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Long-term stock performance following extraordinary and special cash dividends

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Abstract

Using essentially all declared extraordinary and special cash dividends between 1926 and 2001 which are not preceded or followed by the same for a period of three years, we find no robust post-declaration long-term abnormal stock returns, even in sub-samples defined by the special dividend yield, the bang-for-the-buck, the declaration-period abnormal return, the sub-sampling period or the stock market condition at declaration. Only event firms in the smallest CRSP market capitalization quintile display significant positive abnormal returns during the first-year following the declaration. However, these latter are not robust across sub-sampling periods. Overall, there is no compelling evidence that investors under- or over-react to extraordinary or special cash dividends.
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There is no clear evidence on the efficiency of investors' response to declarations of extraordinary or special dividends. Lie (2000) examines this issue briefly using a sample of 570 cases from the 1978–1993 period and finds a post-declaration three-year buy-and-hold abnormal return (computed using size and book-to-market ratio matched firms) of 6.5%. However, he does not use

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any other matching criteria or procedure for computing long-term abnormal returns, and buy-and-hold abnormal returns have serious statistical problems (Mitchell & Stafford, 2000). In addition, he does not account for the changing role of special dividends over time (DeAngelo, DeAngelo, & Skinner, 2000). For these reasons, we re-examine this issue.

Examining the efficiency of investors' response to extraordinary and special cash dividends is important for at least two reasons. First, the empirical evidence pertaining to whether investors react efficiently to all types of dividend news is inconclusive. The study of Benartzi, Michaely, and Thaler (1997) on dividend increases,[3] the study of Boehme and Sorescu (2002) on dividend initiations and resumptions, the study of Byun and Rozeff (2003) on stock splits, and the study of Liu, Szewczyk, and Zantout (2007) on dividend reductions and omissions,[4] all provide results that indicate no compelling or robust evidence of over- or under-reaction to these dividend news. However, the studies of Ikenberry, Lakonishok, and Vermaelen (1995, 2000) and Grullon and Michaely (2004) on stock repurchases find a significant under-reaction. Therefore, the evidence from extraordinary and special dividends will be helpful in determining whether stock repurchases are the only exception.

Second, since regular dividend increases (or decreases) may be more permanent (Brickley, 1983), and they *may be* associated with significant post dividend-announcement earnings drifts,[5] then any post-announcement long-term abnormal returns may be attributed to these latter. On the other hand, extraordinary dividends are one-time payments (i.e., not sticky), Lie (2000) finds that, in contrast to dividend increases, they are made by firms with non-recurring excess funds, and Brickley (1983) and Lie (2000) report that while they are associated with increases in earnings during the fiscal year of the event, they are not associated with any increases in earnings during the year following the event (i.e., they are transitory).[6] Therefore, examining any mis-reaction to these events constitutes a lower-bound test for the "efficient capital markets" hypothesis. In other words, if investors do not efficiently interpret the information content of one-time corporate disbursements which are not followed by any earnings-drift, it is difficult to envision they can efficiently interpret

[3] Benartzi et al. (1997) find that firms that increase their dividend payment experience a significant 3-year (buy-and-hold) positive excess return of 8.01% (computed using size matched portfolios) in a sample of 4249 cases from the 1979–1991 period. However, they note that the sample quintile announcing the largest dividend increases (774 observations) earns only 5.1% excess return (cumulative) over the 3 years, which is not significant statistically. Also, they do not examine the robustness of their results across sampling periods, firm sizes, and different methods for measuring the abnormal stock return. Therefore, they have no robust evidence of under-reaction.

[4] Liu et al. (2007) report a significant positive 1-year abnormal stock return following dividend reduction and omission announcements, but they attribute it to the post-earnings price-drift.

[5] The studies of Healy and Palepu (1988), DeAngelo, DeAngelo, and Skinner (1992), Jensen and Johnson (1995), and Benartzi et al. (1997) indicate a consensus about a very strong correlation between dividend changes and changes in earnings performance in the year preceding and the year of the dividend change. However, the evidence on the relation between dividend changes and future earnings changes is not conclusive. DeAngelo et al. (1992) examine a sample of firms that had an annual loss following an established track record of positive earnings and dividend payments and report that dividend-reducers typically experience greater future earnings problems than do non-reducers. However, DeAngelo, DeAngelo, and Skinner (1996) find that firms that increase their dividends despite suffering a decline in their annual earnings following a consistent earnings growth over at least 10 years show neither signs of systematically positive future earnings surprises nor greater abnormal future earnings performance relative to a comparable group of no-dividend-increase firms. Similarly, Benartzi et al. (1997) report that there is not much evidence of a positive relation between dividend changes and future earnings changes in samples of dividend increases, no-changes, and decreases. Therefore, the evidence on the relation between dividend changes and future earnings changes is inconclusive.

[6] Interestingly, Lie (2000) provides evidence that "special dividends generally constitute much larger incremental disbursements than do increases in dividends, not considering the effect of special dividends and regular dividend increases on future dividends." (page 225).

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