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Impact of Dividend Policy on Share Price Volatility: Evidence from Sri Lankan Service Sector

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Abstract

This study aims to examine the relationship between dividend policy and the share price volatility (SPV) of the service sector companies listed on the Colombo Stock Exchange (CSE). The data set used in this research was compiled from financial statements of thirty data observational points of 10 listed service sector companies. After adjusting for firm size, four important variables—asset growth, earning volatility, dividend yield, and dividend payout—have been chosen as the independent variables. The volatility of the stock price has been taken as the dependent variable. The magnitude of the effects was used to examine the relationship between SPV and dividend policy. First, the relationship between SPV, dividend payout ratio (DPR), and dividend yield (DY) is regressed. Second, the relationship between SPV and dividend policy is investigated using firm size as a control variable. In both

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models, the results show a significant positive relationship between a firm's SPV and DY. The dividend payout ratio is significant and positively related to stock price movement. Further, the results revealed that the company size is inversely related to price volatility, implying that the larger the firm, the less volatile the stock price. As a result, the dividend policy influences share price changes in the Colombo stock market. Furthermore, this research sheds light on the process for figuring out what influences stock prices and crucial elements that investors should think about before making investment decisions, as well as management's process for developing dividend policies for their companies, given that both management and investors are concerned about the volatility of the stock price.

Keywords: CSE, Dividend Policy, Share price volatility, Service sector companies

Introduction

One of the hardest problems financial economists have to deal with is explaining dividend policy. Despite years of research, the dividend policy seems more and more like a puzzle with pieces that do not fit together based on the analysis from four decades ago (Black 1976, p. 5). Anyhow, the situation is mostly the same and unchanged. Recent surveys of dividend policy by Allen and Michaely (1995), Rajput and Jhunjhunwala (2019), and Ain and Manping (2022) all concluded that much more empirical and theoretical research on dividends is needed before a consensus can be formed. The listing of dividends supports this assertion as one of the top ten significant unresolved financial problems in a reputable textbook by Brealey and Myers' 2002. Lintner (1956) surveyed business managers to learn how they came up with the dividend policy, which resulted in the first empirical research of dividend policy. Lintner discovered that the management used the current dividend rate as a benchmark. Typically, the management of companies showed a great reluctance to cut payouts. According to Lintner, managers typically have rather clear target payout ratios. Dividends gradually increase at a specific adjustment rate, bringing the actual payout ratio closer to the desired payout ratio.

The "dividend policy" refers to the corporate guidelines that specify how much will be paid out in dividends and how much will be kept back to fund future

investments. This policy deals with how the company allocates its earnings between paying out dividends to shareholders and reinvesting in new business ventures. In light of this, a company's decision to pay dividends becomes an important aspect of financial management. The capital structure is indirectly tied to dividend policy as well, and various dividend policies may call for various capital structures. The decision regarding dividend policy becomes complicated since capital structure and dividend policy both affect the wealth of shareholders and because dividend policy also impacts capital structure. On the other hand, dividends may be viewed favourably from the perspective of shareholders because they tend to raise the present return. However, dividends count as using the company's resources. The payout ratio is defined as the dividend as a proportion of earnings, and the retention ratio a 100% less payout percentage.

According to Nishat and Irfan (2003), and Nguyen et al., (2020), dividend distribution policy may negatively correlate with firm size and asset growth, making it important to understand how it affects the organization's or industry's growth. Additionally, it's conceivable that systematic variations in cost structures, legal constraints, market conditions, and other factors could influence the dividend policy. However, there are different arguments raised by previous scholars. For instance, these factors affect price volatility but dividends do not matter and have no impact on stock price, according to Miller and Modigliani (1961). A company can essentially avoid disbursing payments if there is no influence. However, Gunathilaka (2009) noted that this has not always been the practice of Sri Lankan businesses; some of the businesses disperse their whole earnings while others keep them all. The dividend payments made by Sri Lankan companies are inconsistent, and they have a bad correlation. This study aims to investigate the connection between dividend policy and share price volatility (SPV) in the Sri Lankan stock market. Corporate dividend policy is perplexing and one of the mysteries in corporate finance, according to Haq, Akram, and Ullah (2015). Financial professionals and economists worldwide are currently focused on dividend decisions and stock price volatility issues to determine the relationship between these characteristics. The degree to which a company's dividend policy influences its share price is crucial information for business officials, new investors, and economists trying to understand how the capital market works.

