The Performance of Firms Post Dividend Announcement: A Test of Signaling Hypothesis Validity in Malaysian Stock Market

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Abstract**—**The argument of what increased dividend announcement is attempting to convey, is still alive. This conceptual paper aims to shed the light on this argument in Malaysian context. Among the different hypotheses; signaling hypothesis and maturity hypothesis which explain the information content of dividend, such explanation found to be inconclusive when different markets are under consideration. Accordingly, Malaysia as an advanced emerging country with distinctive stock market characteristics lacks the sufficient work in this regard. The few traced works in Malaysia were having either methodological downsides in explaining what increased dividend aim to convey or they were adopting the market price reaction as an indicator to test the different dividend information content hypotheses, this research differently highlight the post performance after dividend announcement as suitable indictor for testing the validity of signaling hypotheses vs. maturity hypothesis.

Keywords**—**dividends, signaling hypothesis, maturity hypothesis, post performance, market price

I. Introduction

THE argument of what increased dividend announcement is trying to convey, is still alive. Lintner in 1956 has explained that an increased dividend announcement is a sign of increased earnings. Later, in 1961 made the proposition such as if imperfect market hypothesis exists then the increased dividend conveys information about the future earnings.

In 1980's the information content of dividend has been highlighted in several scholars' works, as [1], and Miller and [2] supported the information content of dividend , in terms of that the substantial increased dividend announcement by firms convey information, since there is asymmetry information . It is further elaborated by these scholars that increased dividend announcement reflects or provides a signal about the future earnings of firms, thereafter; the development of signalling hypothesis was emerged.

The researchers are currently doing DBA at Multimedia University in Malaysia, their area of researches focus on capital market performance, dividends policy and other behavioural financial aspects.

The validity of signalling hypothesis is examined in the literature through two dimensions, namely; the share price reaction upon dividend changes announcement and through the expected improved performance of firms [3].

It would be expected as suggested by signalling hypothesis that the share price will react positively to the increased dividend announcement due to future earnings signal and there will be noticeable improvement of firms' performance post increased dividend announcement. However, the empirical results are found to be contradictory to the signalling hypothesis claim.

With regard of positive share price reaction upon increased dividend announcement, [4] and [5] empirically found that the increased dividend announcement has a positive reaction on the share price due to the expected future earnings. The implications of these findings support the claim of signaling hypothesis.

On the other hand, [6] challenged the validity of signaling hypothesis, as their empirical finding found that the share price reaction upon dividend increased is not due to the potential future earnings, but such a share price reaction is related with the reduced risk upon dividend increased announcement.

Apart from the share price reaction and the increased dividend announcement, different scholars have provided contradictory point of views on the validity of the increased dividend announcement to be an informative signal for future improved firms' performance; future profitability is one indicator of improved performance.

The work of Benartzi, Michealy and Thaler (BMT hereafter) in 1997 on the listed companies of NYSE stock exchange, reached to a conclusion that the increased dividend announcement does not necessarily indicate that the potential future profitability is guaranteed, such finding implies that the increased dividend announcement is incorrect to convey the prospect of future earnings.

After four years, the empirical study conducted by [7] have challenged the findings of [8], based on the judgement of signalling hypothesis validity. [7]'s finding confirmed that the dividend increased announcement is a signal for the prospective future earnings that implies the signalling hypothesis is alive. [7] Attributed the wrong judgement made by BMT (1997), is due to an improper methodology were

followed, such as an inappropriate control of elements influence the profitability.

In line with the findings of [7] and [6] observed that post increased dividend announcement, certain firms have experienced reduction of performance in terms of profitability and capital expenditure. They argued if a signaling hypothesis is to be valid, it would be expected that firms' performance will be improved. Therefore, their finding concluded that increased dividend announcement convey other information rather than future earnings.

Subsequent to [6] findings, they have justified that the maturity hypothesis is better to explain the information content of increased dividend announcement, on contrary of the explanation of the increased dividend announcement information content provided by signaling hypothesis. Maturity hypothesis explains the increased dividend announcement as an indication of firms is shifting from the higher growth stage to the maturity stage (lower growth stage) in the life cycle. This entails declining in the profitability and capital expenditure; hence, management will be left with excess free cash flow that ultimately will be paid in a form of increased dividend.

Other scholars view the increased dividend announcement does not convey future earnings either. Instead, such increasing in dividend announcement is used as mechanism to mitigate the agency cost arises between management and investors.

Accordingly, the free cash flow hypothesis was developed by [9] which explains that investors are favoring the increased announced dividends, as such increasing of dividends will reduce the free cash flow available within the management (limiting the overinvestment). The implication of free cash flow hypothesis will indicate that management will announce the excess free cash flow as dividend due to the lack of positive NPV projects to invest in, which indicates firms is in maturity phase life cycle.

