Faculty of Economics and Business

A STUDY ON RISK AND RETURN OF MALAYSIAN FIRMS: HOW DO THEY AFFECT DIVIDENDS?

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Statement of Originality

The work described in this Final Year Project, entitled
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is to the best of the author's knowledge that of the author except where due reference is made.

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ABSTRACT

A STUDY ON RISK AND RETURN OF MALAYSIAN FIRMS: HOW DO THEY AFFECT DIVIDENDS?

By

Kelly anak Usit

This study focuses on determining how risk and return of Malaysian public listed firms affect the dividend payments. Specifically, this study is aimed to investigate the actual relationship between risk and return as well as profitability and firm size of Malaysian firm and dividends. The sample data were collected from a total of 248 companies which listed in Bursa Malaysia. On the other hand, the test of study is conducted from a period January 2006 to December 2010 and used average stock returns, beta coefficient of each firma as a proxy of risk, profitability and firm size. Six hypothesized relationship were tested. Descriptive statistics, correlation matrix and panel regression tests were utilized to test the hypotheses. The results obtained were appealing as risk and stock return in Malaysia in line with CAPM Theory. The risk and returns as well as firm size of the firms have a negative relationship with dividend payment contradicts with the results between profitability and dividends where exists a positive relationship. This study may be practical for directors and managers to comprehend the scope of dividend payments based on firm's characteristics towards a better dividend policy. This study enhances the knowledge and understanding in this area to both academicians and practitioners.

ABSTRAK

KAJIAN TENTANG RISIKO DAN PULANGAN BAGI FIRMA DI MALAYSIA: BAGAIMANAKAH MEREKA MEMPENGARUHI DIVIDEN?

Oleh

Kelly anak Usit

Kajian ini memberi tumpuan dalam menentukan bagaimana risiko and pulangan bagi firma tersenarai di Malaysia mempengaruhi pembayaran dividen. Secara khususnya, kajian ini bertujuan untuk menguij hubungan sebenar antara risiko dan pulangan serta keuntungan dan saiz firma dengan dividen. Sampel data dikumpul dengan jumlah 248 firma awam tersenarai yang tersenarai dalam Bursa Malaysia. Selain itu, kaijan ini dijalankan dari masa Januari 2006 hingga Disember 2010 dan menggunakan nilai purata pulangan stok, beta pekali untuk setiap firma sebagai proksi risiko, keuntungan dan saiz firma. Enam hipotesis hubungan telah diuji. Statistik descriptif, korelasi matriks dan uji panel regresi diaplikasikan untuk menguji hipotesis. Keputusan diperolehi dan menunjukkan risiko dan pulangan di Malaysia sama dengan teori CAPM. Risiko dan pulangan serta saiz firma mempunyai hubungan negatif dengan pembayaran dividen namun bertentangan pula dengan keputusan antara keuntungan dan dividen telah wujud hubungan positif. Kajian ini mungkin praktikal untuk pengarah dan pengurus untuk memahami skop pembayaran dividen berdasarkan sifat firma terhadap polisi dividen yang lebih baik. Kajian ini menambahkan pengetahuan dan pemahaman dalam area ini untuk ahli akademik dan pengamal.

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INTRODUCTION

1.1 Introduction

Generally, firms make a set of decision which leads to the maximization on firm value which is measured by a market price of returns and dividends. In order to maximize the firm value, the firms shall giving priority to maximization on shareholders' wealth. Hence, the concept of shareholders wealth maximization is therefore related to the ability of the managers to maximize the long run value of the firms' market price per share.

In order to achieve this primary objective, the firms must decide to produce products that customers want in efficient way and sell at a competitive price with observe laws which comply with corporate behaviour (Birmingham & Houston, 2007). If the firms tend to follow these rules, the firms should able to generate profits for their shareholders. Therefore, investors will prefer the firms that offer an attractive share price per earning with higher profits from investment.

Obviously, a successful firm will generate profit (Amidu & Abor, 2006). The investors believe that the profitable and stable firms manage to maximize their wealth in a long term period. As a return, the firms will distribute the profits in term of paying dividends or using the cash to repurchase common stock. For instance, mature firms with stable cash flows and limited growth investment opportunities tend to distribute more cash to their shareholders.

In term of focusing on shareholders wealth maximization by distributing dividends and repurchase an additional stock, the firms also concern on the risk of the stocks which also influence the amount of the profits. Holton (2004) referred a risk as an exposure to proposition of which one is uncertain. While, in investment terms, Reilly and Brown (2009) defined risk as the degree of uncertainty of futures outcomes which impact the return of investments.