This study's significance lies in its capacity to offer management, investors, policymakers, and financial institutions the background knowledge they need to analyze the relationship between dividend policy measures and share price volatility (SPV). However, it is also crucial to consider the impact of a company's dividend policy on the current price of its shares. This is true for management, which must set the policy, as well as for investors planning portfolios and economists attempting to understand and evaluate how the capital market functions. The relationship between stock market volatility and dividend policy has been extensively studied in developed and developing countries. There are still very limited studies that specifically focus on this topic in regard to the Sri Lankan environment.

There were a few research conducted in Sri Lanka on the impact of dividend payout, earning yield, and dividend yield on stock prices without taking into account the trend in dividend payment by companies listed on the Colombo Stock Exchange (CSE) (Kengatharan, & Ford, 2021; Sugathadasa, 2018; Dissanayake, & Kumari, 2020; Kawhari, 2022; Jayamanna, & Wijesinghe, 2018). This study will solve this deficiency by investigating the company size of dividend policy among the sampled listed companies in the service sector in the Sri Lankan market. The trend estimation reveals the dividend policy on the market share prices of the corporations with dividends per share that control market expansion. By examining the dividend policy trend over three years, this study will fill in any knowledge gaps about service sector companies in Sri Lanka listed on the CSE. Additionally, the researchers of this study are informing business owners about the main variables that cause share price volatility so that they might attempt to regulate those variables and bring about price stability. This study is crucial because it aims to fill a gap in the literature by examining the relationship between dividend policy and stock price volatility while controlling other factors like business size and asset growth. In addition to the research's above aim, specific objectives were covered.

1) Determine the key factors of dividend policies among service sector companies listed in CSE.
2) Evaluate the moderating impact of firm size on the SPV of service sector companies in Sri Lanka.
3) Examine the relationship between dividend payout ratio and price volatility in Sri Lanka's Stock Market.

Literature Review

For more than six decades, corporate dividend policy has been extensively researched. However, no specific conclusion has been reached on this matter thus far. Because dividend policy can affect stock prices, investors and the management board must agree on the best dividend policy. Existing research on dividend policy has been conducted from the standpoint of developed countries. Research in this field is very limited in a developing country like Sri Lanka. The impact of the dividend policy on stock price volatility has been tested early by many researchers (Gordon, 1959; Miller & Modigliani, 1961; Baskin, 1989, Allen & Rachim, 1996). Some theories i.e., irrelevant theory, bird in hand theory, signaling theory, clientele effect theory, and tax preference theory were developed to explain the effect of the dividend policy on stock price volatility. Many scholars have proposed and applied signaling theory by analyzing previous studies conducted on dividend policy on stock price volatility in different countries and contexts.

The signaling theory, proposed in the early 1980s, served as the foundation for another explanation for the popularity of dividend policy. According to signaling theory, or the information content hypothesis, dividend payments carry information, which serves as a signal to investors. Because of the information asymmetry phenomenon, investors always have less information about the company than management, believing that dividends carry the information managers want to convey (Bhattacharya, 1979). Advocates of signaling theories argue that the separation of ownership, combined with the information asymmetry between managers and outside shareholders, allows managers to use dividends to signal private information about a firm's performance to outsiders. Miller and Rock (1985) assert that when a corporation announces dividends, it informs its shareholders of its financial situation and earnings potential. An agency cost argument was proposed by Jensen and Meckling in 1976, contending that dividend payments lower the cost of borrowing and boost a company's cash flow. After paying cash dividends to stockholders, the company's managers would have fewer idle funds to invest in low- or negative-NPV ventures. The claim that dividend payout significantly impacts the firm's share price is therefore supported by signaling theory.

