to the shareholders after deducting the fixed interest and tax obligations on debt capital. This concept is consistent with Watson and Head (15). However, dividend can be distributed to the shareholders in three ways i.e. cash, stock and liquidating dividend (16). Additionally, Jo and Pan (17) states that dividend payment can provide perception to the investors that corporation is conforming to good corporate governance functions. According to Lease, John (18), the company's dividend policy indicates to "the practice that management pursues in making dividend payout decisions or, in other words, the pattern of dividend and size of cash distributions over time to the shareholders". Since 1950, financial academicians attention has been gained by the dividend policy decision of the firm. Many studies have been performed to resolve the issues concerning dividends for decades, but no acceptable opinion of convergence-illustrating company's expected payout behavior ever discovered. Brealey, Myers (19) stated that dividend payout policy is among the toughest unresolved topics in financial economics. This fact is similar with Black (20) who asserted that "the more the payout policy is looked at, the harder it appears to be, as it has components that cannot fit together". This study stated dividend policy as "dividend puzzle". Since Black declaration, a huge extent of investigation has been dedicated to solve the dividend puzzle. Allen, Bernardo (21), p.2499 specified the prevailing consensus view that "Although a number of theories have been put forward in the literature to explain their pervasive presence, dividends remain one of the thorniest puzzles in corporate finance". It is harmony even in today's world that dividend puzzle cannot be resolved with any certain theory or factor (22). Hence, a mix of belief occurs about the fact that why companies pay dividends and whether the choice of a specific dividend policy can effect the share price and firm value.

3. Theories of Dividend Policy

Dividend payout policy has always been a debatable issue and unresolved puzzle in the area of corporate finance. Several studies had already been conducted on dividend policy, which lead to a strong bone of controversy in the field of finance. The finance literature comprises of different underpinning theories such as dividend irrelevance, relevance, bird in hand, signaling, agency & clientele effect. Brealey, Myers (19) stated that increase in dividend reveals management's optimism about earnings and consequently affects the share price. However, the increase in share price and an unexpected dividend increase can only be happened if the information related to future earnings is spread out through other channels. A question appears that dividend just provides the signal of stock value or dividend decision influences the value of stock (firm value). These aspects are discussed in detail by the help of different theories in the following sections.

3.1 Dividend irrelevance theory:

Miller and Modigliani (1) proposed one of the most prominent and influential dividend theories. Although, it was presented more than 50 years ago but still it is considered to be one of the most respected theories. When the irrelevance proposition was published in the article "Dividend policy, growth and the valuation of shares", it changed the opinions of both academics and practitioners that they had about dividend and offered a new benchmark for them (23p. 98). Before the proposition of Modigliani-Miller's irrelevance theory, the general belief was that a dividend payout is positively correlated to the firm's value. This belief originated from so-called "bird-in-hand" hypothesis (24, p. 134). These both theorist argued in their work that " the sole purpose for the existence of a corporation is to pay dividends and firms that pay higher dividends must sell their shares at higher prices" as quoted by Frankfurter, Kosedag (25), p. 202.

However, when the period of finance began, Miller and Modigliani (1) presented the irrelevance theorem, usually known as M & M theorem. They argued that under certain presumptions, a company's dividend policy does not affect on either share price or its cost of capital; If policy on dividends has no substantial impacts, then it would not be relevant. The basic idea of their argument was that the worth of the company is derived by its earning power and depends on its profit that accrue from selecting optimal investments (investment policy). Thus, as the decision of investment is made, the payout policy becomes irrelevant to the firm's value. This is because the difference between the investments and earnings, and a residual represents net payout. In other words, the firm's value depends on revenue earned by its assets, not in what way this revenue is divided into retained earnings and dividends. From investor's point of view, dividend policy is inconsequential, because appropriate purchases and sales of equity can replicate the desired stream of payments. A company can alter its dividends to any level with a balancing alteration in shares outstanding. According to authors, dividend policy is not relevant to the shareholder, as it cannot change the shareholder's wealth and hence, what ever so the dividend policy is the investors will not pay the premium. This suggestion appears with some assumptions. Among these assumptions the opponents of this theory consider few as fairly unrealistic. Dividend irrelevance theory has five main idealistic assumptions. First, the information is symmetrical and free (costless) available equally to everyone participating in the market. Second, there is no existence of taxes on capital gains and dividends. Third, transportation and floatation costs do not exist during buying and selling of securities. Forth, there is no divergence between managers and security holders' interest i.e. no agency cost. Fifth, individual firms and investors cannot influence the price of the security in market (1). Among these suppositions, practical applicability of a few assumptions is lacking. For example, many researchers have already contradicted the assumption that there is no agency problem. The opponents of this suggestion oppose that firm has same managers and owners i.e. that agent (managers) will work in the best interest of the shareholder (owners). This argument is also supported by Nizar Al-Malkawi (26), which explains that agents (mangers) will follow those policies that are in their own interests on the expense of owners (shareholders) of the firm. A lot of bombardment has already been done on the assumption of no taxes, as it is not practical.

