DIVIDEND SIGNALING HYPOTHESIS:
EVIDENCE FROM BANKING SECTOR
IN MALAYSIA MARKET

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DIVIDEND SIGNALING HYPOTHESIS: EVIDENCE FROM BANKING SECTOR IN MALAYSIA MARKET

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This project is submitted as a partial fulfillment of the requirements for the degree of Bachelor of Finance (Honours)

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Statement of Originality

The work described in this Final Year Project, entitled “Dividend Signaling Hypothesis: Evidence from Banking Sector in Malaysia Market” is to the best of the author’s knowledge that of the author except where due reference is made.

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(Date Submitted)            ANG HUI MEI

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ABSTRAK

HIPOTESIS DIVIDEN SIGNALING: BUKTI DARI SEKTOR PERBANKAN DI MALAYSIA

Oleh

ANG HUI MEI

Kertas ini mengkaji sama ada hipotesis dividen signaling boleh diaplikasikan di sektor perbankan di Malaysia. Maybank, CIMB Bank and Public Bank adalah sampel yang dipilih untuk kajian ini. Hal ini disebabkan ketiga-tiga bank tersebut merupakan pemegang saham pasaran yang terbesar dalam sektor perbankan di Malaysia. Ujian yang telah digunakan ialah ujian kepegunan, ujian kopengamiran Johansen dan Juselius dan ujian penyebab Granger VECM. Keputusan tersebut tidak mempunyai bukti yang kukuh untuk menunjukkan kebolehan dalam mengaplikasikan hipotesis dividen signaling dalam sektor perbankan di Malaysia dan pasaran untuk sektor perbankan di Malaysia memiliki kecekapan pasaran yang separuh kuat.
This paper examines on whether dividend signaling hypothesis is applicable in the banking sector in Malaysia market. Maybank, CIMB Bank and Public Bank are the samples used in this study as they hold the major market share in the banking sector. The empirical tests employed are unit root tests, Johansen and Juselius cointegration test, and VECM Granger causality test. The findings show little evidence on dividend signaling hypothesis in the banking sector and the market for the banking sector is belongs to semi-strong form of market efficiency.
CHAPTER ONE
INTRODUCTION

1.0 Introduction

Stock market is a public market which enables companies to trade stocks and derivatives at an agreed price. It is an important source for companies to raise additional capital through shares trading. The liquidity of the exchange enables investors to sell securities easily, thus making the stock market attractive. The price for shares and other assets is a vital part of dynamics of the economy. This can be seen from the rise and fall in the stock market. If the stock market rises, then the economy will be considered as the up-and-coming economy and vice versa. In fact, the stock market is the primary indicator of a country’s economic strength and development as the rise or fall of share price is associated with the amount of business investment made. Therefore, smooth functions in the stock market will enhance the economic growth.

Bursa Malaysia is the stock market in Malaysia. Served as the country’s formal securities business organization and financial market barometer, it governs and regulates Malaysia’s financial market. It is a fully-integrated exchange and offers a complete range of exchange-related services which include trading, clearing, settlement and depository services. It consists of main market and Access Certainty Efficiency (ACE) market with total market capitalization of RM1275 billion in 2010.

1 The main discussion in this section is adopted from Bursa Malaysia.
(Annual Report of Bursa Malaysia, 2010). Besides the two markets for securities, it also has bond market and offshore market.

In the early of 1930s, Bursa Malaysia was known as Malayan Stockbroker’s Association whereby there were no shares traded during that time. Later, Malayan Stock Exchange was established and started to trade shares publicly in the 1960s. Stock Exchange of Malaysia was established at a year before the independence of Singapore. However, a year later the common stock exchange functioned under Stock Exchange of Malaysia and Singapore (SEMS) due to the secession of Singapore from Malaysia. In 1973, SEMS was separated as a result of the currency inter-changeability between the two countries. The formal securities business organization in Malaysia was then named Kuala Lumpur Stock Exchange Berhad (KLSEB). The operation of KLSEB was later taken over by a new company limited by guarantee named Kuala Lumpur Stock Exchange (KLSE) in 1976. Twenty nine years later, it became a demutualized exchange and re-named as Bursa Malaysia Berhad.

