The Impact of Dividend Policy on Share Price Volatility in the Context of Banking Sector of Pakistan

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Abstract

The study has been conducted with a purpose to examine the relationship between dividend policy and share price volatility in the context of banking sector of Pakistan. Sample of 10 banks was selected from Pakistan Stock Exchange through convenient sampling. The panel data of ten banks for three years ranging from 2014-2016 has been used for analysis. Share price volatility (SPV) was used as dependant variable of the study whereas Dividend policy was used as an independent variable. Dividend yield (dy) and dividend payout (dpo) were used as proxy of dividend policy. In order to avoid spurious relationship between dividend policy and share price volatility, growth in assets and assets size were used as fundamental variables. Empirical results of the study revealed significant negative relationship between dividend yield and share price volatility in the context of banking sector of Pakistan, where as dividend payout ratio reflected insignificant relationship with dependant variable of the study. Growth has significant negative relationship with share price volatility and asset size has insignificant relationship with share price volatility.

Keywords: Dividend Policy, Share Price Volatility, Banking Sector, Pakistan

Introduction

Dividend is an important concept of corporate finance. Dividend refers to the cash paid out from the firm's earnings. It is the distribution of cash among the shareholders. If the cash payment is made other than the current or accumulated retained earnings, the term distribution can be used rather than the dividend. There are different forms of dividend (i.e.) cash dividend, extra dividend, special dividend and liquidating dividend. Dividend policy is the time pattern of dividend payout. It is basically the decision of a firm's financial management whether the firm pays out

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large percentage of its earning or small percentage (even zero percentage) and retains the balance earnings. Financial management of a firm can take different positions on dividend payment.

There are two schools of thought about the effect of dividend on firm's value. The first school of thought believes that dividend policy is irrelevant. Miller and Modigliani(1961) were the first ones who presented the concept of irrelevance dividend theory. According to them, there is no effect of dividend policy on capital structure, growth and share prices. The Miller and Modigliani (1961) theory of irrelevance validity is depends upon the assumption that there is no transaction cost and no taxes. But it is a well known fact that these two are the important components of every organized economy and, therefore, one can hardly defend this theory.

The second school of thought, known as relevance school of thought, opines that dividend payment is relevant. This school of thought opposes the irrelevance theory on the assumption of perfect market. They presume that irrelevance theory has been based on unrealistic assumptions of no taxes and transaction cost (as discussed above). These dividend relevance theorists believe that dividend policy affects a firm's growth, value and share prices. This school of thought, led by Gordon (1963), views that investors would prefer dividend as compared to capital gains. The idea is based on an old saying that a bird in the hand is worth than two in bushes. Bird in hand is dividend and two in bushes refer to capital gains. An investor prefers earning today rather than keeps it in the hands of someone else (the firm) and reaping the benefits in future. Some of these theorists favor paying out of low dividend. These theorists argue that this policy should be adopted due to tax effects for individual investor and cost of issue of new stock. However, some theorists, in this school, favor high dividend policy because individual investor aspires for current income (Jordan,(2003).

The above mentioned two schools of thought have also differences of opinions about the retaining of dividend or otherwise. The irrelevant dividend school of thought argues that dividend policy is irrelevant. It means whether a corporation pays dividend or not it does not affect the market value of the firm or its share price. Because investors look the earning from stocks in two different perspectives i.e. dividend and capital gains. If dividend is low then the capital gains will be high and vice versa. An individual investor can create dividend policy for herself/himself by buying the additional shares or sell the current shares. It is called home made dividend policy. It may also be mentioned that the impact of dividend policy on share price volatility has been an important issue in corporate finance for many decades.

Volatility in share price which is used as dependant variable of this study has been the topic of discussion among researchers. The concept has been examined by many researchers from different angles (discussed in detail in Literature Review). Share prices have fluctuation with huge margins in Pakistan, a clear indicator of risk to invest in capital markets of Pakistan.

As discussed above dividend policy is a key variable in share price volatility. There are number of studies conducted on share price volatility in Pakistan, majorly in the context of Karachi Stock Exchange. Now all the Stock Exchanges (i.e., Karachi Stock Exchange, Lahore Stock Exchange and Islamabad Stock Exchange) in Pakistan are being consolidated into one large Stock Exchange i.e. Pakistan Stock Exchange. The new stock exchange has started working from 1st January 2016. This study will probe the impact of dividend policy on share price volatility in the context of banking sector of Pakistan.