[4] focused on Japenesse firms to test the free cash flow hypothesis, their study revealed that the rational behind changes in the dividend announcement is not for controlling the overinsetment issue, however, dividend changes is a valuable information about the earnings prospects of Japanesse firms under the study. This indicates that niether maturity hypothesis nor the free cashflow hypothesises are valid in japnesse context.

Based on the aforementioned argumentative empirical findings, it is noticed that the scholars have extreme directions, either by supporting the claim of signaling hypothesis or the claims provided by maturity and free cash flow hypothesizes to explain the increased dividend information content. This implies that there is no unanimity on what increased dividend announcement convey.

Additionally, the aforementioned argumentative discussion with regard of what dividend announcement convey is based on the developed countries' perspectives, that each may has its own particularity to support one hypothesis claim over the other one.

Differently, the current work will shed the light on the Malaysian stock market, as the Malaysian stock market operates in an advanced emerging country, which is expected to possess different policies and characteristics from the developed countries' stock market. One important characteristics of Malaysian stock market is the ownership concentration, as the owners of the stock participate in the management, which implicitly indicates that the agency problem as explained by cash free flow hypothesis may not be prevalent in the Malaysian stock market.

The choice of conducting the study on Malaysian stock market is motivated by the lack of sufficient empirical findings on what increased dividend convey in emerging countries; more specifically into the Malaysian context. A very few empirical researches in Malaysian context address the issue of the information content of dividend changes; nevertheless, they solely measured the market reaction as criteria of testing the signaling and cash flow hypotheses, none of the academic researchers in Malaysia have tested the maturity hypothesis, nor the researchers in Malaysia have used the post performance dividend announcement as criteria to test the validities of the hypotheses.

Accordingly, this paper is formulated to respond to the following research problem; to what extent increased dividend announcement is valuable information about the future earnings in Malaysian stock market (signaling hypothesis)? Is the maturity hypothesis better explains the increased dividend announcement in Malaysian stock market? Or both hypotheses are likely to coexist with each others to explain the increased dividend announcement in the Malaysian stock market, despite the argument of relying on certain extreme direction of the proposed hypotheses?

The fundamental objective of this paper is to measure the post dividend announcement firms' performance, as to decide on the validity of signaling hypothesis exists (if any) in the Malaysian stock market. Ultimately, there will be a reached conclusion on what increased dividend announcement try to convey from Malaysian perspective.

The significance of investigating on what increased dividend convey, lies in informing investors about the Malaysian listed companies life cycle stage, either maturity stage or growth stage , it might be even consists of both stages. Such determining of life cycle stage will be effective in informing about the risks involved when trading on Malaysian stock market.

On the other hand investigating on what increased dividend convey, allows managers to critically examine and match their motivation behind dividend increase with the finding that will be concluded in this work.

II. Literature Review

Information Content of the Dividend changes in Malaysian Stock Market

The studies conducted on the information content of dividend changes in Malaysia are considered to be few, moreover, these studies are considered to be insufficient in explaining what an increased dividend conveys.

The work of [10] attempted to investigate the relationship between earnings and dividends for listed companies in Kuala lumpur Stock Exchange (KLSE). The finding of their work has resulted in concluding that there is a significant relation between the amount of current earnings and dividend changes,

whereby the past dividends also influence the decision of dividend declaration. Their conclusion is just merely supporting the Lintner claim proposed in 1956.

On the other hand, [11] investigated the reaction of the stock price for the listed companies in KLSE with regard of different announcement of dividends. Their finding approved that a decrease (increase) of dividend announcement entails a decrease (increase) in the stock prices. Nevertheless, such finding is a merely indication of whether the dividend changes have information content or not.

Additionally the work of [10] used the market adjusted return, to determine whether there is abnormal return associated with dividend changes in KLSE. Their work concluded that an increase in dividends will entail a positive abnormal return; however, the dividends decrease did not entail a negative abnormal return. The reached conclusion is that the positive reaction of stock prices as response of dividend increase is a verification of signalling hypothesis and free cash flow hypothesis. From the aforementioned discussion based on the authors' findings' in KLSE, it is obvious that there were no sufficient elaboration on what increased dividends convey, such as the work [11] & [12].

Though the work of [10] is an exceptional, as it discussed what dividend changes convey. Nevertheless, the flaw in [10] work stemmed from the absence of an appropriate test to distinguish between the signalling hypothesis and free cash flow hypothesis, since the market positive price reaction were used as an indicator to validate the cash free hypothesis.

Differently ,[13] tested three different hypothesis to investigate on what dividend changes convey, the hypotheses were tested are; the signaling hypothesis, the clientele dividend hypothesis and free cash flow hypothesis. The regression model used three different indicators to test the valid hypothesis; the growth opportunities measure to test the free cash flow hypothesis, dividend yield measure to test the clientele dividend hypothesis and the unexpected dividends change measure to test the signalling hypothesis.