3.2 Dividend relevance theory:

The study conducted by Baker and Powell (27) discuss that managers consider that the effective way to maximize the investors value can be through paying dividends and that the finest dividend policy should be a equalize combination of future growth and dividend payout. These findings also supported the study of Lintner (2) which argue that dividends are the significant element of the firm value. According to Gordon (28) point of view, dividends has a significant role because it has been used in his study as a valuation technique for corporations.

However, the investors may consider dividend policy as indifferent but empirically, dividends have proven themselves as significant in the eyes of investors (29). In a world of uncertainty, frictionless and no perfect markets, investors can be affected by dividend policy by means of behavioral considerations and market imperfections. These market imperfections are "the bird-in-hand theory, the signaling theory, the agency theory and the clientele effect" (30). They have discussed the problems faced by the managers in the firm when selecting dividend strategy and also explained that why investors view dividend policy as significant through four different and relevant facets.

3.2.1 Bird-in-hand theory:

The opposite opinion concerning Modigliani-Miller's irrelevance theory is that company's value can be affected by dividends and this supposition is denoted as "bird-in-hand theory". Lintner (2) first presented this theory and it became umbrella term for all those studies that claims that firm's value is positively correlated to dividend payments. This theory is developed on the concept that "Better a bird in the hand than two in the bush". This theory proposes that the preference of investors is "one bird in hand" represented by dividend disbursement from a stock, because it is better than "two in the bush" with a prospective higher and unclear capital gain. In financial terms, investors are more eager to invest in the stocks that give current dividend rather than those that disburse dividends in future and retain the earnings. This conception was also supported by Gordon (4) and Gordon (28). They said that investors are interested in their returns and prefer to get dividends today because high degree of uncertainty exists in capital gains and future dividends. This perception was also supported by Nizar Al-Malkawi (26),who states that investors consider dividends of more worth than retained earnings due to uncertainty in the future cash flows. Current dividends are more certain than capital gains because managers do not control the share price rather it is controlled by market forces due to high level of uncertainty involved (31). The solid reason behind this is investors are willing to secure certain amount of the money invested as investment holds a level of uncertainty (32).

The bird-in-hand theory suggests that getting the cash dividend now can decrease the risk linked with the uncertainty of deferred income (capital gain). Therefore, investors will be interested to buy the shares of the companies that pay continuous dividends than those firms, which retain much for the growth and expansion. According to Khan and Jain (33), the fundamental suppositions of Gordon's model is based on the concept of comparison among dividends available today and dividends / capital gains available in the future. The logic behind this is that if the future is at a more distance then the possibility of uncertainty regarding future dividends and capital gains will be higher. While, capital gains may give higher return in the future as compared to present dividends, but no surety exists concerning investor will get better return because high level of uncertainty (28). Thus, investors will not be interested to invest in the firms where time frame of dividends is at more distant. Hence, from investor's point of view, the price of the firm will be higher for those that would be giving current dividends. Whereas the firms that are not paying current dividends, investors will use higher discount rate to discount earnings of these firms, thus the value will be lower as compared to current dividend paying firms (33).

