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DIVIDEND POLICY AND ITS IMPACT ON STOCK PRICE: A CASE STUDY ON SENSEX COMPANIES

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ABSTRACT

Dividends are the part of the firm's earnings which is distributed among shareholders, various studies have been conducted to test how stock price and stock market reacts in response to decision taken by the management with relation to dividend payment. The purpose of this study is to examine the relationship between dividend policy and share price volatility focused on sensx companies in order to measure these relationships we have considered two most important measurement of dividend policy i.e. Dividend Payout Ratio and Dividend Yield. The time period is considered for the study is 5 years from 2011-2015. Descriptive statistics, correlation and regression models were used to perform the data analysis. The primarily regression model was expanded by adding control variables including size, earning volatility, growth and leverage. The empirical study proved that there is a negative relationship between dividend policies on share price volatility and there is a positive relationship between dividend yield and with other control variables.

KEYWORDS

share price volatility, dividend yield, dividend payout ratio, leverage and firm size.

INTRODUCTION

Dividend policy is an important financing decision that involves with the payment to shareholders in return on their investment. Every organization has its own dividend payment pattern or dividend policy. It is a financial indicator; hence the demand of the firm's share should be to some extent dependent on the firm's dividend policy.

Dividend policy is the most widely debatable and widely researched topic in the field of finance, but yet it is an unresolved problem. The dividend decision is the most important decision that the managers have to take. This aims to shareholder's wealth maximization hence the companies have to balance between dividend payout ratio Khan et al (2011)

There are three conflicting theories examined the relationship between dividend and stock price Linter (1959) and Gordon (1963) indicated that there is a positive relationship between dividend policy and stock price. MM (1961) in his theory Indicated negative relationship and Tax preference theory also indicated negative relationship between dividend and stock price. Hence many study indicated dividend is a puzzle.

The most well-known study on dividend irrelevance theory was developed by MM (1961). His study has become benchmark to other researcher in developing various models pertaining to dividend values and the policies that guided the managers in setting up company payout policies. MM stated that firm value is independent on dividend policy he also argued that value is driven only by future earnings and risk of its investments. In reality investors will be paying high taxes on dividends instead of capital gain. The investor will be taxable once the shares are sold. A company that pay no dividends will be more attractive since it's avoids excess payment of taxes (Blake 1986) for this reason companies will be tempted to eliminate dividend policy. Recently as we could see even well performing companies are reluctant to increase dividend payments but contrarily at the same time some company's despite of experienced decrease in net income have announced constant or increase their dividend payment rather than cut down them. The purpose of this study is to test the hypothesis that the payout of a dividend does in fact have a negative correlation with the stock's price volatility and that it has the most significant correlation when compared to other variable. This negative correlation would convey that the higher the percentage payout, the less the stock price volatility will be. The regression will also test my hypotheses that certain selected variables also have their respective effects on price volatility and the significance of their correlation will also be found.

OBJECTIVES OF THE STUDY

The main objective of the study is

1. To examine the relationship between dividend yield and stock price volatility
2. To examine the relationship between dividend payout ratio and stock price volatility

HYPOTHESIS FOR THE STUDY

In the background of the study, the following hypothesis was developed:

1. H0: There is no significant association between stock price volatility and dividend yield
H1: There is a significant association between stock price volatility and dividend yield
2. H0: There is no significant association between stock price volatility and dividend payout ratio
H1: There is a significant association between stock price volatility and dividend payout ratio

RESEARCH METHODOLOGY

In the background of the objective of the study and hypothesis for the study, the following research design has followed: a) Sources of information b) Selection of Sample Companies c) Period covered for the study d) Selection of Variables e) Statistical tool used

A) SOURCES OF INFORMATION

This research use financial accounting data downloaded from data stream from the sensx companies listed in stock exchange. This study is based on purely secondary source of information were dividend payout ratio, dividend yield, Stock Price, Size, Growth and Earning volatility information were sourced from annual reports and websites.

B) SELECTION OF SAMPLE COMPANIES

The empirical study mainly focused on SENSEX companies that consists of 30 companies listed in BSE.

C) PERIOD COVERED FOR THE STUDY

The time period considered for the study is from 2011-2015

D) SELECTION OF VARIABLES

To test the relationship few variables has been considered. In the present study stock price or share price taken as a dependent variable and Dividend Yield and Dividend payout ratio taken as independent variable along with this size, growth, leverage and earning volatility control variables are taken as independent variable

MEASUREMENT OF VARIABLES

Stock Price volatility (Dependent Variable): SPV is calculated by firstly, the annual range of stock price is divided by average of the highest and lowest price for each year.