The three measures were regressed against the cumulated abnormal rate of return of stock price (CAR). Their study found there was appositive significant relation between the CAR and unexpected dividends change, an increase (decrease) of unexpected dividends resulted in increase (decrease) in CAR, which implies that KLSEs' investors use dividend changes as a signal for companies' future earnings.

Besides, the study resulted in significant negative relation between the growth opportunities that is measured through Tobin's Q and CAR, which indicates that the lower growth opportunities of firms led to a higher CAR, as KLSE's investors view the companies in KLSE don't overinvest in negative net present value project, instead at lower growth investors view managers paying that excess free cash flow as dividends, that is reflected by a higher stock price reaction.

The early discussed literature regarding the dividend changes information content in Malaysia such as; [10], [11], [12] and [13] have common indicator as there were a focuse on the market reaction to investigate the information content of dividend changes.

Though [13] considered to be more in depth, as it tested the validity of signaling hypothesis , clientele dividend hypothesis and cash free flow hypothesis, nevertheless, the market reaction was the indicator to validate the proposed tests. Additionally, the provided empirical findings in Malaysia have focused on the dividend changes in terms of increasing (decreasing) dividends.

Ironically, [14] conducted a study in Malaysian stock market, to test the relevancy of the signalling dividend hypothesis, whereby the authors in their study solely focused on the firms who have significant announcement of increased dividends throughout the selected years of study. Though the current work resembles the work of [15] in utilising the criteria of the increased dividend announcement, nevertheless, the work of [15] used the event study methodology to determine the average cumulated abnormal return, that determine if there is a statistical difference between the actual and the required return, thereafter, judge whether increased dividend has information content.

It is observed that the work of [14] has to some extent failed in determining what increased dividend announcement convey, due to the choice of limited methodology such as the use of t-statistical test and event methodology. The authors have concluded that increased dividend announcement carries positive information; therefore, positive market reaction was entailed. But it would be a logic wondering regards [14] work, such as to what extent that increased dividend is confirmed to be a signal for future earnings, additional test or different methodology shouldn't be applied? To judge on the dividend signalling hypothesis validity?

Accordingly the current work extends the existed literature in Malaysian context, by utilising the post announcement firms' characteristics' or performances as the basis to validate the proposed tests, instead of market reaction. Moreover the current work extends the literature in Malaysian context by relying on the increased dividends, instead of relying on the dividend changes (increase and decrease).

The underlying reasons on substituting the market reaction by selecting the post announcement characteristics of firms as an indicator, to examine the validity of signalling hypothesis could be attributed to; the failure of market reaction as an indicator to represent the truthfulness of the signal, as the stock price will be bid up or down according to the investors' reactions and behaviours, but how likely is the signal will be true, this has lead to measure the post announcement characteristics of firms to judge on the truthfulness of the signalling hypothesis, whether firms have increased dividend and noticeably post dividend announcement have achieved the signalled future earnings, (Comparing performance pre and post dividend announcement).

Performance Measures Post Dividend Announcement

[8] Identified the performance measures as the future profitability, to test the dividend signalling hypothesis, as it would be expected that the earnings will be increased post dividend announcement as stated in dividend signalling hypothesis.

Further, [8] operationalized the future profitability changes, by observing the return on asset (ROA), level of ROA and the dividend payout ratio. It is indicated that higher ROA associated with declining in dividend payout ratio post dividend announcement is confirmation of signalling

hypothesis of dividends. Nevertheless, [8] did not consider the systematic risk changes as characteristics of firms post dividend announcement, to differentiate between the valid hypotheses. [16] Considered the change in the systematic risk as indication of judging on the valid test. It is likely that firms who expose to decline in the risk while paying increased dividends are at maturity stage. [16] In this essence identified three factors to measure the systematic risk; three-factor model, debt ratings, and financial leverage.

Exceptionally, the study of [6] combined the measure of systematic risk and the future earnings, addtionally, the capital expenditure changes were used as a measure to judge on the valide proposed hypotheses.

Differently, the study conducted by [5] focused on post announcement performance in terms of cash flow return on assets, in contrast to the other dividend literature that examined the earnings performance represented by the return on assets (ROA). The cash flow return on asset measure (CFROA) is preferred over earnings because it is less likely to be manipulated than ROA. In addition, the CFROA is not sensitive to capital structure changes.

III. Conclusion

To conclude, the Malaysian stock market requires further investigation regards the information content of dividend, this achieved through proper understanding of the underlying objectives of companies paying an increased dividend. As Malaysian stock market is an emerging market operates in developing countries, it is likely to expect different underlying objectives of paying increased dividends relative to the advanced stock markets in developed countries.

The testing of the dividends signaling hypothesis and maturity hypothesis is based on post performance analysis of firms' characteristics' in Malaysia. Investigating what increased dividends convey have been done in Malaysia through observing market reaction, though these works were not sufficient as discussed earlier.

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