As discussed above that this theory is against the views of Modigliani-Miller's dividend irrelevance theory and it states that companies having greater profits disburse more dividends to its stockholders. As this opinion is contradictory to the Modigliani-Miller's theory, it would be thought provoking to exam this opinion that firms having greater profits disburse more dividends to its stockholders. If the company is profitable enough then investor may view the potential, but if the company is not much profitable then opposite may be true.

3.2.2 Signaling theory:

In a balanced informed market, all the concerned participants have similar information concerning the company including shareholders, banker, managers and others. Though, if one participant has more information about the company's future scenarios and current situations then there exist an information asymmetry. The concept information asymmetry was introduced by Akerlof (34) who examine the market of "lemons" with the help of automobile markets. In the existence of information asymmetry, all the items (lemons which represents bad cars and cherries denotes good cars) in the market can be sold at the identical price because the owners can only differentiate the attribute of the cars. Therefore, under the information asymmetry scenario, the owners that owns good car will attempt to signal positive information to the outsiders. Likewise, companies that disburse dividends can be view as a signal that they have positive future prospect and are not like "lemons".

The dividend signaling theory has its roots in the study presented by Lintner (2) who disclosed that the company's stock price usually changes with the change in dividend payments. Although Miller and Modigliani (1), p. 430 said in the support of irrelevance theory of dividend, but they also argued that in an actual world ignoring the capital markets which is perfect, dividends communicates an "information content" which might impact the market value of the stock. Thereafter many researchers have been involved in the process of developing this theory and today it is consider being one of the most powerful dividend theories.

The signaling theory is among one of those theories that consider that dividend is significant in affecting the firm's value. While Miller and Modigliani (1) supposed that managers and investors knows exact scenario or information concerning the company. This suggestion has received huge amount of criticism. As several researchers believes that managers who are involve in managing day-to-day transaction of the firm have more exact and timely knowledge about the company as compared to external investors. This consequently generates a gap among investors & management. To bridge this information gap, Nizar Al-Malkawi (26) states that dividends can be used as one of the method by the management to communicate private information to the shareholders and is consistent with the findings of Pettit (35). However, a rise in dividend could be understood as virtuous information & brighter prospects. In this course, Hussainey and Walker (36) and Basiddig and Hussainey (37) documented a noteworthy increase in share value returns followed by an unexpected boost in dividend payout and vice versa.

3.2.3 Agency theory:

The hypothesis given by Jensen and Meckling (38) is perceived as a benchmark for agency theory. They states that when managers are given responsibility to maximize the wealth of shareholder, the conflict of interest originate between shareholders (principals) and management (agents). This perception was also discussed by Ross (39). This conflict occurs when managers act in such a way that their own wealth increases at the cost of principals (stockholders) who actually own the company. This intention opposes the propositions of Miller and Modigliani (1) who anticipated that the managers are perfect agents on behalf of principals (stockholders) and there is no existence of conflict of intension concerning them. This is rather doubtful supposition that shareholders are different entities from the management of the firm. In such situations, manager's intentions are not necessary the same as the intentions of shareholders and manager might perform such activities that are costly and harmful to the interests of shareholders i.e. using excessive compensations or investing in those projects that provide more unnecessary returns to them and are unprofitable for shareholders (26). Thus, shareholders have to borne this (agency) costs needed to monitor the behavior of managers. These costs are essential and may be the consequence of probability of conflicting interest among shareholders and managers of the firm. Therefore, dividend payments are a method of acting to organize the conflicting positions and resolve the ownership problems prevailing between shareholders and managers, by limiting the liquidity left at the discretion of managers (40). Hence, shareholder can scrutinize mangers economically. Therefore, it indicates that paying dividends can reduce possibilities of managers acting selfishly because dividend disbursement increases the responsibility and accountability of managers to several stakeholders.

Easterbrook (41) suggests that increase in dividends might force the managers to take actions that reduce the free cash flow available for manipulation. Furthermore, the value of the firms is affected by dividend payout and eventually obliged managers to approach the capital market for external financing.

