Literature Review

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Abstract

A discussion of past literature that has influenced the investigation into dividend strategies. We take a novel approach in combining firms of the same sectors but in different geographical regional. Overall we find that the effect is much more pronounced used a forward and backward looking indicator.

Keywords: Multivariate GARCH, Kalman Filter, Copula

JEL classification L250, L100

1. Introduction

2. Dividends constitution and Impliaction on Stakeholder and Firms

Dividends are cash payouts that companies use to distribute capital to their shareholders. They can take various forms, such as cash, stock, liquidating, scrip, or property [baker2009understanding]. However, cash dividends are the most common type. The decision to issue dividends is typically made by the board of directors, taking into account the company's operating needs for a given financial year. When a dividend is announced, it has an impact on the financial statements of a company. Resultantly, dividend announcements create a liability which impacts the balance sheet by increasing the current liabilities and decreases shareholder equity, specifically retained earnings, on the balance Baker & Powell (2009: 374). In other words, the company incurs an obligation to pay out the dividend, and the value of the company retained by shareholders decreases accordingly. Various literature have shown that in some countries shareholder values dcreases in line with dividend payments. Vijayakumar (2010), Hussainey, Mgbame & Chijoke-Mgbame (2011) and Masum (2014) show negative effect on prices on ex dividend day following the payments of dividends. This effectively means that value of a shareholder remains the same as capital its just swapped for cash.

Cash dividends, although widely used, are not as tax-efficient as other types of capital distributions,

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such as share buybacks or stock repurchases. This form of capital redistribution a firm exchanges assets for outstanding shares, which shrinks the company's assets by the amount of cash paid out. This action too reduces both its borrowing base and the shareholders' aggregate equity Baker & Powell (2009: 429). A clear benefit to the company is that it is more flexible when compared to the rigid dividend payout structures. To most higher net worth investors, tax benefits in the form of lower capital gains taxes also apply in most jurisdictions. It is thus no surprise that this form of earnings redistribution has gained traction in some advanced economies such as the US (with the Financial Times recently reporting that announced stock buybacks in the US reached an all time high of $437 billion in 2018). Surprisingly, their adoption has been relatively slow in some emerging economies. According to a study by Wesson, Muller & Ward (2014), there were only 195 open market share repurchases announced in South Africa from 1999 to 2009. In comparison, Manconi, Peyer & Vermaelen (2014) estimated that share repurchases constituted approximately 58% of total announcements in the United States, 15% in Canada, and 11% in Japan over the same period, indicative of a significant disparity in the adoption of share buybacks across the world, despite their popularity in the United States.

The logical question then is why do firms pay dividends? Miller & Rock (1985) opines that dividends are irrelevant (MM theory), it argues that shareholders are indifferent to dividend payments, implying that there is no optimal dividend policy. They contend that all dividend policies are equally good and thus payments of dividends could easily be reinvested in shares and make no difference to share holder wealth. However, the MM theorem fails to consider real-world market imperfections that may give relevance to dividend payments. To this end we we unpack the dividend puzzel that suggest dividends reduce equity value and make investors worse off Black (1996). However, dividends can be seen as a reward to investors who bear the risk associated with their investments. Also, dividends can be considered a return on investment rather than relying solely on capital gains Black (1996). Various literature has emerged trying to solve the puzzel, either supporting irrelevance or relevance in dividend payments.Global assets market face multiple constraints or imperfections namely flotation costs, transaction costs (e.g., taxes and flotation costs), information asymmetry, and principal-agent problems.

Tax preferences play a role in the argument for dividend relevance. Different investors may be attracted to different stocks based on their tax treatments, thus investors choose stocks based on their individual investment needs Van Deventer, Imai & Mesler (2013) Baker & Powell (2009). However, supporters of the MM theorem argue that changes in dividend policy should not significantly impact stock prices due to the substitution effect. According to this effect, allocation decisions of firms occur almost simultaneously, resulting in a net zero effect on prices [baker2009understanding]. Flotation costs refer to the opportunity costs incurred by a firm when paying dividends. By distributing dividends, companies forego opportunities to expand their operations using retained earnings. In a world without flotation costs, as suggested by the MM theorem, management would be indifferent between issuing dividends and borrowing from the market. However, in reality, external financing comes at a higher

cost, leading to trade-offs in dividend policy decisions.

Information asymmetry between shareholders and managers is another factor that gives relevance to dividend payments. Investors rely on dividend announcements to assess a company's stock price. Dividend signaling conveys information about the company's quality [al2018revisiting & baker1999corporate]. Investors compare dividend announcements to historical levels while considering company fundamentals. However, there is a risk of manipulation by management, making the dividend signal imperfect for determining share prices. Extending the argument on information asymmetry leads to the principal-agent problem, where management and shareholders may have differing goals for the use of retained earnings, leading to conflict [baker2009understanding]. The free cash flow hypothesis suggests that dividend payments force management to raise capital from external sources, which increases borrowing costs and scrutiny from capital markets. This, in turn, reduces management's ability to make sub optimal investments [baker2009understanding].

Studies on dividend signaling for returns can be categorized into academic return signaling studies and practitioner-oriented long-term return studies. Academic studies, such as Fama & French (1988), initially found a positive correlation between increasing predictive power and longer forecast horizons. However, subsequent studies like Ang & Bekaert (2007) found no evidence of long-term predictability in stock returns when considering finite sample influence. This suggests that dividend yield may not be a reliable predictor of subsequent returns. One possible reason for this declining predictive power is the increasing use of share buybacks as an alternative means for capital distribution, which reduces the contribution of dividend yield to total return [robertson2006dividends].

On the other hand, practitioner-oriented literature focuses on the long-term returns of systematic dividend portfolios. One popular strategy is the "Dogs of the Dow (DOD)," which involves creating a portfolio of the top 10 highest-paying dividend stocks on the Dow Jones Industrial Index at the beginning of the year based on the dividends paid in the previous 12 months. The portfolio is held for 12 months, and the process is repeated annually. Various studies have examined the DOD strategy or similar high-yield dividend strategies in different time periods and regions, consistently showing superior risk-adjusted returns compared to the market index. Examples of such studies include Lemmon & Nguyen (2015) in Hong Kong, Brzeszczyński & Gajdka (2007) in Poland, Visscher & Filbeck (2003) in Canada, Filbeck & Visscher (1997) in Britian, and Wang, Larsen, Ainina, Akhbari & Gressis (2011) in China. More recently, Filbeck, Holzhauer & Zhao (2017) investigated the performance of DOD against a high-yield portfolio of Fortune Most Desired Companies (MAC) compared to the Dow Jones Industrial Average and the S&P 500. The study found significantly higher risk-adjusted returns for the DOD strategy.

- Look at papers that investigate dividend signalling by sector.

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