

Influence of Dividend Payout on Investment in Shares - A Survey of Retail Investors in Kenya

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Abstract

The main objective of this study was to examine the effect of dividend payout on investment in shares for Kenyan retail investors, applying the behavioral finance theory. There has been a paradigm shift in thinking from the traditional Efficient Market Hypothesis in trying to analyze the capital markets with the proposition that investor decisions to invest could be impacted on by behavioral factors. Primary data was collected from 311 respondents randomly sampled from the population of 836,250 investors participating at the Nairobi Securities Exchange as at March 2013. Data analysis was done applying descriptive and linear regression statistical data analysis. The results revealed that dividend payout had a significant influence on decisions to invest in shares with p-value .000 ($p < 0.05$). In view of the findings, the researchers recommend that policy makers steadfast to enhance securities market activity should purposely structure strategies aimed to increase profitability and consequently guarantee dividend payout to bolster investor confidence. This will support to stimulate development of the financial markets to mobilize long term capital for economic development. The study findings are incongruent to MM the dividend irrelevance theory.

Key Words: Behavioral Finance, Dividend Payouts, Financial System, Retail Investors

1.0 Introduction

In the investment market individuals are faced with an increasing complex choice of financial products from which to make investment decisions. An investor will logically choose the investment that guarantees protection of wealth, and comparatively provides higher returns in the market (Cole & Shastry, 2009). The Rationality and Efficient Market Hypothesis (EMH) predominated theory and practice in the financial markets starting 1960's to 1980's. Fama (1970) explains that in an efficient market stocks will always trade at their fair market value in the securities exchange reflecting all available information, making it almost impossible for investors to purchase undervalued shares or sell shares at inflated prices. This then means that the only way an investor would probably achieve higher returns in this market set up is by investing in riskier stocks.

Research studies have shown that investors do not necessarily think rationally but are led by emotions, subjective thinking, and at times by the herd mentality (Shah & Oppenheimer, 2008). Overtime, the EMH is steadily becoming deficient to provide explanation for the market behavior, subsequently leading to a shift in thinking, with the understanding that the market consists of human beings whose behaviors cannot solely be understood through mathematical or economic studies (Ozerolet *et al.*, 2011). The contemporary capital markets are therefore being analyzed from a new perspective of behavioral finance, a theoretical model applying the principles of psychology and sociology to finance (Pompion, 2008). The behavioral theorists' postulate that investment decisions are to some extent influenced by personal prejudices and perceptions that fall short of the criteria of rationality as proposed in the EMH.

1.1 The Kenyan Capital Market – An Overview

The capital market plays a fundamental role in stimulating economic growth and development through mobilization of resources in an economy (Yartey&Adjasi, 2007). The markets provide a platform for exchange of financial assets (stocks and bonds), following established regulations to provide continuous liquidity in the market. The Kenyan capital market is formalized by existence of a Securities Exchange, the Nairobi Securities Exchange (NSE), consisting of the primary and secondary segments where investors participate. An analysis of the NSE performance for the period between 2008 and 2010 using secondary data reveals that the macroeconomic environment has been quite volatile, slowing down a sustained stable financial market for long term resource mobilization (Aroni, 2011).

The Kenya Vision 2030 development blueprint covering the period 2008-2030 aims to achieve an economic growth rate of 10 per cent per annually with 30 per cent of the resources to be financed from mobilization of domestic resources (GoK, 2007). The strategy aims to realize the objective through creating a vibrant and globally competitive financial sector promoting high-levels of savings and financing for Kenya's investment needs. The GoK Annual Progress Report indicates below target achievement for the country with annual average growth rate of below 5 per cent, and gross national savings of 13.4 per cent as a percentage of GDP (GoK, 2011). Trading in shares in Kenya started in 1920's when the country was still a British colony and Africans were not allowed to trade. At the initial formative stages, the market was mainly characterized with informal rules and regulations and dominated by foreign investors. Trading took place on gentleman's agreement arrangement in which standard commissions were charged with clients being obligated to honor their contractual commitments making good delivery, and settling relevant costs (NSE, 2010).

