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THE DIVIDEND DISAPPEARING PHENOMENON – A THEORETICAL APPROACH

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***Abstract:** Explaining dividend policy has been a challenge for economists. Even after decades of study, we cannot say that there were identified and understood all the complex factors involved in this initiative. In this context, however, research has brought into attention a phenomenon, not so new, according to other opinions, the disappearance of dividends. This paper addresses this issue theoretically, in terms of research results centralized for a better understanding of a controversial phenomenon. The different opinions identified confirm, once again, that dividends remain an open issue, in their both forms of manifestation: appearance and disappearance.*

***Keywords:** dividend policy, disappearing dividends, clientele theory, catering theory of dividends*

1. INTRODUCTION

Without trying to be an exhaustive approach, this paper aims to identify and bring into attention the results of specialized studies carried out on a relatively controversial phenomenon: the disappearance of dividends. Dividends, as a separate issue have been a subject upon which many and different opinions were expressed. The phenomenon of their disappearance, analyzed in terms of causes, becomes more interesting.

The paper begins with identifying the first observations in the literature about the disappearance of dividends and continues to address relevant and recent results on the studied subject. We respect a temporal coordinate, in order to better understand this phenomenon.

2. THE FIRST OBSERVERS OF THE DIVIDENDS DISAPPEARING PHENOMENON

A controversial study of Fama and French (2001) brought to light a problem, stated before in the media and in the literature: the disappearance of dividends. According to the analysis, the authors identified a lower importance of dividends, as a signal instrument and thus the possibility of eliminating them. They found a major decline in the number of non-financial companies paying dividends and in the actual amount of them. The main identified causes were the decrease in the number of public owned companies and the weakening propensity to pay dividends, in general. Based on these considerations, researchers have established the disappearance of dividends as a real phenomenon.

DeAngelo et al. (2004) responded to the research conducted by Fama and French (2001), based on concrete data: although the number of industrial firms who provided dividends decreased by 50% (a reduction of approximately 1.000 companies), in the last 20-25 years, the aggregate amount of dividends, both in nominal and real terms, between 1987 and 2000, grew by 224.6% overall, with 22.7% in the studied sample. The authors offered two reasons for this paradox: (1) the dividend paying companies that have disappeared from the stock exchange were most of them small and (2) dividends were increased by the major big companies, almost simultaneously. By default, results supported the existence of a high concentration of dividends in a few large firms.

In these circumstances, a new issue appeared - the truthfulness of two important theories: *the dividend clientele effect theory* and *the signaling theory*. The first theory is based on the heterogeneity assumption of dividend policy, to which investors respond by holding or not a certain stock. Given that, between 1996 and 2000, many non-paying dividend companies registered losses. Under these conditions, researchers asked to what extent market offered investors the opportunity to actually create a portfolio of profitable companies and non-paying dividend ones, at the same time. In other words, under the effect of clientele generated by the dividend policy, there ought to be heterogeneity among large companies that were found in most portfolios, assuming that investors differ in their preference for dividend or not. Reality, however, showed that dividend policy depends to a lesser extent of investors preference.

According to the second theory, in the virtue of signaling capacity, small firms especially, less visible, would be entitled to use dividends in order to communicate positive news to market. The fact that large firms, in a small number but with considerable financial strength, offered dividends and enjoyed a strong promotion, questioned the intention of signaling through dividends.

Grullon and Michaely (2002) also responded to the results of Fama and French, saying that the total payments to shareholders

as dividends or stock repurchases, did not decrease, especially because of the intensification of repurchases.

In order to better understand why companies would give up to dividends, we should understand the motivations for offering them, at a certain moment in time. At this level, once again, researchers opinions are not unanimous. Baker and Wurgler (2002) explained the fluctuation of the decision to pay dividends through catering theory. Using the methodology of Fama and French (2001), authors went more in the past with the study, beginning with 1963 (to 2000) and identified four trends in the evolution of dividends: two ascending ones and two descending ones, all explained by the catering effect. They sustained that dividends tend to disappear when stock prices go up and tend to reappear after a crash of stock prices.