3.2.4 Clientele effects of dividend theory:

The theory argues that different investors or shareholders have their own expectations and preferences regarding dividend payout policy. As a consequence, shareholders tend to choose the stocks of firms that satisfy a specific need. This is because shareholders have to encounter with distinct tax treatment for capital gains & dividends and also confront with certain transaction costs as they buy and sell securities in different markets. Miller and Modigliani (1) assert that to minimize these costs, shareholders will be inclined towards those companies that offer them those expected benefits. Similarly, companies would appeal diverse clientele established on their dividend payout policies. However, they states that while clientele effect might modify a company's dividend payout policy, one clientele is equally commendable as another, thus dividend payout policy remain irrelevant. Nizar Al-Malkawi (26) asserts that companies in their development phase, which incline to pay lesser dividend would appeal clientele that appeal capital gratitude, however those companies in their maturity phase which disburse greater dividends appeal clientele that need instant revenue in the shape of dividend. According to Nizar Al-Malkawi (26), there are two groups of clientele effect, those that are based on taxation and transaction cost. This study said that investors in high tax range would attract to those stocks that have minor or no dividends to receive compensation in the shape of stock price moving upwards and vice versa. Berk and DeMarzo (42) narrate that individual investor in a market held 54% of market value of stock will only receive 35% of the dividends. On the other hand transaction cost induced clientele occurs when small investors depend on dividends for their requirements and desire firms who fulfill this requirement because they cannot bear the transaction cost (high) involve in selling the securities. All investors have to face these effects differently, depending on the portfolio size, what kind of investor you are and where buying and selling of securities is done (32).

4. Research Method

This is primarily a conceptual review paper that inspects the effect of dividend policy on share price by reviewing the prevailing theories related to dividend policy and their empirical evidences across different countries. The method used to conduct the review process involves different stages as show in figure 1. We searched different databases (Google Scholar, Web of Science and EBSCOhost), which are mostly used by researchers across several disciplines (43). Since, dividend policy is an extensively debated issue in corporate finance, thus we have no difficulty in finding out the related articles. In the process of evaluating these articles, we also discovered related references, which made our literature search easier. During the search for literature, we also revealed a lot of financial blog on the topic under study, which were also appropriate for our research. We exclude these blogs as it is considered to be unreliable and biased type of sources.

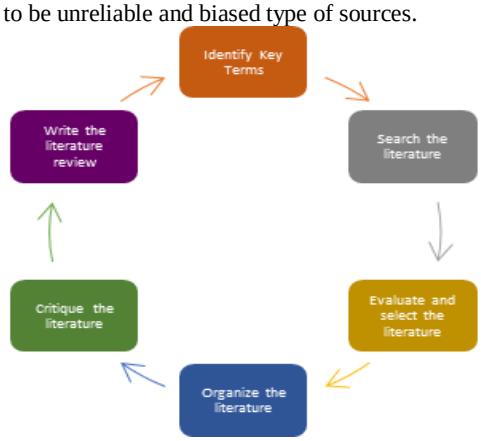


Figure 1: Process of literature review.

5. Empirical Evidence from Cross-Countries

Extensive empirical studies have been performed to analyze the association between stock price and dividend policy (32, 44, 45). However, these researchers have no consistent findings. Black and Scholes (46) discovered that no connection exist between share prices and dividend policy which further explains that it is the decision of investor to hold low or high yield securities and in both cases the return earned remains the same. According to Baskin (47), a negative connection exists between dividend yield and share prices. However, the findings of study was inconsistent with Hussainey, Oscar Mgbame (32). Many different researchers found a strong proof that support Miller & Modigliani's irrelevance theory of dividend and does not believe it related to share prices (48-51).

Gordon (52) presented another concept about dividend policy that is relevance theory of dividend. The theory states that dividend payout policy influences the market value of stocks and the value of the company. As investors are more interested to get safe and current revenue in terms of dividends instead of capital gains. This concept was further supported through different studies conducted by (Baker, Powell (53), Dong, Robinson (54), Maditinos, Sevic (55), Myers and Frank (56), Travlos, Trigeorgis (57)).