The rate of return on stocks is measured by the level of riskiness. There are two basic types of risk which are systematic risk and unsystematic risk (Galagedera, 2007). Systematic risk is one that investors have concern more in computing returns. Alternatively, to achieve shareholders' wealth maximization, the firms shall define a solution to hedge the risk arise from investment. Therefore, it can attract more investors to purchase their stocks.

According to Expected Utility Theory, investors are typically risk averse, because they like returns and require higher rate of return but dislike risk and in fact they prefer low risk with high return. In other words, they will not purchase risky stocks unless these stocks that will offer higher returns. However, based on illustration on CAPM (Capital Asset Pricing Model) theory, an asset with a high degree of relevant risk must associate with a relatively higher expected rate of returns to attract investors. Therefore, the firms need to measure and identify the expected rate of returns that is relevant to its riskiness thus can be more attractive and competitive stock in trading market. Most finance scholars believe that the stocks offer the chance of higher returns compared to other financial products.

The investors known to invest in those stocks that guarantee a higher stock returns because the share price of the stocks has directly affects the wealth of households and their consumptions. Therefore, they expect to earn a positive return on their investment. Their purchasing power has increases and tends to own more cash in hand which is generated by their investment sources. Hence, to increase their own wealth, the investors themselves shall also dare to be risk taker thus to get valuable expected rate of returns.

Stock return is defined as the rate of return expected to be realized from an investment or the weighted average of the probability distribution of possible results (Brigham & Houston, 2007). In corporate finance, there is a trade off between risks and stock return. Due to some evidences, risk and stock returns have highly correlation and have numerous implications on managers and investors. Sharpe (1964) and Lintner (1965) have proposed that in the CAPM theory, there an existence of a linear relation between the expected rate of returns on a risky and its systematic risk. Investors do like higher rate of return because they defined the returns as a compensation given by firms for them after they invest in riskier stock (Tang & Wai, 2004).

Research by Lee and Lee (2008) acknowledged that the returns to an investment in shares trade on their stock market usually come from two forms which are capital gains and dividends. To achieve the primary goal of management which is to maximize the shareholders' wealth, most of the firms choose to pay dividends. Oxford English Dictionary defines dividend as a sum of money paid regularly by a company to its shareholders out of its profits.

If a firm generate profits, it can be reinvested into the shares by the shareholders or it can be distributed as dividends to the shareholders by the firm. This statement has supported by Amidu and Abor (2006), according to them in order to distribute the dividends to shareholders and investors, the managers' firms do need to determine in what way they want to distribute the profits among their shareholders either in terms of capital gain or dividend.

1.2 Background of study

Malaysia is formerly colonized by British and she is one of developing countries that practice liberalization when Bursa Malaysia opened to foreign investors. In Malaysia, the main stock market that is actively operating is called Bursa Malaysia. Bursa Malaysia has important role to maintaining an active, proficient and secure stock market especially for domestic and global investors in order to assisting the development of Malaysia capital market.

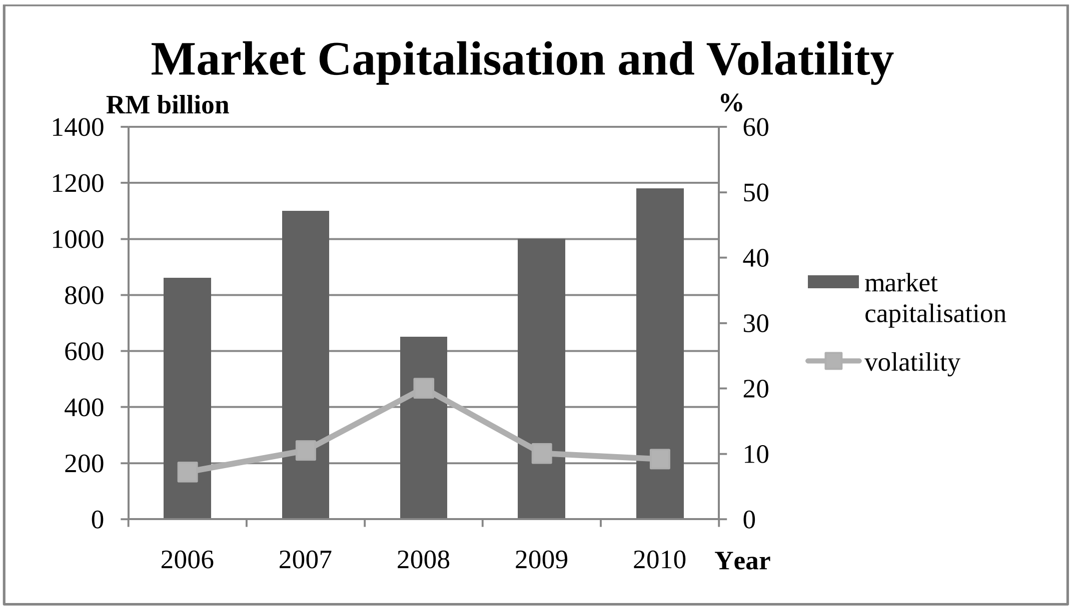
The stock market is a main source for companies to raise capital which allowed the companies to go public and raise additional capital for expansion by issuing stock to investors. Therefore, Bank Negara Malaysia need to keep on eyes on the movement and behaviour of every stock market traded in Bursa Malaysia. In addition, Bursa Malaysia itself monitors the amount of return and dividend distribution by the firms through the buy or sells transactions that done by the investors (Lee & Lee, 2008).