The Nairobi Securities Exchange (NSE) was informally established in (1954) as a voluntary association of stock brokers registered under the societies act with the objective to facilitate mobilization of resources to provide long term capital for financing investments (NSE, 2010). In this formalization stage, a self-regulatory system is adopted while attempts are made to increase the participation of local investors by the post independent government. After attainment of independence in 1963, Africans and Asians were permitted to trade in shares, during this time the market activity slumped due to uncertainty about the future following declaration of independence. In the late 1980s liberalization and privatization took Centre stage as development strategies in the Kenyan economy following poor performance of the public sector, characterized with misallocation of resources, market distortions, and negative low economic growth (Kibuthu, 2005). To strengthen the market, various institutional and policy reforms were implemented to enhance the growth of the market through stringent listing requirements to promote higher standards of accounting, resource management and transparency in the management of business (Ngugi, 2003). An important development was a study conducted by International Finance Corporation (IFC) collaborating with the Central Bank of Kenya (CBK) which recommended structural reforms in the financial markets leading to the formation of the regulatory body, the Capital Markets Authority (CMA) in 1989 (IFC/CBK, 1984). The overall objective of CMA was set to support creation of an environment conducive for growth and development of the country's capital markets (CMA, 2010). The exchange has continuously lobbied the government to create a favorable policy framework to facilitate growth of the economy and the private sector to enhance growth of the stock market (Ngugi & Njiru, 2005).

The NSE is propped up by the Central Depository and Settlement Corporation (CDSC) which provides clearing, delivery and settlement services for securities traded at the Exchange. It oversees the conduct of Central Depository Agents comprised of stockbrokers and investments banks which are members of NSE and Custodians (CDSC, 2004). These regulatory frameworks are aimed to sustain a robust stock market exchange that supports efficient allocation of capital allowing price discovery to take place freely based on the market forces.

The NSE as at 2013 had 59 companies with equity listings in the Main Investment Market Segment, Alternative Investment Market Segment, Fixed Income Market segment and Growth Enterprise Market Segment (NSE, 2014). The frameworks for other segments in the derivatives market and Real Estate Investment Trusts are being streamlined by the CMA. The NSE currently uses an Automated Trading System (ATS) which is a fully automated screen-based system. The ATS adopts the principles of order-driven market in which the best-buy order is matched with the best-sell order. In July, 2011, the NSE adopted a T+3 settlement system with the expectation that efficiency gains from the shorter settlement cycle will improve liquidity in the market (NSE, 2011).

Olweny and Kimani (2011) in their study of the relationship between the stock market and economic growth in Kenya find that an increase in the NSE 20 share index potentially signals the markets expectation of higher dividends, corporate profits and in turn a higher economic growth. The study concludes that the stock market had a positive effect on economic growth. Aduda *et al.*, (2012) finding shows that there were varied behaviors and financial performance of individual investors in Kenya with some investors exhibiting rational behavior while making investment decisions. Olweny *et al.*, (2012) investigates the effect of stock market experience on risk tolerance and in their finding investors with previous experience in the market were found to be more tolerant to risk compared to those without experience, probably due to previous exposure to market volatility to which newcomers may be reluctant to risk. Ndiege (2012) examined the factors influencing investment decision in equity stocks at the Nairobi stock exchange among teachers in Kisumu Municipality. The study noted that majority of the investors preferred to invest in real estate as opposed to investment stocks in which only small proportion of 28 per cent of the respondents invested. The study findings also showed that decisions to invest in equity stocks were influenced by expected dividends, capital appreciation and affordability of shares. The herd mentality was also found to play a role as explained by investment decisions based on shares in high demand and friends and co-workers recommendation

Although the NSE provides avenues for investment opportunities that encourage thrift culture, critical in increasing domestic savings and investment ratios that are essential for rapid industrialization, the savings and investment ratios in Kenya are too low, below 10 per cent of GDP (CMA, 2011). Although the Kenyan capital market has continued to record a gloomy performance as a financing source, the Nairobi Securities Exchange reported remarkable improvement in turnover performance in 2011, the best since inception (NSE, 2012). However, the annual reports indicate a significant drop in equities turnover from Kshs 107 billion in 2011 to 67.1 billion in 2012 (CMA, 2013) representing approximately 4.4 percent of GDP. This figure is quite low as compared to 40.8 percent in Malaysia 70.8 percent in China 37.0 percent in Brazil 37.8 percent in India and 81.1 per cent in South Africa (World Bank, 2013). As savings increase, capital accumulation is expected to be stimulated eventually leading to higher output levels in an economy. The Kenya capital market has been described as narrow and shallow only able to raise less than one per cent of growth finance from the stock and bond market (Ngugiet *al.*, 2007). In spite of the NSE providing avenues for investment opportunities that should encourage a thrift culture, which is critical to increasing domestic savings and investment ratios essential for rapid industrialization, the savings and investment ratios are still too low, below 10 per cent of GDP (CMA, 2011). An understanding of the how dividend payout influences the stock investment decision process is important as will provide an insight into how investors react to these variable as well as to what extent these factor affect their investment decision making.

