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Dividend initiations, increases and idiosyncratic volatility

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ABSTRACT

We examine three aspects of the relation between dividend initiation and increase announcements and idiosyncratic volatility. First, consistent with dividend signaling, we find that firms with higher levels of idiosyncratic volatility are associated with higher announcement abnormal returns when initiating or increasing dividends. Second, firms on average experience an ex post reduction in idiosyncratic volatility following dividend initiations that is associated with announcement and long-term abnormal returns. Finally, high idiosyncratic volatility firms are associated with stronger positive post event return drift.

1. Introduction

We conduct a comprehensive analysis of the link between dividend initiations and increases and firm idiosyncratic volatility in U.S. firms over the period 1963–2013. Our theoretical motivation is based on the long established dividend signaling literature and on Eades (1982) in particular. While dividend announcements and idiosyncratic volatility have received some attention with respect to determinants of payout policy, considerably less is known about the relation between dividend events and idiosyncratic volatility in the context of abnormal returns as well as ex post volatility changes.

In order to better understand the link between idiosyncratic volatility and dividend initiations and increases, we examine three aspects of the relation. First, we provide evidence on the link between idiosyncratic volatility and the market reaction to dividend initiations and increases, which builds on the model of Eades (1982). This analysis relates to the dividend signaling hypothesis. The literature has thoroughly examined the dividend signaling hypothesis, yet controversy remains about whether it holds empirically. Dividend signaling suggests that firms with higher levels of information asymmetry would be able to reduce such asymmetry through dividends (Modigliani and Miller, 1961). However, the literature has documented that such firms are less likely to pay dividends (Li and Zhao, 2008), suggesting the signaling hypothesis does not hold. We introduce firm idiosyncratic volatility as an information asymmetry proxy in the context of dividend changes. While high idiosyncratic volatility firms have been found to be less likely to pay dividends (Hoberg and Prabhala, 2009), little is known about the market reaction to dividends from such firms. In short, even though high information asymmetry and idiosyncratic volatility firms are less likely to pay dividends, a stronger positive reaction to dividend changes by such firms would be consistent with the signaling hypothesis. Our results indeed indicate a strong positive link between dividend initiation and increase announcements and idiosyncratic volatility. Further, our results suggest that idiosyncratic volatility, and not systematic risk, drives the market response to dividends.

Second, we examine the changes in idiosyncratic volatility following dividend initiations and increases and their link to announcement returns. Grullon et al. (2002) find that systematic risk, as measured using the Fama-French three-factor model,

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declines in the three years following dividend increases. Similarly, Venkatesh (1989) finds that total volatility (i.e., standard deviation of daily returns) declines following dividend initiations. Dyl and Weigand (1998) find similar evidence and also establish a positive link between volatility decline and announcement returns for dividend initiations. However, we are the first to our knowledge to directly examine idiosyncratic volatility in this context. Using the definition of idiosyncratic volatility from Hoberg and Prabhala (2009) (i.e., standard deviation of residuals from daily market model), we find that idiosyncratic volatility declines following dividend initiations. We find similar results for dividend increases, but only when restricting the sample to large (i.e., >12.5%) increases to dividends. Additionally, we find that firms with ex post declines in idiosyncratic volatility are associated with stronger positive abnormal returns at the time of announcement for dividend initiations which is counter to signaling. Our results differ from prior literature in that we find that it is idiosyncratic volatility changes, not systematic risk changes that best explain market reactions to dividends.

Third, we test the degree to which idiosyncratic volatility and other information asymmetry proxies are related to the positive return drift documented by Michaely and Thaler (1995) and Benartzi et al. (1997). If one source of the drift is information asymmetry (i.e., difficult to measure the impact of an event at announcement for relatively high asymmetry firms), we would expect relatively stronger longer-term abnormal returns for firms with high information asymmetry. Consistent with this explanation, we find that firms with above median levels of idiosyncratic volatility show between five and ten times the magnitude of positive drift in one and three-year long-term event studies for dividend initiations and increases. The results are similar for firm size and bid-ask spread which are our other information asymmetry proxies. Finally, we find that dividend event firms that realize ex post reductions in idiosyncratic volatility show much stronger positive long-term abnormal returns than firms with increases in idiosyncratic volatility.

Our results regarding idiosyncratic volatility hold when controlling for other information asymmetry measures as well as a host of firm variables identified by the literature as related to payout policy. The results for other information asymmetry measures, namely firm size and bid-ask spread, confirm that information asymmetry is related to announcement abnormal returns and long-term abnormal returns.

Our results add to the literature on dividend signaling. While firms with high information asymmetry have been found to be less likely to pay dividends, we find that when such firms do pay, the signal is quite strong. Our results are also related to the literature on idiosyncratic volatility. Consistent with Ang et al. (2006) who document a negative relation between idiosyncratic risk and return, we find that firms with reductions in idiosyncratic volatility show relatively stronger positive long-term abnormal returns following the dividend announcement.

The rest of our paper is organized as follows. Section 2 presents the literature review and theoretical motivation. Section 3 presents our data and methodology. Section 4 presents our results, and Section 5 concludes.

2. Literature review and theoretical motivation

2.1. Dividend signaling literature

Dividend signaling theory is established by Modigliani and Miller (1961). They show that payout policy does not affect shareholder value and therefore conclude that payout policy is irrelevant. However, they recognize that changes in dividend policy are accompanied by abnormal returns surrounding the announcement date. They suggest that the information content of dividends may explain the result. Specifically, they argue that markets respond to changes in dividends because investors interpret the change in payout as a signal of information about firm value. This paper along with Lintner (1956) and Miller and Modigliani (1958) laid the foundations for dividend signaling theory. Dividend signaling theory suggests that there is asymmetric information between inside managers and outside investors. To resolve the difference in information sets, managers take actions to signal information to investors. Dividends are viewed as a signal of firm stability, health, and as an indication of relatively predictable future earnings.

Bhattacharya (1979) shows that dividends represent costly signals. If a signal has no related cost then it may not be credible. John and Williams (1985) show that there is a theoretical signaling equilibrium for taxable dividends. This is driven by asymmetric information between insiders and outsiders. Miller and Rock (1985) provide a framework where inside managers know more about the firm and its prospects than outside investors. Ambarish et al. (1987) provide a model where firms signal with both dividend and investment decisions.

Dividend signaling is usually linked to signals about future earnings. Healy and Palepu (1988) show that earnings changes precede and follow dividend changes. They further show that dividends forecast future earnings changes. DeAngelo et al. (1992) show that dividend policy has information content. They show reduced dividends improve the ability of current earnings to predict future earnings.

In addition to the evidence that firms signal future earnings with dividends, there is considerable evidence that firms use dividend changes to signal other attributes as well. Asquith and Mullins (1986) compare dividends, stock repurchases, and equity issues as communicators of firm value. They argue that dividends are credible signals and asymmetric information leads to signaling. Yoon and Starks (1995) show that dividend increases lead to capital expenditure increases. Dividend changes are associated with revisions in analyst earnings forecasts. Guay and Harford (2000); Jagannathan et al. (2000) and Lee and Rui (2007) show that dividends are related to permanent cash flows and repurchases to nonpermanent cash flows (see also Lee, 1996). The market interprets the payout action as a way to update opinions on cash flows. Nissim and Ziv (2001) show dividend changes provide