In both developed and developing markets, there is a consistent correlation between dividend yield, dividend payout ratio, and stock price volatility. First, numerous academics have provided the groundwork for future research on dividend policy and stock price volatility in the context of developed countries like the United States, United Kingdom, Australia, etc. The relationship between dividend policy and share price volatility was studied by Hashemijoo et al. (2012) with a focus on consumer product businesses listed on the Malaysian stock market. In addition to six other control variables, including business size, earnings volatility, leverage, debt, and growth, they concentrated on dividend yield and payout, two of the key indicators of dividend policy. The results demonstrate a significant negative relationship between share price volatility and the two key measures of dividend policy, dividend yield and dividend payout, as well as a significant negative relationship between share price volatility and firm size, demonstrating that, among the predictor variables, dividend yield and firm size have the greatest influence on share price volatility (Hashemijoo, Ardekani and Younesi 2012).

On the other hand, from 2005 to 2010, Zakaria et al. (2012) analyzed the effect of dividend policy on the share price volatility of 106 Malaysian-listed construction and material companies. Along with six other control variables, including debt, business size, investment growth, and earnings volatility, they also concentrated on the two primary indicators of dividend policy: dividend yield and dividend payout. The outcome of the least square regression demonstrates a positive correlation between the dividend payout ratio and share price volatility and a negligible negative correlation between the dividend yield and the firms' share price volatility (Zakaria, Muhammad, and Zulkifli 2012). The association between dividend policy and share price volatility in the Malaysian market was studied by Hooi et al. as well in 2015. They discovered that dividend yield and dividend payout are adversely correlated with stock price volatility after studying a sample of 319 businesses from the Kuala Lumpur stock exchange (Hooi, Albaity and Ibrahimy 2015).

Moreover, the relationship between SPV and dividend policy in the UK was investigated by Hussainey, Mgbame, and Chijoke-Mgbame (2011). For the years 1998 to 2007, the authors chose 123 English businesses to conduct the study. Based on Baskin's (1989) research, they performed multiple regression analyses to determine the correlation between share price, dividend payment ratio (DPR), and DY. Their model's control variables were size, debt level,

earning volatility, and expansion rate. Hussainey, Mgbame, and Chijoke-Mgbame (2011) discovered a substantial negative association between SPV and payout ratio as well as between SPV and DY, which is in line with Allen and Rachim's findings from 1996. In contrast, they discovered that a firm's size has a large negative impact on stock price volatility, which runs counter to Allen and Rachim's (1996) findings that a firm's size and debt have a significant beneficial impact on SPV.

Furthermore, Hashemijoo (2012) focused on consumer goods businesses listed on the Malaysian stock market when examining the connection between dividend policy and share price volatility. This analysis demonstrates a large inverse link between share price volatility and the two key indicators of dividend policy: dividend yield and dividend payout. The authors Nishat & Irfan hypothesized that dividend policy influences stock price volatility. The research study conducted by (Irandoost et al., 2013) examined the impact of dividend policy on stock price volatility and investment choices using a sample of 65 companies from the Tehran Stock Exchange for the years 2007 to 2012 in relation to the service sector. According to the study's findings, the dividend policy significantly affects stock price volatility over a short period but not over an extended period. Additionally, it found that the dividend policy had little impact on accrual- and cash-based investing choices.

However, the effect of Sri Lanka's dividend policy on SPV has been the subject of very few studies. Between 2005–2006 and 2010–11, Periyathamby & Navaratnaseelan studied the effect of a company's dividend policy on shareholders' wealth from listed businesses in the CSE. It showed that there is no meaningful relationship between dividends and share prices. Dewasiri and Banda (2014) used a sample of 40 businesses listed on the Colombo Stock Exchange over a ten-year period from 2003 to 2012 to investigate the connection between dividend policy and stock price volatility. The study's conclusions showed no evidence of a substantial impact from dividend yield on stock price volatility, however there is a significant negative impact from dividend payment and a significant positive impact from firm size. The results revealed that while higher dividend yield would increase short-term stock price volatility, a high dividend payout would result in less volatility in stock price.