In developed countries, the relationship between dividend policy and share price has been thoroughly studied. With regard to US market Fama, Fisher (58), Jahnke (59), Asquith and Mullins Jr (60), Baker and Powell (27) and Howatt, Zuber (61) discovered positive association between dividend and share price. The findings of these studies were consistent with Ariff and Finn (62), Conroy, Eades (63), Gunasekarage and Power (64), Hussainey and Walker (36) and Andres, Betzer (65) conducted in different developed countries. Moreover, Bulan, Subramanian (66) and Hussainey, Oscar Mgbame (32) found positive as well as negative link. However, no relationship between dividend and share price was revealed by Iqbal and Rahman (67), Amihud and Li (68) & Vieira and Raposo (69) in developed countries.

Conversely in developing countries, most of the studies revealed positive connection between dividend policy and share price (44, 70-82). These studies were inconsistent with Hashemijoo, Mahdavi-Ardekani (83) and Shah and Noreen (84). Moreover, Habib, Kiani (85), Ilaboya and Aggreh (86), Hunjra, Ijaz (87) and Ntui, Yuda (88) discovered both positive and negative relation. Though, few studied found no relationship between dividend policy and share price in developing countries (48, 89, 90).

Table 1: Summary of studies on relationship between dividend policy and share price across countries.

Direction of Findings	Developed Countries	Developing Countries
Positive Relationship	Fama, Fisher (58), Jahnke (59), Asquith and Mullins Jr (60), Ariff and Finn (62), Baker and Powell (27), Conroy, Eades (63), Gunasekarage and Power (64), Howatt, Zuber (61), Hussainey and Walker (36), Andres, Betzer (65)	Chawla and Srinivasan (72), Azhagaiah and Priya (71), Chen, Liu (73), Nazir, Nawaz (80), Khan, Aamir (79), Asghar, Shah (44), Al-Hasan, Asaduzzaman (70), Kamyabi and Nazemi (78) , Iqbal, Waseem (75), Sharif, Ali (81), Ullah, e Saqib (82), Jahfer and Mulafara (76), Hamid, Khurram (74), Kamali and Neysi (77)
Negative Relationship	-	Hashemijoo, Mahdavi-Ardekani (83), Shah and Noreen (84)
Positive as well as Negative Relationship	Bulan, Subramanian (66), Hussainey, Oscar Mgbame (32)	Habib, Kiani (85), Ilaboya and Aggreh (86), Hunjra, Ijaz (87), Ntui, Yuda (88)
No Relationship	Iqbal and Rahman (67), Amihud and Li (68), Vieira and Raposo (69)	Adefila, Oladipo (48), Abrar-ul-haq, Akram (89), Pekkaya and Acikgoz (90)

6. Conclusion

Dividend policy has always been a debatable issue and unresolved puzzle in the area of corporate finance. Several studies had already been conducted on dividend policy, which lead to a strong bone of controversy in finance field. A question appears that whether dividend policy impacts share prices remains valid controversial among policy makers, managers and researchers to date. From the literature, dividend policy can be summarized into two groups of opinions. Irrelevant school of thought theorized by Miller and Modigliani (1), which states that company's dividend policy and stock price is irrelevant whereas the second perspective supports the opinion of Gordon (52) and believes that firm's dividend policy and share price is relevant. Therefore, the dilemma that exists between managers and investors is to which theory should the firms adopt in formulating their dividend decisions. Although various studies have investigated different issues related to dividend policy i.e. why firms pay dividend, but dividend puzzle remains unresolved and inconclusive. The empirical literature has logged systematic deviations in dividend policy behavior across different companies, countries and time interval. In specific, despite of more than fifty years of debate and attempts to empirically prove the several theories, the evidences gathered are not conclusive nor does it completely clarify the effect of dividend policy on share price.

Indeed, our review findings have noteworthy policy implications for academicians, analysts, managers, speculators and investors. Since, these stakeholders can test the effect of dividend policy on share price across different sectors. Moreover, the study can find out other explanatory variables, which can use dividend policy as a moderating or mediating variable to test the effect on share price.

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