This study will investigate the impact of dividend policy on share price volatility by selecting a representative sample through convenient sampling (as explained in methodology section). There are four different independent variables used in this study with share price volatility (SPV) i.e. dividend payout ratio, dividend yield, assets growth and assets size. The first two variables (dividend yield and dividend payout) are dividend policy measures while the later two (assets growth and assets size) are used as control variables to avoid any spurious relationship.

Literature Review

Dividend is the amount of money paid to the shareholders as a profit on their investment in firm's shares. Dividend can be paid in different form like cash dividend, extra dividend, special dividend and liquidating dividend. Dividend policy is the time pattern of dividend payment to stockholders. It is the discretionary power of financial management of the company whether they pay zero dividends or paid out each penny earned by the firm. There are two important schools of thought about i.e. relevant school of thought and irrelevant school of thought. The theorists who plead the case of irrelevant school of thought opine that firm's dividend payment doesn't affect the firm's performance or financial management. Miller and Modigliani (1961)was the effective companion of this school of thought. They viewed that firms with dividend and without dividend are the same, hence reject the role of dividend policy as financial tool. However relevant school of thought theorists are not impressing and convince from the argument presented by the dividend irrelevant theorists. This school of thought led by

(Gordon, 1963; Walter, 1963) argued that firm's dividend policy play an important role in determining the growth, value and prices of the stock.

Volatility in share prices is the topic of discussion in corporate finance since last few decades. According to Kotze (2005), it is upward and downward movement of share prices. Shares prices of any firm have more fluctuation is deemed more volatile. There are many reasons of uncertainty or volatility in the firm's stocks like investor confidence, direct government intervention, booming and bursting bubbles.

In this research study the stance of dividend relevant theorists has been favored because it is hypothesized that dividend policy impact the share price volatility. The impact of dividend policy on share price volatility will be determined in this research endeavor. A case of banking sector of Pakistan is taken into consideration. There are many research studies conducted in Pakistan and abroad on the subject matter, details of which are given below.

Baskin(1989) carried out study to determine the impact of dividend policy on share price volatility in U.S. context. The author found negative impact of dividend yield and dividend payout (used as proxy of dividend policy) on share price volatility. In this research study size, earning volatility and debt as controlled variables. The author has presented four mechanisms of risk and dividend i.e. (duration effect, rate of return effect, arbitrage realization effect and information effect). Duration effect implies that high dividend yield stocks are less sensitive to discounts rates because it involves more near term cash flows. On the other hand rate of return effect suggests that low dividend yield and payout ratio firm may be given more value because it has more investment opportunities. The firm can invest more effectively than an individual investor, which develops expectations about high profit in future from the investment opportunities. If the expectations of investor about profit are not met, it will lead to high share price volatility. Arbitrage realization effect is also mechanism provided by author in the paper which argued that financial market is inefficient materially, which means that mispricing is possible. The investor who knows the mispricing and expected dividend over next period is concerned about the return over next periods. In addition information effect also takes place, which suggests that information transmitted to the capital market through dividend policy of the firm.

Allen and Rachim(1996)replicated the study of Baskin(1989) in the context of Australia. The findings of study revealed that the impact of dividend yield on share price volatility is positive and insignificant which is in contrast of Baskin (1989) results found in the context of United States. However the relationship found between dividend payout and

share price volatility is negative and significant. The study also found negative and significant relationship of share price volatility with assets size where as positive and insignificant relationship detected with assets growth in this study.

Stasescu (2006)also conducted study on dividend policy in Switzerland. The author used the data ranging from 1974-2004 for 175 non-financial and non-utility firms listed in Switzerland. The findings of the study revealed that dividend payment show negative relationship with market-to-book ratio, price volatility, and leverage where as this relationship is positive with profitability and the firm assets size. The results suggest that firm can reduce price volatility by increasing dividend payment. It is also found that high leveraged firm pay less dividend. According to the findings, firms with large assets size and more profit tends to pay more dividends.

