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Dividend Puzzle – A Review of Dividend Theories

This paper describes the discussion on divi- dends and dividend theories. The main part of that discussion is related to the evaluation of financial research, because at all times researchers have tried to solve the dividend puzzle by using new theories and insights. There are a number of theories of dividend behaviour, and empirical studies provide little evidence for one over the other.

Historically there has been discussion on why firms pay dividends and whether it affects the market value of the share. Until the 1960s this discussion was divided into two schools of thought: Dividend theoreticians claimed that the market value of the share depends on dividends. On the other hand, earnings theoreticians stated that the market value of the share was not affected by dividends. In the background was studied how managers set their dividends (behavioural models of dividend policy).

Empirically it has been found that the market value of the share and dividends has some kind of interdependence. Dividend theories explained that it was because the value of the share depends on dividends. Earnings theories argued that by dividends managers signal the firm's future earnings (signalling hypothesis). Modigliani-Miller also argued that changes in dividend policy do not affect the value of the firm because only clienteles change but not the value of the firm (clientele hypothesis). In this question researchers were also interested in how dividend announcements and dividends affect share prices (ex-date effects).

The discussion was polarised until the 1970s when the Capital Asset Pricing Model and market efficiency hypothesis gave a new insight into the discussion on corporate finance. Later studies have relaxed the perfect market assumptions and found views on the agency theory, asymmetric information in dividends and wealth transfer hypothesis.

Agency-theory based optimal dividend applications confused the discussion still more. The later discussion on dividends is concentrated on studing the importance of various ways to divide earnings and dividend policies in various situations. Dividends and taxes have been researched all the time. In the latter part of the 1990s the discussion turned back to starting point, relaxing the basic assumptions of the dividend irrelevancy. In fact, it is one way to explain the dilemma between the propositions of Miller-Modigliani and some schools based on empirical results. Latest discussion turned to legal regimes and controlling shareholders. They may also include future research areas.

In dividend decisions, the question is about decision-making and controlling power. The one who affects dividend decisions is doing it from the perspective of his/her own preferences. Controlling the corporation makes also it possible to control dividend decisions. The three groups affected the most by the firm's dividend policy are stockholders, bondholders and managers. Studies so far have researched the relations between each group as a whole. The role of controlling shareholder in different situations requires more research.

Dividend puzzle has remained unexplained over half a century and still we must state: The harder we look at the dividend picture, the more it seems like a puzzle, with pieces that just don't fit together.