Literature Review

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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 dividends. 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. It creates a liability in the form of current liabilities and decreases shareholder equity, specifically retained earnings, on the balance sheet. In other words, the company incurs an obligation to pay out the dividend, and the value of the company retained by shareholders decreases accordingly.

- give examples of the decrease in shareholder value when dividends are announced
- Include the argumemt that there are a proxy for value

Cash dividends, although widely used, are not as tax-efficient as other types of capital distributions, such as share buybacks. Share buybacks have gained popularity in advanced economies, particularly in the United States, where they reached a high of $437 billion in 2018. Surprisingly, their adoption has been relatively slow in South Africa. According to a study by Wesson, Muller, and Ward in 2014, there were only 195 open market share repurchases announced in South Africa from 1999 to 2009. In comparison, Manconi, Peyer, and Vermaelen 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. This indicates a significant disparity in the adoption of share buybacks across the world, despite their popularity in the United States.

- update argument on sharebuybacks and why you just mentioned them instead of others

Where else are share buybacks less popular versus dividends Are dividends still relevant

Why do firms pay dividends

The issue of dividend policy and its impact on shareholder wealth has sparked debates and opposing arguments in financial literature. On one hand, the dividend puzzle suggests that dividends reduce equity value and make investors worse off. According to this view, dividends can be seen as a reward for investors who bear the risk associated with their investments. Additionally, dividends can be considered a return on investment rather than relying solely on capital gains. Various literature has emerged trying to solve the puzzel, either supporting irrelevance or relevance in dividend payments.The Modigliani-Miller (MM) theory opines that dividends are irrelevant, 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. 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. 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. 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. 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 conflicts. 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.

Dividend Portfolios To Signal Returns

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 and French (1988), initially found a positive correlation between increasing predictive power and longer forecast horizons. However, subsequent studies like Bekaert and Ang (2001) and Ang and Bekaert (2006) 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 (Robertson and Wright, 2006).

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 Da Silva (2001) in Latin America, Alles and Sheng (2008) in Australia, Visscher and Filbeck (2003) in Canada, Kotkamp and Otte (2001) in Germany, and Wang et al. (2011) in China. More recently, Filbeck (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.

- Give a summary of the indexes and methodology used in all the papers listed.
- Look at papers that investigate dividend signalling by sector, this moves it away from just bunching all sectors into one portfolio
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