Masum (2014) carried out research study on dividend policy and its impact on share prices by analyzing the data of commercial banks listed on Dhaka Stock Exchange. The author examined the impact of dividend policy on share prices by using dividend policy as independent variable where as assets size and assets growth used as fundamental variables. The study findings divulge that dividend yield and profit after taxes have negative relationship while return on equity, retention ratio and earnings per share have positive relationship with dependant variable. The research study found that retention ratio was statistically insignificant where as the rest of the explanatory variables were significant statistically. Adjusted R Square was 0.5344 which implies that exogenous variables used explain about 53% of the variation in share prices

Similar study was conducted by Ramadan(2013)in the context of Jordan. The study analyzed 77 industrial firms listed on Amman Stock Exchange for the period of 12 years from 2000-2011. The study found that dividend policy measures have negative relationship with share price volatility. The study provides useful policy inputs to the policy makers who can get benefit from the findings of this study to stabilize the market.

Ilaboya and Aggreh (2013)also studied the impact of dividend policy on share price volatility. The authors used sample of 26 randomly selected firms from different sector of Nigerian financial markets for analysis by using the data of eight years from 2004-2011. The findings of study revealed that dividend policy measures give mixed result in the form that dividend yield has positive relationship while dividend payout has negative relationship with share price volatility. Moreover, the study also revealed that dividend yield is significant statistically and dividend

payout is statistically insignificant. The authors also used (assets size, earning volatility, debt and assets growth) as fundamental variables. Earning volatility and debt were statistically significant while other two variables were insignificant statistically. Adjusted R Square is (0.157) which postulate that the variables used in the study explain 15.7% of the changes in share price volatility.

Nusrathunnisa and Duraipandian(2015)studied the effect of dividend policy on shareholders wealth in banking sector of India. The sample was selected from Nifty index constituent banks. A sample of 10 banks was selected out of total twelve banks. The author used 12 years data ranging from 2003-2014 for analysis. The study data has been analyzed year wise and bank wise separately. The researchers used six independent variables (Dividend per share, Earning per share, Retention ration, Price earnings ratio, lagged market price per share and lagged price earnings ratio) where as market price per share is used as dependant variable. The study found mixed results related to the impact of dividend policy on shareholders wealth of different banks. However the study arrived at the conclusion that dividend policy is not the only factor that affects the shareholders wealth.

Another similar study was conducted by Khan (2012)on Pharmaceutical Industry of Pakistan by using different exogenous variables i.e. stock dividend(SD), profit after tax (PAT), return on equity (ROE), earning per share(EPS) and retention ratio(RR) with share price volatility as dependent variable. The results of study revealed that retention ratio, profit after taxes and return on equity were statistically insignificant where as stock dividend and earnings per share were significant statistically. The two important independent variables of the study i.e. stock dividend (SD) and earnings per share (EPS) were significant statistically and positively related with share prices. It means increase in the two ratios will decrease the share price volatility. Hence it can be concluded that findings of this research study verify dividend relevance theory.

Iqbal, Ahmad, Ullah, and Abbas (2014)conducted a study on the banking sector of Pakistan which examined the impact of dividend announcements on stock prices. The author used data ranging from 2008-2012 and found that dividend announcement has negative but insignificant relationship with share prices. However, earnings per share have a positive and significant relationship with share prices. The findings of the study divulge that dividend has no effect on share prices in the banking sector of Pakistan which is in line with dividend irrelevance theory. The author used very cranky methodology because it is not very clear whether the study is going to determine the impact of

dividend announcement or dividend policy on share prices. In the same study taxes is also used as dependant variable, so on the basis of that it is very hard to deduce anything from this research study.

Imran(2011) investigated the determinants of dividend payout policy of the engineering sector of Pakistan. The researcher used the data of 36 firms from the engineering sector listed on Karachi Stock Exchange for the period from 1996-2008 and observed that dividend per share has a positive relationship with the previous year dividend, sales growth, profitability, earning per share and assets size of the firm. However, the research found that dividend per share has negative relationship with cash flows. The author used Ordinary least square (OLS), fixed effect model (FEM) and Random effect model (REM) for analysis.

