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The wealth effects of dividend announcements on bondholders: New evidence from the over-the-counter market



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ABSTRACT

This paper investigates the announcement effect of dividend changes on bondholders using bond transaction data from the over-the-counter market. Abnormal bond returns over a three-day event window are positive surrounding dividend increase announcements and negative surrounding dividend omission announcements. The bond market reaction to the dividend increases is more positive for larger dividend increases, speculative grade bonds and the period from 2008 to 2010. Most of the results are consistent with the signaling hypothesis. Additionally, bond market reactions to dividend decreases and initiations are insignificant. The stock market reacts negatively to dividend decreases and positively to dividend initiations. The bond and stock market reactions to dividend decreases and initiations suggest that there is also a wealth transfer effect.

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1. Introduction

This study examines the bond price response to dividend increases, decreases, initiations, and omissions and how this response varies with bond, firm, and market characteristics. It is well established that dividend increases (decreases) or initiations (omissions) are associated with positive (negative) stock returns on average (Asquith & Mullins, 1983; Grullon, Michaely & Swaminathan, 2002; Healy

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& Palepu, 1988). The main explanation of this stock price response is the *signaling hypothesis* – that dividend increases signal management is confident future earnings will be strong enough to continue paying the higher dividends in the future while dividend cuts signal management's expectations of lower future earnings. To the extent that dividend increases (decreases) signal increases (decreases) in future earnings, bond prices should also react positively (negatively) to dividend increases (decreases). On the other hand, a dividend increase means that there is less cash to service debt, possibly increasing the likelihood of default. As Admati and Fama state, "A dollar paid out to shareholders through either dividends or share repurchases is a dollar that would not be accessible to creditors in a situation of financial distress."¹ This *wealth transfer hypothesis* suggests a negative bond price response to dividend increases and positive response to decreases. So, the question about how bondholders react to dividend changes is a matter of empirical investigation. Since both the signaling and wealth transfer hypotheses predict a positive (negative) stock market response to dividend increases (decreases) or initiations (omissions), it is impossible to distinguish between the two hypotheses with stock market data. An investigation of the impact of dividend announcements on the bond market can help distinguish between the two hypotheses since they have opposite predictions for the bond market. I test the sign of the bond price response to dividend increases, decreases, initiations, and omissions using the comprehensive data on over-the-counter (OTC) bond trades now available through the Trade Reporting and Compliance Engine (TRACE).

I also examine the determinants of bond price reactions to dividend announcements. For instance, news indicating that earnings will likely increase or decrease in the future should be more relevant to speculative grade bonds than for investment grade where the chance of default is remote. Hence, the signaling hypothesis implies a stronger positive (negative) reaction for speculative grade bonds to dividend increases (decreases). However, the reduction or increase in assets available to service debt should also be more relevant to lower grade bonds. As a result, the wealth transfer hypothesis suggests a stronger negative (positive) reaction of speculative grade bonds to dividend increases (decreases) than investment grade bonds. Therefore, I investigate how bond price reactions differ for speculative and investment grade bond bonds surrounding dividend change announcements.

There has been a large body of literature examining the information implications of dividend announcements on stock prices, firms' subsequent operating performance, and analysts' earnings forecasts. Evidence suggests that dividend increases (decreases) or initiations (omissions) are associated with positive (negative) stock returns on average. Studies on firms' subsequent operating performance changes after dividend changes provide mixed evidence. Nissim and Ziv (2001) and Skinner and Soltes (2011) show that dividend changes are followed by subsequent operating performance changes in the same direction. In contrast, Grullon, Michaely, Benartzi, and Thaler (2005), Healy and Palepu (1988), and Jensen, Lundstrum, and Miller (2010) document an increase in earnings in the years following the dividend decreases. Last, empirical studies show that dividend changes are followed by revisions in analysts' earnings forecasts in the same direction (Ofer & Siegel, 1987; Officer, 2011).

However, empirical evidence on the impact of dividend change announcements on bondholders is surprisingly scarce and inconclusive. Three previous studies have examined competing dividend announcement hypotheses: wealth transfer versus signaling. Woolridge (1983) and Handjinicolaou and Kalay (1984) provide evidence supporting the signaling hypothesis. On the contrary, Dhillon and Johnson (1994) find evidence for the wealth transfer hypothesis. The contradictory conclusions of these papers can be attributed to historical deficiencies in the quality and availability of bond price data. Prior to the introduction of TRACE data, researchers were forced to collect data by hand. This exhaustive data collection led to small sample sizes that focused on heavily traded bonds. These studies employ data on bond trades from the NYSE, which is a small, odd-lot market marked by infrequent trading that stands in contrast to the institutional nature of over-the-counter (OTC) trading in the corporate bond market. This paper improves on prior work by employing comprehensive data on OTC corporate bond transactions from TRACE, which provides greater precision and accuracy in estimating bond market price reactions to dividend announcements. By the end of January 2005, the transaction data in TRACE, which accounts for 99% of trades equaling 95% of market value, were published in

¹ <http://www.ft.com/intl/cms/s/0/44540816-38f7-11e0-b0f6-00144feabdc0.html#axzz3lxUc5Q0>.

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