Methodology

In order to analyse the relationship between dividend policy and stock price volatility, data from the year 2019 to 2021 for 10 service sector companies that are listed and actively traded in the Colombo stock exchange for all these years are utilized. Data was collected from the annual reports published by the selected companies as the sample. In order to eliminate the potential industry effects, a single sector was selected. Altogether, there are 294 listed companies on the CSE representing 20 business sectors out of which 51 companies are listed under the service category. The target population comprises service sector companies including health care, hotel and travel, plantations, chemical and pharmaceutical, services. Companies that did not have complete data during the period of study were excluded. Thus, the final samples of 10 service sector companies out of 51 (30 observational data points) were selected and companies were sorted based on the market capitalization and the sample was chosen by using a systematic random sampling method.

In this research, data were analysed by using a regression model. Descriptive statistical methods have been used to calculate mean, variance, and standard deviation. Correlation matrix and multiple regression analyses have been used to examine the relationship between dividend policy (independent variable) and SPV (dependent variable). In line with previous studies, control variables such as firm size were included to account for the effects of both dividend policy and stock price volatility. This study adopts Baskin's (1989) framework, which is also in line with more recent empirical studies conducted in emerging markets (e.g., Sew et al., 2015; Shah and Noreen, 2016; Sharif et al., 2015; Hamid et al., 2017). Baskin (1989) demonstrates that dividend policy effectively predicts SPV even when many financial and industrial factors are controlled for. The basic regression model relates SPV with two measures of dividend policy –DPR and DY. To examine the relationship between SPV and dividend policy, the following equation is used as in model 1.

$$SPV = \alpha + \beta 1\ DPR + \beta 2\ DY + \beta 3\ EV + \varepsilon\ \beta 4\ AG + \varepsilon \qquad \ldots\ldots\ldots\ldots\ldots\ldots\ldots (1)$$

In the previous studies, Baskin (1989) reported a negative relationship between DY and DPR and stock price volatility but Allen and Rachim (1996) showed a positive relationship. There are a number of factors that may moderate the relationship between dividend policy (independent variable) and SPV

(dependent variable). Therefore, the following equation is tested including control variables as in model 2.

$SPV = \alpha + \beta 1\ DPR + \beta 2\ DY + \beta 3\ EV + \varepsilon\ \beta 4\ AG + \beta 5 SIZE + \varepsilon$ …… (2)

Where:

SPV = stock price volatility

DPR = dividend payout ratio

DY = dividend yield

AG = asset growth

EV = earnings volatility

Size = firm size

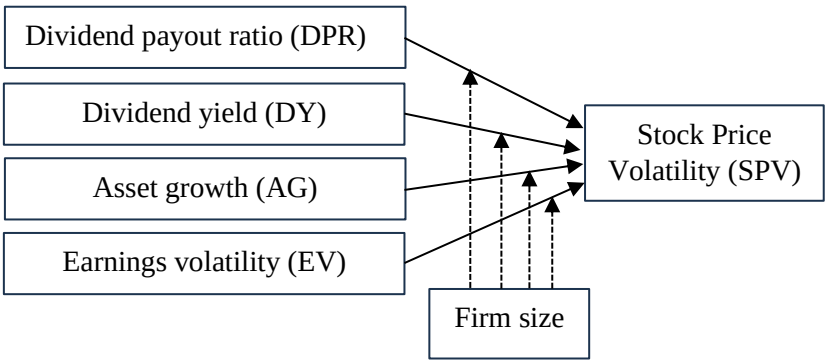

Figure 01: Conceptual Model

The above conceptual framework was constructed in line with the theory and the literature, including four independent variables and one moderating variable to achieve the study's overall objective.