Methodology

In this section the research framework has been developed based on which the method of research was selected and hypotheses were developed. The operational definitions and computation of dependant and independent variables of the underlying study have been established by using standard practices. The details about the methodology used in this study are mentioned below:

Research Philosophy:

In this study, objective ontological approach was followed according to which in Pakistan, there are established rules and regulations for the enlisted companies. Securities and Exchange Commission of Pakistan (SECP) is the regulatory body which governs the affairs of companies listed on Pakistan Stock Exchange. The Board of Directors of the company has discretionary powers to declare dividend or keep it as retained earnings. However, this study is purely quantitative approach which favors the positivist epistemological philosophy i.e. the assumption about the knowledge is external to researcher's perception. In other words, the perception of the researcher cannot influence data fact in any way.

Method

Panel data for three years covering the period from 2014 to 2016has been used. Share price volatility (SPV) is used as dependant variable of the study while dividend yields (dy), dividend payout (dpo), assets growth and assets size are used as exogenous variable of the study. Dividend payout and dividend yield have been used as dividend policy measure while controlling the effect of assets size and assets growth. Sample of ten banks selected through convenience sampling from banking sector of Pakistan have been considered for analysis. The list of banks used for analysis is given in table 1.

Table 1: ***Banks Selected for Analysis***

S.No	NAME OF BANKS
1	SILK BANK
2	BANK AL-ISLAMI
3	NIB BANK
4	ALLIED BANK
5	ESCORT BANK
6	JS BANK
7	UNITED BANK
8	SUMMIT BANK
9	TRUST BANK
10	BANK ALFALAH

The details of variables used are given below:

Share Price Volatility

Share price volatility is a very common term in stock markets. Many experts of financial market present different logical explanation of the term. For example, according to Kotze(2005), volatility is the calculation of the 'share price movement' in capital market. This concept has many dimensions and analyst have looked into it from different perspectives, like Hashemijoo, Ardekani, and Younesi (2012) look at it from the perspective of risk measurement. There are many ways to determine the SPV, however the approach given in equation 1 is used by the analysts most commonly and considered for this study as well. Many researchers used the same method while conducting study to examined the impact of dividend policy on SPV (Baskin, 1989; Hashemijoo et al., 2012; Lashgari & Ahmadi, 2014).This method computes the annual range of highest and lowest prices divided by the average of highest and lowest prices raised to the square and then take the under root of the whole as given in equation 1.

$$PV_{it} = \sqrt{\frac{HP_{it} - LP_{it}}{\left(\frac{HP_{it} + LP_{it}}{2}\right)^2}} \qquad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots(1)$$

PV= Price volatility
HP= Highest Prices
LP= Lowest prices

Dividend Yield (dy):

Dividend yield is one of the dividend policy measures. It can be computed as annual dividend per share divided by the market value per share. It is the most commonly used approach applied to determine the dividend yield ratio. Many researchers have used this approach (Baskin, 1989; Hashemijoo et al., 2012; Hussainey, Mgambe, & Mgbame, 2011; Irfan & Nishat, 2002).Dividend yield formula is given in equation 2.

Dividend Yield = Dividend per share/Market Value per share ……. (2)

Annual dividend per share is usually available in the Annual Financial Report of every company under the 'changes ***in owners' equity***' section. The market value can be computed as the average of low and high share price during the said year (Masum, 2014).

Dividend Payout (dpo):

Dividend payout ratio provides evidence about the company policy that how much money it returns to shareholders as dividend and how much amount of money it keeps as retained earnings. To calculate this ratio, the following formula has been used:

Dividend payout ratio = Dividend per share/ Earning per share …eq. (3)

Many researchers have used the formula given in eq.3for computing dividend payout ratio(Asghar, Shah, Hamid, & Suleman, 2011; Baskin, 1989; Hussainey et al., 2011; Ilaboya & Aggreh, 2013; Irfan & Nishat, 2002; Nazir, Nawaz, Anwar, & Ahmed, 2010; Ramadan, 2013; Rashid & Rahman, 2008).

Assets Growth:

Assets growth can be defined as increase in firm's assets from one period to another period. It can be calculated as change in assets from one period to another period. In this research study the following formula has been used for computing the assets growth.

Growth = At-At-1/At-1 …….. eq. (4)

At= Current Year Assets

At-1= Previous year Assets

Many researchers(Asghar et al., 2011; Baskin, 1989; Hashemijoo et al., 2012; Hussainey et al., 2011)have used the formula given in equation 4.