Managers conservatism in setting dividend policy attracted the attention of many researchers, in their attempt to find the cause of reducing dividends. The starting point was the idea that managers are reluctant to change dividend policy [10, 26]. Moreover, because of this conservatism, setting dividends implies a negative relationship between dividends and risk, so a new element was emerging as essential in the dividend decision: risk [6].

The signaling capacity of dividends acts closely related with the market perception of issuer's risk. The decision to reduce dividends was recorded as having a significantly negative effect on investors who correlated the issuer's risk to the capacity of rewarding shareholders. The danger of omitting dividends stated to be greater than that of reducing them. Following the evolution of dividends distributed by 80 companies, listed on the NYSE, from 1980 to 1985, a period marked by substantial losses, DeAngelo and DeAngelo (1990) found that more than half of the companies with debt repayment difficulties applied, mainly, the policy to reduce dividends instead of eliminating them. A sensitive issue appears in terms of dividend behavior: "managers are reluctant to omit dividends more than reducing them" [10]. A complete withdrawal from dividends, after a history of



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distribution, may be a negative signal to the market, that can severely punish stock prices.

Another key element in setting dividend policy was recognized in the company's age [20,24]. As the firm is in a mature phase, the more it is tempted to pay dividends to its shareholders, because is in a relatively safe stage of existence with low risk.

Investors preference for firms that pay or not dividends is another variable in the decision to offer this form of reward. According to some authors, institutional investors are attracted to dividends but not to a special level of them [18]. According to other researchers, individual investors do not prefer companies that pay dividends in a special way, but they choose from them the ones with a higher level of dividends [17]. A relevant study is that of Allen, Bernardo and Welch (2006) who, contrary to catering theory (companies cater to individual sentiments for dividends), support the idea that dividends are used to attract institutional investors, with greater financial strength.

3. RECENT IMPORTANT RESULTS

Recent studies approach the phenomenon of disappearing dividends as a real process explained by some major factors. Vieira (2008) studied this phenomenon on three stock markets, different as size, structure and legal basis (Portuguese, French and British ones), for a period of about 10 years (1992-2002). If on the Portuguese and British markets there was identified a decrease in dividends phenomenon, not the same thing happened on the French stock market. The study concludes that European markets, despite their low value of dividends, have a higher percentage of dividend payers, being representative in this sense the London stock

market. Another result of the study was that companies that provided dividends were among the largest in the French and London stock exchanges and among the most profitable, on the Portuguese and also London markets.

Hoberg and Prabhala (2009) examine the dividend policy of firms listed on NYSE, AMEX and NASDAQ, from 1963 to 2004. The authors conclude that 40% of the dividend reduction phenomenon is explained by increased risk and the disappearance of dividends is not correlated with the companies attempt to meet temporary fads of investors (as opposed to catering theory of Baker and Wurgler). Moreover, they confirm the results obtained by Fama and French (2001), namely that large profitable firms are more tempted to pay dividends than firms with growth potential, less inclined to pay dividends. Profitability, size and total assets are variables that positively influence the decision to increase dividends [21].

Another recent study which approaches the phenomenon of disappearing dividends is that of Guluzar and Bern (2010). They focus their study on the decision to pay dividends for the companies listed on Istanbul Stock Exchange, between 1991 and 2006. The authors identify a decrease in the number of dividend payers and in the dividend net amount, even if in the studied market they did not observe that dividend concentration, as a specificity for major foreign exchanges. Financial crisis (Asian crisis - 1997, Russian crisis - 1998, banking crisis - 2001) are identified as having a significant role in the declined phenomenon of dividends, in the sense of decreasing profitability and therefore increasing risk for companies.

Among all the results, an interesting one is related to the idea that as a company is more profitable, it has a more propensity to

pay dividends, but the decision does not depend of past earnings. Another result is that increasing indebtedness affects the decision to offer dividends, by reducing them, because of the decreased free cash flow [5]. In addition, firms with growth potential choose to pay dividends, apparently a paradoxical result, given the investment needs, but a truthful one, if we consider the attempt to signal confidence to investors [23]. In conclusion, Bern and Guluzar (2010) argue that of all firms with traditional dividend payments, which choose to reduce them, previously faced with declining revenues, increasing debt and decreasing investment potential.