Bursa Malaysia was listed on the main board of Bursa Malaysia Securities Berhad in 2005. At the same year, CMDS\(^2\) Bursa Research Scheme (CBRS) was introduced as a scheme that allowed the investor to retrieve annual reports of Bursa’s listed companies without charges. Kuala Lumpur Composite Index (KLCI) was the main index used that time. In order to provide a complete and comprehensive set of indices to investor, FTSE Bursa Malaysia index, a new index series jointly developed by Bursa Malaysia and FTSE Group, was introduced in June 2006. The index passed the 1000 mark hurdle and closed at 1003.28 after three months.

\(^2\)CMDS refers to Capital Market Development Fund.
Bursa Trade Securities, a new trading platform with extensive trading function and features that could enhance the processing and execution of orders, was launched in December 2008. The stock exchange was renamed as FTSE Bursa Malaysia KLCI (FBM KLCI) after the enhancement of KLCI in July 2009. The enhancement was the integration of internationally accepted index calculation methodology which intended to maintain the robustness in measuring the national economy into the former KLCI. It was intended to enhance the relationship with the global economy. The enhancement was also part of the strategic initiative of Bursa Malaysia. Besides maintaining its representativeness in stock market, the enhancement of KLCI also granted extensive range of appealing and investable opportunities. The strengths of FBM KLCI are summarized in Table 1.

Table 1: Summary of Strengths of FTSE Bursa Malaysia KLCI

<table>
<thead>
<tr>
<th>No.</th>
<th>Strengths</th>
</tr>
</thead>
<tbody>
<tr>
<td>i.</td>
<td>The KLCI is known as FTSE Bursa Malaysia KLCI to provide global relevance, recognition and reach</td>
</tr>
<tr>
<td>ii.</td>
<td>A market barometer made up of primary market movers will more aptly define market activities while remaining representative of the Malaysian stock market</td>
</tr>
<tr>
<td>iii.</td>
<td>The FTSE Bursa Malaysia Index calculation methodology emphasises free float and liquidity</td>
</tr>
<tr>
<td>iv.</td>
<td>A smaller basket of 30 stocks makes it easier to manage and more appealing for the creation of Index Linked products to promote market liquidity</td>
</tr>
<tr>
<td>v.</td>
<td>Increasing the frequency of index calculation from every 60 seconds to every 15 seconds tracks the market pulse closely and more efficiently</td>
</tr>
<tr>
<td>vi.</td>
<td>The continuity of the KLCI index value preserves the historical movements of the Malaysian stock market</td>
</tr>
</tbody>
</table>

Generally, most of the investors use FBM KLCI as the benchmark to evaluate the stocks on hold. They will depend on whether the stock return is outperforming or underperforming from FBM KLCI after any announcement from the firm like earnings announcement, dividend announcement, stock splits and many more. According to the random walk theory by Fama (1965), the pattern of the stock prices no longer exists and price changes in one period will be independent of changes in the next. In other words, the current stock prices can be tracked by the trend of past prices in only a short period of time. Therefore, investors will try to take advantage on the opportunity to gain some profit. Hussin et al. (2010) proved that the stock market for Malaysia is under the category of semi-strong form of efficiency as their findings evidenced that there has been an efficient adjustment on the stock prices towards the announcements on both earnings and dividends. This indicated that predictions on stock prices can be made based on the published announcement that can create the arbitrage opportunity for capital gain. As for investors who aim to maximize their return from the stocks, those announcements are also essential for them to make the decision whether to hold, sell or buy the stock of the company.

1.1 Dividend and Stock Price

Dividend is a type of payment to the shareholders as a return upon their investment in the firm. It is a taxable payment from a portion of the company’s current retained earnings that was declared by the board of the director of the company. Some companies distribute the dividend to their shareholders biannually whereas some companies distribute it annually. It comprises of both interim dividend
and final dividend. However, this depends on the payout policy set in the company. Dividend per share (DPS) is the amount that investor will receive for each share that they have owned. According to Brigham and Houston (2007, pp. 73), DPS is determined by the total dividends paid to common stockholders divided by common share outstanding. Generally, the company’s board of committees will decide to either pay out cash to shareholders by dividend or share repurchase for the upcoming financial year during the Annual General Meeting of the current financial year.