The rest of the paper is organized as follows: The next section provides that literature review. The methodology is developed in section three while section four provides analysis of the results. The last section provides conclusions, policy and management implications.

2. Literature Review

The Rationality and Efficient Market Hypothesis (EMH) predominated theory and practice in the financial markets starting 1960's to 1980's. Fama (1970) describes an efficient market as one where a large number of rational investors intent to maximize profit, compete with each other in trying to predict future values of individual securities, and one where current information is almost available to all participants. In an efficient market, the security prices are presumed to reflect the effects of information based on past, current and future events. However in a study conducted by Lee *et al.*, (2010) investigating the inertia of real stock prices for 32 developed and 26 developing countries, the researchers in their finding report that stock markets may not be efficient after all. Mlambo & Biekpe (2007) examine the weak form of market efficiency of ten Africa stock exchanges using daily data for the period between January, 1997 to May, 2002, and the result showed that all the markets rejected the random walk proposition. Enowbi *et al.*, (2009) also examine weak form efficiency of four African Stock Exchanges namely, Egypt, Morocco, South Africa, and Tunisia using daily data collected and the findings indicate that none of the markets followed the random walk hypothesis with the exception of South Africa.

Tenaie *et al.*, (2011) investigates determinants of initial public offer pricing in Kenya and their findings conclude that public information disclosed in the prospectus is not significantly reflected in IPO prices and the rational theory therefore cannot explain the effect of investor sentiment in IPO market in Kenya. The IPO pricing in Kenya is inconsistent with the EMH, as evidenced by the under and overpricing phenomenon observed in Kenya.

Kiplangat *et al.*, (2010) examine determinants of investor confidence in Kenya and find that daily price movements in the NSE are significantly related to investor sentiment since the Equity Market Sentiment Index (EMSI) captured capital market related news and events. It is therefore probable that investors' psychology is a potential explanation for stock activity movements. EMH has steadily become deficient to provide explanation for the market behavior, more dramatically perhaps, the drastic drop in United States share prices by over 30 per cent during a two month period that preceded the crash of October 1987 (Mosomi & Ghayekhloo, 2011). Subsequently, there has been a shift in thinking, with the understanding that markets consist of human beings whose behavior cannot be understood solely through mathematical or economic studies (Ozerolet *et al.*, 2011). The stock markets are therefore being analyzed from a new perspective of behavioral finance, a theoretical model applying the principle of psychology and sociology to finance (Pompion, 2008)

Dividend payout has been postulated as one of the variables that could influence investor behavior while making investment decisions on the investment option to select. According to Chong & Lal (2011) dividend payout refers to annual payments declared and effected to shareholders based on their outstanding stockholding at the end of a financial period. This variable is considered to influence the decision of an investor whose primary aim is to get compensated with regular periodical payments for the investment made. It is presumed that an investor will choose an investment solely driven by personal preference to get a dividend payout, in which case, review of past performance and expected performance will play significant role in making the decision to invest in a certain class of shares. A potential investor, desirous to increase his/her current return, will most likely prefer to invest in stocks where dividend payout is assured. To the perception of a potential investor, the payment of dividend puts across the message that the company is profitable and financially strong and therefore probably worth taking the risk to invest in its shares.

The dividend policy of a company determines what proportion of the available earnings are to be distributed to equity holders by way of dividends, and what proportion will be retained for taking up new investments. According to Davis (2006) dividend policy is in essence the framework which the Managers choose to pursue in deciding the quantum and pattern of the cash distribution to the shareholders over a period. The impact of a firm's dividend policy is still an issue of contention. Capstaff *et al.*, (2004) define dividend policy under the relevance theory – that dividend policy is a practical approach which treats dividend payable as an active decision variable and retention only as residue. Dividends are not just a means of distributing the profits but any variation on payment of dividend could affect share prices, and investors' perception of the firm.

Capstaff *et al.*, (2004) posit that a firm should therefore establish an optimal policy to ensure shareholder wealth maximization. Dividend policy suggests a positive attitude to deliberately maintain or increase dividend to a certain level with the ultimate aim to sustain the price of ordinary shares in the stock exchange consequently enhancing confidence of current and potential investors (Waithaka *et al.*, 2012). Kiyondi & Oyugi (2013) find a strong positive correlation between an increase in dividend and an increase in the earnings resulting in the conclusion that that dividend policy is relevant and that managers should as deliberate strategy design a dividend policy that will enhance firm performance and therefore shareholder value, which will attract investors to invest in the firm's shares.

