The Case for Tipping the Market to that Div Cut

By Ed Zwirn
Created 2011-08-06 10:35

Should companies “prepare” the market in advance for dividend cuts? A study from Boston College’s Carroll School of Management and Indiana University’s Kelley School shows that long-term stock return performance is better when investors are given such a heads-up.

Dividend cuts are understandably viewed as bad news by the investing public. But before the news goes public, CFOs, CEOs and other insiders with adverse private information about company cash flows and growth opportunities must wrestle with the choice of whether to soften the blow by giving some advance word about it, and inviting a negative reaction.

A paper by Thomas J. Chemmanur of Boston College’s Carroll School of Management and Xuan Tian of Indiana University’s Kelley School, however, concludes that companies undergoing “temporary financial difficulties” -- but having good long-term growth prospects -- are more likely to prepare the market in advance of dividend cuts. And that means that the market may give the announcement a positive reading, compared with companies having “permanently declining earnings,” and which are less likely to prepare the market.

Indeed, the research, to appear in an upcoming Journal of Financial and Quantitative Analysis, shows that the long-term stock performance of “prepared” dividend cutters is better than that of non-prepared dividend cutters.

Still, a footnote by the authors cautions readers to beware of the “usual caveats” common to predictions about long-term stock returns.

“If we assume that all investors are fully rational, and instantly infer firm insiders’ private information from their choice to prepare the market for a dividend cut or not, then all effects on the stock returns … will be captured by the announcement,” they write.

But if “firm insiders’ private information is not fully reflected in the stock price on the day of announcement of dividend cuts, but is incorporated only over a longer period,” they add, “then our model predicts superior long-term stock return performance for dividend cutters.”
Looking at future dividend performance, the study similarly shows that “dividend payment performance subsequent to dividend cuts will be better for prepared dividend cutters” because, in the long run, “dividend payment performance cannot deviate significantly from performance.”

The study also finds that while more “transparent” companies are less likely to prepare the market for dividend cuts, those with “high perceived industry risk” are more likely to announce dividend cuts in advance, compared with firms in industries that have low perceived industry risk.

Source URL: http://www.cfoworld.com/investor-relations/17062/case-tipping-market-div-cut