Dividend yield (DY) (Independent Variable): Dividend per share divided by average closing share price

Dividend Payout Ratio (DPR) (Independent Variable): Dividend per share divided by earning per share we followed as per previous research like Hussainey, Khaled, & Mgbame, Chijoke Oscar, & Chijoke-Mgbame, Aruoriwo M (2011). Size: It's a control variable measured by Total asset

Growth: It's a control variable measured by Asset turnover ratio

Leverage: it's measured by debt to equity ratio as suggested by most of the previous research

Earning Volatility: Is measured with EBIT

In order to prove the hypotheses model was developed as suggested by most of the previous research like Nazir, Mian Sajid, & Nawaz, Muhammad Musarat, & Anwar, Wasseem, & Ahmed, Farhan (2010). Allen, F., Bernardo, A., & Welch, J. (1998)

Model 1: In this model the actual dependent variable Stock price volatility was regarded with two separate variables, dividend yield and dividend payout ratio, this provides some sort of crude test in the relationship between stock price volatility and dividend policy, Using regression model

$$SPV = A1 + ADY2 + ADPR3 + \epsilon$$

A1= Constant, ADY2= Dividend yield, ADPR3= Dividend payout ratio and ϵ = error term

Model 2: In this model control variables and DY and DPR are regressed to examine the close relationship between DY and DPR

$$SPV = A1 + ADY2 + ADPR3 + AS4 + AG5 + AL6 + AEV7 + \epsilon$$

A1= Constant, ADY2= Dividend yield, ADPR3= Dividend payout ratio, AS4= Size, AG5= Growth, AL6= Leverage, AEV7= Earnings Volatility and ϵ = error term

E) STATISTICAL TOOL USED

Descriptive statistics, correlation and regression models were used to perform the data analysis. The primarily regression model was expanded by adding control variables including size, earning volatility, growth and leverage recommended by (Baskin 1989).

REVIEW OF LITERATURE

The study done by Farroq, Saoud, & Agnaou (2012), took the above idea a step further. In this study they, not only observed the effects of dividend policy in an emerging market, but they also looked at the differing affects in diverse market conditions. More specifically, they observed the effects of dividend policy on stock price volatility both, in a period of market growth and market stability.

In a study conducted by Hussainey, Mgbame, Chijoke-Mgbame, & Aruoriwo (2011), the objective was to find the relationship and affects that dividend policy had on a given stock's volatility in the developed economy of England. During the study they also ran regressions between certain factors that could affect the volatility such as size and leverage. In their study they discovered that both the payout ratio and dividend yield had significant negative relationships to stock volatility. Further, a negative relationship was found between size and volatility and a positive relationship between leverage and volatility. They cited that through their finding they show that the larger a company was (in assets), the less volatile the stock tended to be. They also pointed out a trend that as financial leverage (debt carried on the balance sheet) increased, the volatility of the stock price tended to increase as well. This study made it evident that other variables would need to be controlled if someone was to attempt to get a true correlation between dividend policy and stock price volatility.

The recent studies that have been conducted have cited Baskin (1989), it is appropriate that his work be mentioned first. What Baskin set out to accomplish was to, not only figure out if dividend yield was a proxy for price volatility, but whether or not dividend yield had a direct effect on the volatility of a common stock's price when other related factors were controlled. Baskin concluded his study by acknowledging that dividend yield among other factors certainly had a defined correlation with the volatility of a given stock price, but could not conclude that dividend yield had a direct cause and effect relationship with price volatility.

Another study was done by Allen & Rachim (1996), which looked at a similar relationship but used the Australia stock exchange as their target market. In their study they found, similar to Hussainey, Mgbame, Chijoke-Mgbame, & Aruoriwo's (2011) findings, that a firm's financial leverage had a large positive correlation to price volatility. In addition to this, they also found that earnings volatility, or the change in quarterly earnings per share had a substantial positive correlation. They cited that this finding was not surprising but sensible in the least. Allen & Rachim went on to find a significant negative correlation between dividend yield and price volatility. A&R pointed out that, because of the high similarity between dividend yield and payout ratio, the decision was made to drop the dividend yield as a variable and focus towards the payout ratio.

Many studies have been conducted to know about the impact of volatility and dividend policy hence based on the above studies has also been considered to develop and hypothesis and to prove the hypothesis. Dividend policy is a puzzle hence need more research to solve these puzzle

RESULTS AND FINDINGS

TABLE 1: DESCRIPTIVE STATISTICS

	Mean	Std. Deviation
PV	.50	.28
DY	1.4	1.82
DPR	32	31.6
SIZE	1.02	143
GROWTH	75	63.
LEVERAGE	1.16	2.75
EV	31	25.

(Source: Annual Report)

Table 1 above describes the results of descriptive statistics for all the dependent variable and independent variable overall in the model. The mean value of price volatility (PV) is .50 with a Standard deviation of 0.28 as stated in Table 1, which means it remains low volatile from 2011-2015. Among the independent variable the mean of earning volatility (EV) is 31 and Standard deviation is 25 which indicates high earning volatility, Growth has the highest mean of 75 and highest Standard deviation of 63 among all the variables. While the dividend payout ratio (DPR) Mean is 32 and Standard deviation is 31.6 respectively, on the other hand the Mean and Standard deviation of dividend yield (DY) is 1.4 and 1.82 respectively. Last variable in the proposed study is size and leverage was its mean and standard deviation is 1.02 and 143, leverage 1.16 and 2.75. The Correlation results are presented in Table 1.1.