Assets Size

There are many ways to compute the size of the firm. But the method given in eq.5 has been selected because of its common usage. The total assets of the firm for the years under study have been taken and converted it into log10 in order to avoid the problem of Hetroscedisticity.

Size = Log10 (Total Assets) or Total assets with base 10 logarithm transformation……..eq. (5)

Many researchers used the same formula to calculate the assets size of the firm (Bushra & Mirza, 2015; Imran, 2011; Kamyabi, 2014).

Hypothesis

The following directional hypothesis of study has been developed and tested. The results of which will be discussed in results and conclusion section.

1. There is a negative relationship between dividend policy and share price volatility

2. There is a negative relationship between dividend payout ratio and share price volatility.
3. There is a negative relationship between growth and share price volatility
4. There is a negative relationship between assets size and share price volatility

Regression model

Multiple regression models have been used in this study. Haussmann test has been applied on the panel data set to observe whether random effect model should be used or fixed effect model is the best alternative. The test results favor the use of random effect model in this study. For estimating the parameters, standard OLS regression model given in equation (6) has been used.

$SPV = \beta 0 - \beta 1(dpo) - \beta 2(dy) - \beta 3(growth) - \beta 4(size) + \mu t$……..eq. (6)

Results and conclusions

Pearson correlations amongst variables are given in Table 2.

Table.2 ***Pearson Correlations between variables***

	SPV	dpo	dy	GR	Size
SPV	1.oooo	-.526**	-0.378*	-0.489**	-0.443*
dpo	-0.526**	1.0000	0.642**	0.624**	0.270
dy	-0.378*	0.642**	1.0000	0.376*	0.083
GR	-0.489**	0.624**	0.376*	1.0000	0.692**
Size	-0.443*	0.270	0.083	0.692**	1.0000

Correlation is significant at .01 level **
Correlation is significant at .05 level *

It shows there is negative correlation between share price volatility and dividend payout with a value of -.526 and significant at level of 1%. This Relationship is consistent with the results of Hashemijoo et al., (2012), Baskin (1989) and Allen and Rachim (1996). Share price volatility has negative correlation (-0.378) with dividend yield which is significant at a level 5%. This result is in line with the results of Baskin (1989) and Hashemijoo et al. (2012) while contradicting the results of (Allen & Rachim, 1996).Asset size is negatively correlated with share price volatility as hypothesized. This negative relationship shows that firm with large size is less exposed to volatility in its share prices. Assets growth also showed negative correlation with share price volatility and this relationship is also according to expectation and consistent with study hypotheses. Growth in firm's assets from one period to another depict positive image which may leads to stability in share prices or reduce volatility in share prices of firm. Dividend payout and growth are positively correlated (0.624)

which is significant at 5% whereas growth and assets size are also positively correlated(0.692)at a significance level of 5%. Dividend yield is positively correlated with growth and assets size at value (0.376) and (0.083) respectively; however correlation with growth is significant at 5% and insignificant with assets size. There is positive correlation between dividend yield and dividend payout (0.642) which is significant at level of 1%. This high correlation between these two independent variables signals a problem of multicollinearity. The relationship between dpo and dy is consistent with the results of Hashemijoo et al.(2012).

In order to further validate the findings related to multicollinearity, another technique i.e. Variance Inflation Factor (VIF) has been used. The results of variance inflation factor are given in Table 3.

Table 3: ***Variance Inflation Factor***

Variable	Co-efficient Variance	Uncentered VIF	Centered VIF
C	0.004650	5.7099	NA
dy	1.0015	1.7836	1.3701
dpo	0.0395	2.9173	2.4835
GR	3.88E-10	1.3778	1.3223
Size	0.0012	8.1267	1.9984

The results of VIF show highest value for dpo (2.4835) and lowest value for growth (1.3223) and the average value is 1.7936. If VIF value for any variable is 10 or above means that the issue of multicollinearity exists(Al-Ghazali, 2014). Hence the findings of VIF results revealed that the problem of multicollinearity does not exist.

Regression Analysis

The first equation has been estimated to observe the impact of dividend policy measures on share price volatility. Regression results shown in table 4are based on the equation (1).