Generally, the investors realize that the stock market is a volatile place to invest their money in. Risk is commonly associated with volatility (Tan *et al.*, 2011). Malaysia had been through a few tough times during Asian financial crisis and mortgage subprime crisis.

Many researchers critically argued that different stock markets such as between developed market and emerging market have different volatility of stock returns. In an emerging market context such as Malaysia, consideration on the volatility of stocks is an important economic fundamental in order to analyse stock return of the firms. Wagner (2008) defined the stock volatility as a measure of distribution around the mean or average return of a security and it measured by standard deviation. When all of stock prices are tightly bunched together, the standard deviation is small, but if the prices are spread, the standard deviation is larger. Thus, when the standard deviation is larger, the risk will in fact also higher.

Wagner (2008) also stated that there is a strong relationship between volatility and market performance. It is because volatility tends to decrease as the stock market rises and increase as the stock market falls. Thus, when the volatility increases, risk increases and return tends to decline.

Figure 1.1: Market Capitalisation and Volatility in Bursa Malaysia



(Source: Bursa Malaysia, 2010/2011)

From Figure 1.1, ended on August 2010, it shows that volatility of stock markets in Bursa Malaysia is below 20% except for year 2008. According to the Economic Report 2010/2011 established by Ministry of Finance Malaysia, it reported that market volatility declined in the Malaysian capital market. In year 2008, due to subprime crisis in United States, the stock's volatility is increased.

Many studies are carried out to analyse the trend and existence of the stock volatility. For example, according to Charette (n.d) the potential of volatility in Malaysian market was occurred starting year 1995. Chin (2008) found that the stock market exhibited the presence of long memory volatility in Malaysian stock market. This aligned with the study done by Tan and Khan (2010) who found that the existence of long memory features in return and volatility in this country. According to them, this feature could happen when stock market has different reaction on market information, interests and risk profile.

This issue supported by Law *et al.* (2008) where the research conducted from period of 1985 to 2006. The empirical results indicate that the stock return volatility fall after the Bursa Malaysia opened up to foreign investors. However, the research finds that the volatility has arisen during the financial crisis period. During the crisis period, the volatility in Bursa Malaysia declines after the introduction of capital control measures. Liberalization allows more investors to share a given amount of risk.

On the other hand, Wee *et al.*'s (2007) survey on dividend distribution stated that the volatility of cash flows or uncertainty of future liquidity is one of the factors that might be considered by the company when setting its dividend policy. Overall, the stock volatility is related to the risk of the stock, hence, helps to measure the return from the investment in emerging market likes Malaysia. Thus, risk and return could be used to explain the dividend distribution in this country.

The topic on dividend policy and its distribution has been discussed and critically explored by researchers in previous studies. Studies in the past have covered many facets of dividend which in terms of determinants of dividend payments, reasons for paying dividends, relationship between dividend and other economic variables. But in this category, many researchers discovered that there are few elements that can determine the policy of dividend payment by the firms such as ownership structure, profitability, liquidity, firms' size and investment opportunities. Yet, not most of empirical studies have conducted a study on relationship between stock returns due to its level of riskiness and dividend payments.

1.3 Problem statement

The dividend policy remains one of the controversial issues in finance since it affects the firm's value and shareholders wealth. "The harder we look at the dividend picture, the more it seems like a puzzle, with pieces that just don't fit together" quoted from Black (1996). Hence, the topic on how firms determine their dividend payment is still a puzzle. Dividend policy has been an issue of interest in financial literature (Anil & Kapoor, 2008; Ahmed & Javid, 2009) and the explanation of it is the most difficult challenges (Bhattacharya, 2007). Nevertheless, Black (1976) found no convincing explanation of why firms declare dividend to their shareholders and investors. Why firms pay dividend is still a main concern by scholars.