As indicated in Table 2, Public Bank paid the highest dividend per share among all the local banks in 2009, whereas Eon Bank paid the lowest. Brealey et al. (2008, pp. 446) suggested that this might be caused by the fact that “they have accumulated large amount of unwanted cash or wish to change the capital structure by replacing equity with debt”, known as share repurchase. On the other hand, Bank Islam did not pay any dividend because the company’s policy is based on profit sharing. Although dividend conveys a powerful message about its future prospect and performance, it holds little value as compared to dividend yield since investors are unable to analyze the dividend payout without comparison with the stock value of the share.
# Table 2: Summary of Dividend per Share, Share Outstanding, Share Price and Dividend Yield of 10 Local Banks in Malaysia

<table>
<thead>
<tr>
<th>Local Banks</th>
<th>Dividend per Share (sen)</th>
<th>Share Outstanding ('000)</th>
<th>Share Price&lt;sup&gt;3&lt;/sup&gt; (RM)</th>
<th>Dividend Yield (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Affin Holdings Berhad</td>
<td>8.50</td>
<td>1439285</td>
<td>2.52</td>
<td>34.00</td>
</tr>
<tr>
<td>Alliance Financial Group Berhad</td>
<td>6.20</td>
<td>600517</td>
<td>2.71</td>
<td>23.00</td>
</tr>
<tr>
<td>AMMB Holdings Berhad</td>
<td>6.00</td>
<td>2722970</td>
<td>5.00</td>
<td>12.00</td>
</tr>
<tr>
<td>BIMB Holdings Berhad</td>
<td>Nil</td>
<td>1725490</td>
<td>1.19</td>
<td>Nil</td>
</tr>
<tr>
<td>CIMB Group Holdings Berhad</td>
<td>25.00</td>
<td>3531766</td>
<td>12.84</td>
<td>19.47</td>
</tr>
<tr>
<td>EON Capital Berhad</td>
<td>5.77</td>
<td>693209</td>
<td>6.84</td>
<td>8.44</td>
</tr>
<tr>
<td>Hong Leong Bank Berhad</td>
<td>18.10</td>
<td>1580107</td>
<td>7.91</td>
<td>22.88</td>
</tr>
<tr>
<td>Malayan Banking Berhad</td>
<td>14.80</td>
<td>7077663</td>
<td>6.43</td>
<td>23.02</td>
</tr>
<tr>
<td>Public Bank Berhad</td>
<td>41.30</td>
<td>3531926</td>
<td>10.84</td>
<td>38.10</td>
</tr>
<tr>
<td>RHB Capital Berhad</td>
<td>22.50</td>
<td>2153474</td>
<td>5.11</td>
<td>44.03</td>
</tr>
</tbody>
</table>


Dividend yield is a financial ratio that indicates the return from a stock based on dividend. It shows the value of an investment - whether a particular stock is worthwhile or not. Brigham and Houston (2007, pp. 294) pointed out that it is determined by expected dividend by the current share price of a stock. By using expected dividend values over a period of time or past dividend values, it can help investors to evaluate their investment and build up the right portfolio.

<sup>3</sup>The share price is based on the adjusted close price on December 31, 2010 which retrieved from Yahoo Finance Malaysia (2011).
Cycle & Carriage Bintang Berhad, Aliran Ihsan Resources Berhad, Jaycorp Berhad, Lingkaran Trans Kota Holdings Berhad, Heitech Padu Berhad, Axis Reits, Hup Seng Industries Berhad, Complete Logistic Services Berhad, Malaysian Bulk Carriers Berhad and Hektar Reits were the top ten in the main market companies based on highest prospective dividend yield on October 18, 2009, as reported in The Star Online (2010). The result has shown that some of the dividends given were 4-5 times higher than fixed deposits rate in the bank during that time even when the current fixed deposit rate in November 2009 was just 2.0-2.5 percent only. This shows that the stocks are indeed attractive to the investors.