Results and Discussion

Sample data was analyzed using descriptive and inferential statistical tools to determine the relationship between dividend policy and stock price volatility and to gain a deeper understanding of the variables concerning service sector companies listed on CSE in Sri Lanka. Figure 2 provides a summary of descriptive statistics of the variables considered for the study over the period of panel data from 2019 to 2021. The SPV is 48% for the selected service

sector companies listed in CSE during the study period. The volatility is lower compared to the research findings of Mohamad and Md Nassir (1993), who found that during the period 1975–1990, the Kuala Lumpur market faced 65.37% SPV.

The SPV for the Australian firms is 49% (Allen and Rachim, 1996) and only 29.4% volatility is recorded for UK firms (Hussainey, Mgbame and Chijoke-Mgbame, 2011). Unsurprisingly, the volatility was lower for the selected companies during the period because some of the companies distributed entire earnings while others retained the entirety. The standard deviation of SPV is 1.13. Baskin (1989) suggests that the standard deviation of stock returns that is equivalent to the measured volatility can be estimated using the formulas derived by Parkinson (1980). This result is in line with Hashemijoo et al. (2012) who reported a 39.60 percent standard deviation of stock returns for 84 consumer products companies in Malaysia from 2005 to 2010.

The volatility of industrial product firms' stock price is much lower compared to the volatility of the construction and material markets in Malaysia, computed as 56.72 percent (Zakaria et al., 2012). On average, service sector companies have a DPR of 28 percent. This result is consistent with the findings of Hashemijoo et al. (2012) and Zakaria et al. (2012) as they reported mean values of 38 percent in consumer products firms and 22 percent for Malaysian construction and material firms. DY recorded a mean value of 0.10 which is lower than DPR's mean value. During 2019–2021, data recorded service sector growth of 11% and EV of 42%, whereas firm size was 22%. Table 01 shows that DY has the lowest mean value and Asset growth has the lowest standard deviation, where size has the highest mean and SPV has the highest standard deviation among the variables.

Table 01: Summary of descriptive statistics from 2019 to 2021

Dimensions	**Mean**	**STD**	**MIN**	**MAX**
Stock price volatility (SPV)	0.48	1.13	-3.04	2.67
Dividend payout ratio (DPR)	0.28	0.40	-0.12	1.48
Dividend yield (DY)	0.10	0.19	0.00	0.89
Earnings volatility (EV)	0.42	3.39	0.68	2.3
Asset Growth	0.11	0.10	-0.07	0.34
Firm size	0.22	1.8	0.9	4.39

Source: Compiled by the author based on the survey 2023

Table 02 indicates the relationship between dividend policy and share price volatility of the service sector companies listed on CSE. Based on the results it indicates that the correlation coefficient between SPV and DPR is significantly negative (−0.002) and the relationship is statistically significant, and it is consistent with the correlation −0.542 (Baskin, 1989) and −0.210 (Allen and Rachim, 1996).

However, the association between SPV and DY is positive (0.053) and the relationship is significant. This is also consistent with Allen and Rachim's (1996) results which were positive (0.006), but in contrast with Baskin's (1989) findings which was −0.643. Also, the correlation between SPV and growth is positive (0.188) but the relationship is not statistically significant. The correlation between size and price volatility is negative (-0.054) and the relationship is significant. However, the correlation between EV and SPV is negative (0.369) but is not able to draw any conclusion about the degree of association.

Table 02: Association between share price volatility dividend policy

		SPV	DPR	DY	EV	Growth	Size
SPV		1					
	Sig	-					
DPR		-.002	1				
	Sig	.003					
DY		.053	-.057	1			
	Sig	.009	.014				
EV		-.043	.244	-.135	1		
	Sig	.820	.193	.476			
Growth		.188	-.212	.202	-.305	1	
	Sig	.321	.020	.283	.102		
Size		-.054	.034	.168	.080	.082	1
	Sig	.023	.040	.005	.003	.007	-

Source: Compiled by the author based on the survey 2023

The model's overall reliability was tested, indicating a Cronbach alpha value of 0.76. Accordingly, Table 03 shows the results of Models 1 and 2 and the relationship between SPV and dividend policy. The model's fitness is 19%, as explained by SPV by the dividend policy of the service sector companies listed on CSE. The results show that dividend policy is positively and significantly related to stock price volatility on Sri Lankan service sector companies.