In the residual dividend policy, the amount of dividend is simply the cash left over after the firm makes desirable and available investments. Applying the Net Present Value rule, if managers believe dividend policy is important to the investors and that it will have a positive influence on the share price valuation, they will adopt a managed dividend policy (Gordon, 1963). Lintner (1956) analyzes how firms set dividends and concluded that firms have four important concerns; long run dividend ratio, higher in case of mature companies and low in case of growth companies. Secondly, dividend policy follows a shift in long term sustainable earnings. The managers are more concerned with dividend changes than with absolute levels. Finally, managers do not intend to reverse the change in dividends. Asquith and Mulling (1985) investigate the impact of dividend on stock brokers' wealth and findings confirm the view that dividends convey unique and valuable information to the investors.

In the clientele effect theory, Botha (1985) argues that in the tax induced decision, preference will be influenced by the different tax status and the return to be earned from the existing scenario. In this case, there are three classes of clientele; those seeking immediate dividend income, those seeking capital appreciations, and those indifferent to dividend payout and capital appreciation.

A firm will therefore be faced with varied clientele, Investors who want current investment income such as retirees, will own shares in high dividend paying firms while investors who do not prefer dividend distribution will own shares in low dividend paying firms with the aim to make capital gains, and hedge the tax impact, The celebrated paper of Modigliani (1961) declares dividend as inherent in a world without taxes, transaction cost, or other market imperfections the investment decision of the firm is not affected by the dividends because investors can add their home made dividends by selling a part from or borrowing against the portfolio. The firms that issue dividend would incur floatation costs on new securities they have to issue to keep the investment policy intact. Kwenga (2012) examines individual investors in Kenya, more specifically investors in Kenya airways, and finds that investors put money in high earning companies, after evaluating the nature of business the companies were involved in, with the aim to earn high dividend payouts. Waitthakaet *al.*, (2012) findings show that an increase in a firms stock trading affected the share prices and investors who wanted current income owned shares in high dividend payout firms. The researchers' findings indicate that the share market was positively responsive to dividend announcement. Based upon the literature review the following research question and hypothesis are generated.

Research Question: How does a making dividend payout influence individuals to invest in shares of firms listed in the NSE?

Research Hypothesis: H₀1. Dividend payouts have a positive influence on individuals' investment in shares.

3. Methodology

The main purpose of the study was to access the influence of dividend payout on investment in shares. The research made use of the existing the literature to derive theselected behavioral variableto the test the hypotheses posit. A survey research design was used to collect data, and then a quantitative approach was applied to analyze the behavioral influence of dividend payout on retail investor's decisions to invest in shares. The research utilizes both descriptive and explanatory research methods in the conduct of the study focusing on the target population of 836,250 retail investors participating in NSE as at March 2013 (CMA, 2013). The respondents were sampled from investors within City of Nairobi who were presumed to be representative of all retail investors participating in the NSE. This is because Nairobi is the commercial Centre of Kenya, and the NSE is situated in Nairobi as are the reputable stock brokerage firms. The city being a metropolis has mix of all the ethnic groups in Kenya, hence be good representation of the population. The data for analysis was obtained by means of a research questionnaire distributed through five various sized brokerage firms which are authorized to trade in the NSE. Purposeful random sampling approach was adopted to collect data from the respondents. Purposeful in the sense that five major stock brokerage firms with offices located at the Central Business District (CBD) had 77 questionnaires each dropped in their offices for completion by retail customers transacting through their offices. The questionnaires were randomly administered on customers that visited their offices over a period of 15 days to attain the calculated sample size of 384 respondents.

3.1 Model and Data Description

The variables under study was analyzed applying the following econometric model adopted from Chong & Lal, (2011) given as;

$$IS = \beta_0 + \beta_1 \cdot DIV + \epsilon$$

Where: IS = Investment in Stock

β_0 = constant term

β_1 , DIV = sensitivity of investment in shares to dividend payout

ϵ = disturbance term with an expected value of zero.

The sensitivity of investment in shares to changes in selected factors was computed by ordinary least squares (OLS) in the framework of the model applied by Chong & Lal, (2011). This factor model was based on the assumption that the disturbance terms are uncorrelated across stocks, meaning that decisions to invest in shares change only as a reaction to a specific factor.

3.2 Variable Definition and Measurement

The researcher investigated stock activities of investors using a response index scale of 1 to 5 to determine the influence of the selected independent variable (Dividend Payout) on the dependent variable (Investment in stock) using a structured questionnaire. The degree of sensitivity of the dependent variable was measured by asking the respondent to assign a weight on equities in their portfolio of financial assets adopting Amromin & Sharpe (2008).