Another relevant study belongs to Chahyadi and Salas (2010), who argue that dividends have been replaced by stock repurchases and that firm characteristics explain 76% of the decrease in the number of dividend payers, between 1978 and 1998 (profitability, growth opportunities, liquidity, debt). The authors conclude also that the tax factor does not significantly influence the firms decision to pay dividends, as previous researches revealed [9, 12, 27]. Another important result is the failure to confirm the theory of catering. Chahyadi and Salas (2010) find no significant relationship between dividend premium and the decrease in the number of dividend payers.

An interesting approach belongs to Fuller and Goldstein (2011), who aim to find out when dividends matter. The analysis targets the dividend paying firms listed on NYSE, AMEX and NASDAQ, during January 1970 - December 2007. The period of analysis is relatively long, about 38 years, with stages of growth and downturn; this is the reason why authors succeed to capture dividends in correlation with the general trend of stock markets, using, as a main tool, the S&P 500 index - for which they record 268 months with positive returns (growing markets) and 188 months with negative returns (markets in regression). They observe that companies with high dividends have higher yields, with 1 and 2%, compared to non-dividend payers, in times of crisis or in bear markets, regardless of size or profitability. Furthermore, investors react differently to the increase, to the decrease

or the maintaining of dividends, in bull markets compared to bear markets, concluding that dividends matter more in declining stock markets [16].

Finally, we bring to attention another paper of interest. The study, belonging to researchers Fatemi and Bildik (2012), performed over 17.106 companies, from 33 countries, between 1985 and 2006, unequivocally concludes that dividends easily disappear. Specifically, the authors identify a sudden drop of them, from 87% to 53%, at a global level and offer, as a main explanation, the increasing use of share buybacks. The last procedure and the seasoned equity offerings allow capital to easily flow from a corporation to another, along a considerable stock market development and sophistication. The authors identify, although in a decreasing stage, a greater propensity to pay dividends for large companies, highly profitable firms and issuers with low growth opportunities. Moreover, there is a variable related to the industry in which issuers act: companies operating in areas such as oil refining, food production, manufacture of electronic materials, production of tobacco, sanitary service are the biggest conservative payers of dividends; of all, more than 75% adopt the practice of offering dividends. Companies that act in mining, oil extraction, medical or business areas pay dividends at a much lower rate, of about 35% [14].

Fatemi and Bildik (2012) identify a decrease not only in the number of dividend paying firms, but also in the actual rate payment among conservative dividend payers. Another important factor identified for the propensity of firms to pay dividends is the country's legal system, common law or civil law. Specifically, the authors note that although the proportion of dividend payers is lower in common law countries, there is a significant decrease in the rate of dividends in civil law countries, given that, simultaneously, in common law countries this rate increased significantly [14]. Due to this phenomenon, along with 1995, the average dividend rate in common law countries was higher than that in the civil law countries. The same researchers confirm the existence of a high concentration



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among dividend paying companies, the most large and profitable ones, a result obtained also by DeAngelo and DeAngelo (2004). Specifically, the dividend concentration exceeds 90% in countries like Denmark, Austria, Netherlands and China, a high level of over 80% being recorded in countries like Belgium, Finland, Norway, Italy and Spain. In contrast, a dividend concentration level of less than 50% was identified in 2006 in USA, Japan, Canada, India and Malaysia [14].

Despite all pessimistic expectations, we consider that the decreasing importance of dividends is a temporary phenomenon, whose explanations could be found in firms characteristics, in the investment environment desires and last but not least in the changes of economic and financial environment.

4. CONCLUSIONS

The paper main objective was to theoretically approach a relatively new phenomenon, the disappearance of dividends, by illustrating some of the most relevant studies on this topic. Dividends, as a decision of the company, relentlessly keeps the mystery and attraction. We cannot say that there have been identified the exact motivations behind their offering or their real effects, deliberately caused or by default. Experts opinions are varied. This is why it is more difficult to understand the motivations of eliminating them, although financial practice experienced periods of decline. Studies have shown that there is a phenomenon of reducing them, but our view is that their disappearance is unlikely to happen, considering that dividends are still an important instrument in the financial sector.

Without claiming to have chosen the most important studies on the approached subject, because we might have omitted other relevant studies, we consider the objective of

this paper achieved by opening a research appetite for a surprising issue.

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