This result is consistent with Nishat and Irfan (2003) and Allen and Rachim (1996). Furthermore, DY has a significant effect on stock price volatility in Sri Lankan selected non-financial companies (t = 2.609; P = 0.0098), this result is consistent with Allen and Rachim (1996). According to the result of model 2, once the firm size is considered as a moderating factor, DPR, DY, EV, and Asset Growth impact the SPV in service sector companies, but EV has no effect on the SPV. DY is a better variable used than DPR because DY is based on the market measure (stock price) as a denominator (Schooley & Barney, 1994). DPR relies on accounting measures (net income) based on an accrued method, which is easy to manipulate. Also, the difficulty that may arise when the company experiences negative net income can be avoided by using DY.

This could result in negative payout ratios or very high payout ratios when the firm's income comes close to zero.

Table 03: Degree of the impact of share price volatility on dividend policy

Coefficients[a]								
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	.073	.495		.148	.884		
	DPR	.091*	.490	.038	.186	.054	.919	1.088
	DY	.088	1.024	.017	.086	.932	.953	1.049
	EV	.011	.268	.009	.043	.966	.868	1.152
	Growth	1.937	2.102	.195	.922	.365	.862	1.161
2	(Constant)	.936	2.315		.404	.090		
	DPR	.097*	.499	.041	.195	.047	.918	1.089
	DY	.155*	1.056	.030	.147	.005	.927	1.079
	EV	.024	.274	.019	.086	.932	.856	1.168
	Growth	2.009*	2.147	.202	.936	.009	.855	1.170
	Size	-.041*	.106	-.078	-.382	.006	.953	1.049

a. Dependent Variable: SPV = stock price volatility

R2=0.190493; Adj. R2=0.129780; F-stat.= 3.137588; F-prob.= 0.000000.

Notes: (**) implies a Significance level of 1%; (*) implies a Significance level of 5%.

Conclusion and Recommendations

The study examined the effects of the dividend policy on stock price volatility in service sector companies listed on CSE Sri Lanka. The relationship between SPV and dividend policy is analysed using correlation and multi-regression models. Based on the correlation test results, SPV negatively correlates with DPR and firm size, the relationship of which is statistically significant. SPV positively correlates with DY. Based on the regression results, SPV, DPR, and

DY are first regressed. Second, the relationship between SPV and dividend policy is analysed by incorporating control variables such as firm size.

The empirical evidence revealed a negative impact of firm size on stock price volatility and this relationship is statistically significant which means the smaller the firms, the higher the volatility. The DPR has shown a significant negative relationship with SPV, which is on par with the results of previous studies conducted on service industries. For instance, Allen and Rachim (1996), Hussainey, Mgbame and Chijoke-Mgbame (2011). The results generally suggest that the high payout ratio rate leads to lower share price volatility. Moreover, this study implied that share price volatility has significant positive relationship with dividend yield. This study's empirical results also showed a positive relationship between dividend yield and market value (Jahfer & Mulafara 2016).

The general effect of dividend yield on price volatility, observed at higher significant levels, leads to the acceptance of the null hypothesis, which states that measures of dividend policy vary inversely with ordinary share price volatility over time. From the results observed in the control variables, the following conclusions are reached, in line with earlier literature. Firms with larger size experience less volatility than smaller firms. Firms with more growth opportunities experience price volatility than those with less opportunity for asset growth. Firms whose earnings are not stable but vary considerably, experience higher price volatility.

Therefore, firms should try as much as possible to improve their financial performance, which will enable a consistent increase in their dividend per share and positively impact market value. This is necessary because a decrease or non-payment of dividends could convey a wrong signal to investors on the viability or profitability of the company. Furthermore, this research area can be integrated with emerging markets to identify or establish the relationship between share price volatility and dividend policy from a global perspective. Studies on the volatility of stock prices, as has often been done in developed economies, can be expanded to show why investors should not be afraid of volatile stocks. In fact, it would show why and when investors should invest in volatile stocks to maximize their returns.

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