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The link between dividend policy and institutional ownership

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Abstract

This paper examines the relatively neglected link between dividend policy and institutional ownership. It is also the first example of using well-established dividend payout models to examine the potential association between ownership structures and dividend policy. Moreover, the paper presents the first results for the UK, where the institutional framework and ownership structures are different from those of the US.

Using a UK panel data set, the role of institutional ownership in association to dividend payout ratios is analysed within the context of the dividend models of Lintner [American Economic Review, 46 (1956) 97], Waud [Journal of the American Statistical Association, 1996] and Fama and Babiak [Journal of the American Statistical Association, 63 (1968) 1132]. The results consistently produce strong support for the hypothesis that a positive association exists between dividend payout policy and institutional ownership. Furthermore, the results for an earnings trend model suggest a positive earnings trend component to the association between institutional ownership and the dividend payout ratio. In addition, there is some evidence in support of the hypothesis that a negative association exists between dividend payout policy and managerial ownership.

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1. Introduction

The link between a firm's financial policy and its ownership structure is recognised in the established literature (for example, Williamson, 1964; Leland and Pyle, 1977; Jensen, 1986). While the empirical evidence of the relation between dividend policy and management ownership has also been well documented within this literature (for example, Rozeff, 1982; Jensen et al., 1992; Eckbo and Verma, 1994; Moh'd et al., 1995), the potential relation between dividend policy and institutional ownership has been somewhat neglected and this is especially the case for non-US firms where the institutional framework and ownership structures are different from those of the US.

In terms of the institutional ownership of firms, there are significant differences between the US and UK. These differences result from the differences in legal restrictions and tax incentives. In fact, institutional shareholdings in the US are only about two-thirds of those in the UK (Kester, 1992). The significantly lower concentration of US institutional shareholdings reflects both the legal restrictions preventing US institutions from building significant stakes in individual firms (see Roe, 1990, for a discussion) and the tax system being largely neutral in relation to dividend policy. In contrast, the UK tax system has (in the period under consideration) provided clear incentives for tax-exempt institutions to demand dividends.

Using a UK panel data set, this paper examines the possible link between dividend policy and institutional ownership. In particular, the role of institutional ownership in relation to dividend payout ratios is analysed within the context of the dividend models of Lintner (1956), Waud (1966) and Fama and Babiak (1968). The evidence from four well-known types of dividend models consistently shows positive and statistically significant associations between institutional ownership and dividend payout ratios and thus suggests a link between institutional ownership and dividend policy.

The paper is organised as follows. Section 2 discusses the relation between dividend policy and institutional ownership in the context of theories that emphasise the importance of taxation, agency and signalling for dividend decisions. A discussion of the statistical models of dividend payout behaviour is provided in Section 3. Section 4 discusses the sample, variables and empirical method to be used in examining the association between dividends and institutional ownership. Section 5 provides the results and a discussion of the empirical analysis. Finally, Section 6 presents the conclusions.

2. Institutional shareholders and dividend payout policy

The relatively high level of dividends paid by UK quoted firms has been the subject of concern for a number of years. In particular, the dividend payout rates of UK firms are significantly greater than those of other countries, such as Germany and Japan, and dividends in the UK are considered to be downwardly inflexible (Mayer and Alexander, 1990; Mayer, 1994). The relatively high levels of dividends paid by UK firms have been argued to reduce the amount of funds available for long-term investment, to the detriment of long-term economic performance (Bond and Meghir, 1994). In particular, attention has focused on the *alleged* role of institutional shareholders in forcing firms to maintain high