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Dividend policy, signaling, and discounts on closed-end funds☆

Shane A. Johnson[a,*], Ji-Chai Lin[b], Kyojik Roy Song[c]

[a]*Mays Business School, Texas A&M University, College Station, TX 77843, USA*

[b]*E.J. Ourso College of Business, Louisiana State University, Baton Rouge, LA 70803, USA*

[c]*School of Business Administration, Sungkyunkwan University, Seoul, Korea*

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Abstract

We test the predictions of dividend signaling models using closed-end equity funds that adopt explicit policies committing them to pay minimum dividend yields. These policies represent deliberate attempts to reduce share price undervaluation relative to NAV. Funds that adopt minimum dividend policies experience reductions in their share price discounts, trade at smaller discounts than other funds, earn greater excess returns following policy adoption, and their managers survive longer than other managers do. The results are broadly consistent with the predictions of dividend signaling models, and suggest that high quality closed-end funds can reduce undervaluation via dividend policy.

JEL classifications: G12; G35

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*Corresponding author. Tel.: +1 979 862 3318; fax +1 979 862 3884.

E-mail address: sjohnson@mays.tamu.edu (S.A. Johnson).

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1. Introduction

We test the predictions of dividend signaling models using a sample of closed-end equity funds. Closed-end equity funds are well suited for this task because many of them adopt explicit minimum dividend policies that commit them to pay dividends of at least a specified percentage of net asset value at periodic intervals. If a fund adopts a minimum dividend policy and generates a portfolio return below the minimum dividend yield, the policy causes a partial self-liquidation of the fund. Fund manager compensation is usually specified as a percentage of total net assets so a partial liquidation reduces compensation, and repeated partial liquidations would eventually drive compensation to zero as the fund liquidates completely. In contrast, a fund manager who generates a portfolio return greater than the promised minimum dividend yield maintains or increases the level of total net assets and in turn his compensation. Thus, a fund manager who generates high future portfolio returns would find the adoption of a minimum dividend policy less costly than would a fund manager who generates low future returns.

Given the differing costs of minimum dividend policies across fund managers that generate low versus high future portfolio returns, we argue that the policies have potential signaling value. Managers of high discount closed-end funds risk losing their jobs via hostile takeovers, liquidations, or investor pressure. To the extent that closed-end fund discounts reflect (at least in part) expectations of inferior future portfolio returns, managers who anticipate superior future portfolio returns have incentives to signal their type to reduce their funds' discounts. Indeed, press releases indicate that funds adopt minimum dividend policies as deliberate attempts to reduce the undervaluation of the funds' market share prices from net asset value (NAV).[1] Thus, these closed-end equity funds allow for tests of the predictions of dividend signaling models on a focused sample of funds that seek to explicitly and deliberately signal undervaluation.

In addition to being able to focus on those funds that deliberately try to signal undervaluation, there are two other advantages to using closed-end equity funds to test dividend signaling. First, the transparency of closed-end funds makes it easy to compare the relative levels of undervaluation (i.e., the discount of market share price from NAV) both before and after the adoption of a minimum dividend policy, and across funds with and without such policies. It is much more difficult to measure undervaluation for traditional corporate firms. Second, it is straightforward to observe and measure changes in the return performance of these funds' investment portfolios surrounding the adoption of a minimum dividend policy.

If minimum dividend policies have signaling value and if closed-end fund discounts reflect expectations of inferior future portfolio returns, then we should observe smaller discounts for funds that adopt these policies. We find that investors distinguish between funds that adopt what we term *strong* (minimum dividend yield of at least 10%) and *weak* (minimum dividend yield below 10%) minimum dividend policies. Closed-end funds that adopt strong policies experience statistically and economically significant reductions in their share price discounts from NAV.[2] We also find that funds with strong policies have a

[1] Announcements of the adoption of a minimum dividend policy typically express the intent to "enhance shareholder value," and refer to the persistent discounts from NAV that the funds suffer.

[2] We measure closed-end fund share price deviations from NAV as (NAV per share – share price) / NAV per share. Whether trading at a discount or a premium, a lower value of this measure implies that the fund market price is higher relative to NAV.