The selected weights were less than 10 percent, between 10 to 25 percent, between 25 and 50 percent, between 50 and 75 percent and more than 75 percent. These parameters were used to carry out data analysis using statistical tools selected.

4. Result and Analysis

The initial target sample size was 384 respondents but a response rate of 81% was achieved as 311 respondents completed the questionnaires that were administered. Table 1 reports the results of the regression coefficient.

Table 1. Coefficient of Regression

Model		Coefficients ^a			T	Sig.
		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta		
1	(Constant)	2.411	.143		16.895	.000
	DIV	.331	.038	.443	8.620	.000

a. Dependent Variable: IS

The results imputed in Table 1 show that the regression coefficient statistic generated p-value 0.000 at significant level of 5%. The postulated alternate hypothesis is therefore accepted implying that dividend payout had a significant influence on decisions to invest in shares. The relationship between dividend payout and investment in shares followed a Linear Regression model of the nature $IS = 2.411 + 0.311DIV$ where IS is the estimated share investment performance, constant intercept term ($\beta_0=2.411$) 0.311 is the slope coefficients (β_1) for dividend payout.

Table 2. Correlation Matrix of the variables

		DIV	IS
DIV	Pearson Correlation	1	.443**
	Sig. (2-tailed)		.000
	N	311	306
IS	Pearson Correlation	.443**	1
	Sig. (2-tailed)	.000	
	N	306	306

** . Correlation is significant at the 0.01 level (2-tailed).

The correlation matrix presented in table 2 shows moderate correlations between the independent variable (proportion of money invested in shares) and independent variables (dividend payout). Although the correlation was significant, the degree of correlation was low implying that other factors could also be playing a role in influencing investor decisions.

Table 3 Analysis of Variance

ANOVA ^a						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	75.439	1	75.439	74.299	.000 ^b
	Residual	308.665	304	1.015		
	Total	384.105	305			

a. Dependent Variable: IS

b. Predictors: (Constant), DIV

The analysis of variance presented in Table 3 shows the F Value of the entire regression model was 74.299df (1, 304) $p < .05$. The sig. value generated by the model was .000 indicating that the dividend payout variable had significant influence on decisions to invest in shares.

5. Discussion of key findings

The key objective of the study was to assess whether dividend payout had a behavioral effect of influencing investment decisions to invest in shares as compared to other available competing avenues of investment. The study sought to examine whether when an investor wanted to invest would generally be influenced by dividend payout (DIV) to investors by the potential companies from which they were interested to buy shares. The result of the analysis indicates dividend payout factor was found to be significantly correlated with investor decisions to invest in shares of firms listed in the NSE. These findings conform to Asquith and Mulling (1985) where the impact of dividend payout was found to convey unique and valuable information to potential investors, and therefore influenced investment decision. It is premised that the perception of a potential investor is impacted upon on the context that dividend payout puts across the message that the company is profitable and financially strong and therefore probably worth taking the risk to invest in its shares.

The result also confirms that assertion of Waithaka *et al.*, (2012) that an increase in dividend to a certain level would ultimately sustain the price of ordinary shares in the stock exchange consequently enhancing confidence of current and potential investors. The current empirical finding shows that investors are responsive to dividend payout by companies, and would therefore choose to invest in companies where dividend payment will be guaranteed. The dividend payout variable however had a moderate degree of correlation possibly on account of the experience of the low dividend payout ratios among the listed firms in Kenya, thus making dividend a lesser important consideration amongst investors whilst making investment decisions.

6. Conclusion and Recommendation

The study offers an explanation of the empirical relationship between the behavioral influence of dividend payout and decisions to invest in shares, specifically targeting retail investors participating in the NSE. The hypothesis that was being tested was accepted as dividend payouts were found to have a significant influence on decisions to invest in shares. This suggests therefore, that while considering on how to allocate their wealth in investment options (portfolio), investors were to some extent influenced by the fact that a company paid dividend in recent times. The study premised that payment of dividend inculcated a sense of confidence that the company was profitable and financially strong, and therefore possibly worth investing in. The empirical findings in the current study show that when a company paid dividend, it certainly did matter for investors in Kenya, and would place them in a position to decide on which company shares to invest in.

This study finding supports the view that dividend payout does have a behavioral influence on investment decisions. Policy makers determined to enhance activity and liquidity in the capital market should consciously structure strategies that contemplate sustainable profitability to allow for payment of dividends to their investors. This will instill confidence and increase investor participation to intensify market turnovers, eventually stimulating development of the financial markets to mobilize long term capital for the economic development.

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