Shareholders foresee a competitive stock return in term of dividend payments and growth in share prices. Wee *et al.* (2007) stated that a company is a channel for investment and as their wealth represents on the return on capital invested by the investors as a reward for bearing risk from investment. He also added that, share price appreciation and dividend payments are common method for companies to distribute its wealth. Due to this scenario, researchers have created and developed many theories on dividends. The theory of dividend and its effect on the firm value is perhaps one of the most important yet still puzzling theories in finance. Modgliani and Miller Theory proposed that shareholders may be indifferent about the amount of dividend as it has no influence on the value of a firm. According to MM theory, in the context of a perfect market, the firms suppose to be transparent and disclosure hence investors can clearly see how a business will perform today and future.

Rational, dividend payments may be irrelevant in a perfect market, yet many know that these perfect market assumptions do not hold in today's world (Ergungor, 2004; Purmessur & Boodhoo, 2009). This may be due to the emergence of global borderless economy and rapid technological changes. Different with Bird-in-the-Hand Theory which argued that firm's value will be maximized if dividend payout ratio is higher thus, increase the shareholders' wealth. The theory proposes that shareholders are risk averse and prefer to receive dividend payments rather than future capital gains because future capital gains considered being uncertainty by shareholders (Srinivasan, 2011). According to La Porta *et al.* (1999), they described that the dividends as a "bird in hand" because dividend is better than retained earnings and in latter might not be a future dividend for the shareholders which "can fly away".

Although declare dividend payments is a way to maximize shareholders' wealth, but not many companies able to maintain a flat and regular dividend payments in long period due to certain obstacles and circumstances. A consistency of dividend payments is an important factor influent these shareholders to invest their money. However, the board of directors is the one who responsible in making declaration and decision on dividends. The decision to pay dividend depends on the amount of the profit that available for distribution after taking into account that is needed to be retained for the operation (Wee *et al.*, 2007).

However, dividend payments do matters for context of Malaysia (Norhayati *et al*, 2006) and paying a high dividend is not the typical feature of Malaysian firms

(Foong et al., 2007). In Malaysia, there is no standard regulatory that governing dividend payment. Additionally, companies are free to decide when and how much to make dividends as long as the companies complied with Companies Act 1965 rules (Ling *et al.,* 2008). Under section 365 of the Companies Act 1965 reads, "No dividends shall be payable to the shareholders of any company except out of profits or pursuant to Section 60." In other words, the Act requires that the dividends of a company can only distributed from the profits earned by the company except pursuant to Section 60. On the hand, Malaysian firms have to pay corporate tax on pre-tax profits that are retained. Hence, it more costly for the Malaysian firms to retain earnings. Therefore, to overcome such tax systems, firms have to pay a high dividend to benefit from tax reduction.

In context of Malaysia, there are few reasons found by Wee *et al.* (2007) as to why firms do not pay dividends particularly by those firms listed in Bursa Malaysia. The first reason is that the firms usually must be profitable and their cash flow must be strong enough in order to support their dividend payout and maintain a consistent dividend policy. Second reason is that the firm might need to fund many investment opportunities with good returns. Therefore, although the firms are operating at a profit and have enough cash to pay dividend, it makes good sense if the firm choose to invest the net positive value project thus able to benefit in the long run.

This typically happens to those firms that at early stages and small size firms because they need to reinvest their excess cash in order to stabilise their operations and to take advantage of any growth opportunities. So, these firms might not too generous to distribute its wealth in term of dividend. Hence, giving away dividend will have less money for investment growth. But, at the same time, risk is higher for these companies when expand their businesses aggressively. Hence, the lack of information and literature on dividend policy of public listed companies in Malaysia provides the motivation of this study.

By studying how risk and stock return of Malaysian’s firms affect dividend payment, we seek to shed a light on their problem in term of dividend payment policy. Hence, we also fill the gap and building the bridge on the relationship between risk-return and dividends. The study therefore addresses the question whether risk and stock return are important determinants in dividend payment in Malaysia. Besides that, we also can help firms makes a better decision to maximize shareholder’s wealth. So, dividend policy has a great role in maximizing the firm value in order to attract more potential investors or shareholders.

1.4 Objective

1.4.1 General objective

The general objective of this study is to determine how the risk and return of the each firm affect the dividend payment of firms in Malaysia.

1.4.2 Specific objective

a) To identify the factors of dividend payments.
b) To measure the dividend payments given by firms to their shareholders
c) To measure risk and expected rate of return that offers by the firms.
d) To determine the relationship between risk and stock return of the firms
e) To identify the relationship between risk-return and dividend payment by the firms.