SPV= $\alpha+\beta1$ (dy)+ $\beta2$(dpo) +ε …….eq. (1)

Table 4:*Regression Analysis*

Model	Unstandardized Co-efficient		Standardize Co-efficient	t	Sig.
	B	Std. errors	Beta		
Constant	.545	.077		7.119	.00
dy	-.109	.037	-.586	-.927	.007
dpo	.001	.066	.004	.019	.985
R-Square	**0.341**	**Adjusted R-Square**	**.292**		

The result given in table (4) shows that share price volatility (SPV) has negative relationship with dividend yield which is exactly hypothesized and significant at a level of 5%. Dividend payout ratio has

no impact on the SPV as it is insignificant at a level of 5%. Adjusted R-Square of the model is (.292) which implies that independent variables explain 29.2% changes in the dependent variable.

In the next stage of regression analysis, fundamental variables of the study are also included in the model. So the equation of the model will be

SPV= $\alpha+\beta1(dy)+ \beta2(dpo) + \beta3(growth)+ \beta4(assets\ size)+\varepsilon$ ……eq. (2)

Regression results shown in table 5are based on the equation (2).

Table 5: Regression Analysis

Model	**Unstandardized Co-efficient**		**Standardize Co-efficient**	**t**	**Sig.**
	B	Std. errors	Beta		
Constant	.583	.081		7.219	.00
dy	-.111	.043	-.597	-2.59	.016
dpo	-.016	.063	.049	-.256	.80
Growth	-2.129	.989	-.463	-2.153	.041
Assets size	.209	.215	.258	.971	.341
R-Square	**0.454 Adjusted R-Square**		**0.367**		

Results revealed that the relationship of SPV and dividend yield is still negative and significant but the relationship of dividend payout with SPV has changed from positive to negative but statistically insignificant. Assets growth is negatively correlated with share price volatility as hypothesized in this study and also statistically significant at a level of 5%, where as assets size is statistically insignificant at level of 5%. After inclusion of assets growth and assets size variables in the model, Adjusted R-Square raised to 0.367 which means independent variables of the study i.e. (dy, dpo, assets growth and assets size) explain 37.6% changes in share price volatility.

In the next stage of regression analysis, dividend payout ratio is excluded from the study due to its insignificant nature of relationship with share price volatility. The equation of this model will be:

SPV= $\alpha+\beta1(dy) + \beta3(growth)+ \beta4(assets\ size)+\varepsilon$ ……eq. (3)

Regression results shown in table 6are based on the equation (3).

Table 6: Regression Analysis

Model	**Unstandardized Co-efficient**		**Standardize Co-efficient**	**t**	**Sig.**
	B	Std. errors	Beta		
Constant	.541	.073		7.373	.00
Dy	-.096	.036	-.547	-.654	.014
Growth	-2.17	.929	-.522	-.335	.028
Size	.192	.203	.259	.943	.355
R-Square	**0.428 Adjusted R-Square**		**0.357**		

The results show that exclusion of dividend payout ratio from the regression model at this stage has not change the relationship between variables considerably. The dividend yield and growth remained statistically significant and their relationship with share price volatility also remained unchanged i.e. negative. However after the exclusion of dividend payout from analysis, adjusted R-Square changed from 36.7% to 35.7%.

Summary and Conclusions

The study has been conducted to investigate the impact of dividend policy on share price volatility in the context of banking sector of Pakistan. For this purpose ten (10) leading banks listed on Pakistan Stock Exchange were selected through convenience sampling. The impact of dividend yield and dividend payout were determined by using multiple regressions on data ranging from 2014-2016. The study has used two important fundamental variables i.e. assets growth and assets size.

The empirical results of the study contended that dividend yield impact the share price volatility in a negative direction. This relationship is statistically significant. On the other hand the relationship of dividend payout with the share price volatility is insignificant statistically. The result of this study is consistent with the study of Baskin (1989) which elaborated that dividend yield has a robust impact on share price volatility while the results findings are opposing to Allen and Rachim (1996). According to Allen and Rachim (1996),"The duration effect and arbitrage effect suggest that dividend yield and not the payout ratio is the relevant measure of influence of dividend" p. 177.The strong inverse relationship between dividend yield and share price volatility provide evidence of arbitrage pricing effect and duration effect. In this study no evidence was found about the relationship between share price volatility and assets size however there is a strong relationship between growth in assets from one period to another and share price volatility in the context of banking sector of Pakistan. The results of this study are limited to the banking sector only and cannot be replicated to the other sector or markets.

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