TABLE 1.1: CORRELATION

	PV	DY	DPR	SIZE	GROWTH	LEVERAGE	EV
PV	1						
DY	.532**	1					
DPR	-.022	.239**	1				
SIZE	.092	.017	-.183*	1			
GROWTH	-.145	-.018	.255**	-.395**	1		
LEVERAGE	.149	.078	-.098	.337**	-.404**	1	
EV	.026	-.084	-.253**	.246**	-.064	-.041	1

(* , ** , Indicates that correlation is significant @ 0.5 and 0.1)

The above Table 1.1 shows the correlation between all the variables. It is clear from the above analysis that price volatility and dividend has strong correlation ($r = 0.532$) at the same time growth and price volatility is negatively correlated which means that the increase in one variable leads to decrease in the other variable. Dividend yield and dividend payout ratio is showing low degree positive correlation

($r = 0.239$), size and dividend payout ratio ($r = -0.18$) indicated low degree negatively correlation, growth and dividend payout ratio is ($r = 0.255$) indicating low degree positively degree correlation. All the remaining variables are indicating weak or medium correlation with each other.

TABLE 1.2: MODEL SUMMARY

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.558 ^a	.312	.283	.2431101

(Table. 1.2 Predictors: (Constant), EV, LEVERAGE, DY, DPR, SIZE, GROWTH)

The value of R^2 shows that the independent variable causes 31% variability in dependent variable which means that the independent variable chosen for the study have low impact on dependent variable; more number of determinants should be taken into consideration to know the impact on other control variables.

TABLE 1.3: ANOVA

Model	Sum of Squares	DF	Mean Square	F	Sig.
Regression	3.827	6	.638	10.791	.000 ^a
Residual	8.452	143	.059	-	-
Total	12.278	149	-	-	-

For the analysis PV is considered as dependent variable and independent variable are dividend yield, dividend payout ratio, size, growth, leverage and earning volatility. The sum of square regressed is 3.827, degree of freedom is 6; mean square is 0.638 and f value is 10.791. The residual sum of square is 8.452, degree of freedom is 143 and mean square is 0.059. The significance of both the variable is 0.000 which is clear that, there is no significant association between stock price volatility and dividend yield and also there is no significant association between stock price volatility and dividend payout ratio.

TABLE 1.4: RESULTS OF MULTIPLE REGRESSION MODEL

Model	Coefficients	Standard Error	t-stat	Sig.
(Constant)	.380	.032	11.752	.000
DY	.088	.011	8.055	.000
DPR	-.001	.001	-2.232	.027

(Table.1.4 Results of regression based on $SPV = A1 + ADY2 + ADPR3 + \epsilon$)

The above Table.1.4 represents results of regression based on equation. In this stage Price volatility is regressed on DY and DPR. The results of this regression show that SPV and DY have no significant association. It is exactly as hypothesizes. The association between SPV and DPR is negative but it is not significant. In the next stage, regression model was expanded by adding controls variables and regression is regressed based on equation. There is no significant association between SPV and DY it remains constant. Moreover, there is negative association between SPV and DPR but it is not significant. As Table 1.5 shows, there is also a significant negative association between SPV and Size. On the other hand, the remaining variables have less impact on SPV

TABLE 1.5

Model	Coefficients	Standard Error	t-stat	Sig.
(Constant)	.376	.056	6.742	.000
DY	.086	.011	7.799	.000
DPR	-.001	.001	-1.569	.119
SIZE	-2.487	.000	-.016	.988
GROWTH	.000	.000	-.938	.350
LEVERAGE	.007	.008	.838	.404
EV	.000	.001	.561	.576

(Table.1.5 Results of regression based on $SPV = A1 + ADY2 + ADPR3 + AS4 + AG5 + AL6 + AEV7 + \epsilon$)

CONCLUSION

The objective of the study is to examine the impact of firms' dividend policy and dividend payout ratio on the share price of the sensex companies. The study covers the period for 5 years from 2011-2015. The empirical study suggests there is no significant association between a SPV and DY. It is exactly as hypothesizes. The association between SPV and DPR is negative but it is not significant, there is a negative relationship between the payout ratio of a firm and the volatility of its stock price and a weak positive relationship between dividend yield and the volatility of stock price. This is consistent with the findings of Allen and Rachim (1996). But the payout ratio is contrary to the findings of Baskin (1989). The results generally suggest that the high rate of payout ratio leads to lower volatility in the share price. The DPR is a main determinant of volatility. Among the control variables, Size had a very low positive relationship with price volatility, suggesting that the larger the firm, the less the stock volatile. The growth, leverage and earning volatility has less impact towards volatility. The time period considered for the study is 5 years and study is limited to sensex companies (30 companies) hence this can be added as the limitation of the study. Further research could be done to increase the time span which will incorporate other variables.

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