As for the banking industry, RHB Bank had the highest dividend yield among all the local banks in Malaysia in 2009 while EON Bank had the lowest as demonstrated in Table 2. In fact, investors often aim for high dividend yield since it signifies high return of a stock. However, high dividend yield does not always signify that it is a good investment as it may turn into losses when the stock prices fall. In other words, the stock price may rise due to the rapid growth of a company. On the other hand, low dividend yield does not mean that it is a bad investment as the future dividend payment may be higher than the current dividend payment. Hence, it is important to study the background of the company as well as its financial health since most of investment is associates with risk. However, the final investment decision still depends on the investors; different investor may have different concern about capital gain.
1.2 Earnings and Share Price

Earnings refer the net income after tax of a financial year of a firm. Brigham and Houston (2007, pp. 69) claimed that retained earnings are a portion of firms net income after tax that will be reserved instead of distribute to shareholder as dividends. Normally it will be utilized for reinvestment or debt payment. On the other hand, the remaining of the earnings will be paid out as dividends. Besides being served as the bottom line and key measure of a business success, earnings are also used with other financial determinants to form instruments that can determine a firm’s performance. These include earnings per share, price earnings ratio and many more. From an investor’s perspective, earnings of a firm determine the attractiveness of its stock. Firm with poorer earnings prospect will undoubtedly has lower share price and vice versa. Thus, the ability of a firm in generating profit is important since its stocks are priced based on future earnings of the firm.

As reference to Table 3, Bank Islam has the lowest attributable earnings of RM161.87 million among all the local banks with the lowest stock price of RM1.19. In contrast, CIMB Bank has greater attributable earnings and thus higher stock price. Therefore, it is true that ‘poor earnings prospect will have lower share price’. The similar trend also happened in the earnings per share of the firm too. Earnings per share are the earnings over the company’s number of share outstanding. Table 3 depicts that CIMB Bank has the highest earnings per share of RM79.51 among all the local banks while Maybank has the lowest, with only RM12.00 per share. Besides serving as a vital figure in valuing the stock, earnings per share also indicates the
firm’s ability to pay dividend to common stockholder and to do reinvestment in the firm.

Table 3: Summary of Earnings per Share, Attributable Earnings, Share Price and Price Earnings Ratio of 10 Local Banks in Malaysia

<table>
<thead>
<tr>
<th>Local Banks</th>
<th>Earnings per share (sen)</th>
<th>Attributable earnings (RM'000)</th>
<th>Share price(^4) (RM)</th>
<th>Price earnings ratio(^5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Affin Holdings Berhad</td>
<td>22.70</td>
<td>317752</td>
<td>2.52</td>
<td>1.11</td>
</tr>
<tr>
<td>Alliance Financial Group Berhad</td>
<td>14.90</td>
<td>237078</td>
<td>2.71</td>
<td>1.82</td>
</tr>
<tr>
<td>AMMB Holdings Berhad</td>
<td>31.60</td>
<td>860824</td>
<td>5.00</td>
<td>1.58</td>
</tr>
<tr>
<td>BIMB Holdings Berhad</td>
<td>12.69</td>
<td>161876</td>
<td>1.19</td>
<td>0.94</td>
</tr>
<tr>
<td>CIMB Group Holdings Berhad</td>
<td>79.51</td>
<td>2806816</td>
<td>12.84</td>
<td>1.61</td>
</tr>
<tr>
<td>EON Capital Berhad</td>
<td>49.20</td>
<td>341104</td>
<td>6.84</td>
<td>1.39</td>
</tr>
<tr>
<td>Hong Leong Bank Berhad</td>
<td>62.50</td>
<td>905335</td>
<td>7.91</td>
<td>1.27</td>
</tr>
<tr>
<td>Malayan Banking Berhad</td>
<td>12.00</td>
<td>691875</td>
<td>6.43</td>
<td>5.36</td>
</tr>
<tr>
<td>Public Bank Berhad</td>
<td>73.30</td>
<td>2517302</td>
<td>10.84</td>
<td>1.48</td>
</tr>
<tr>
<td>RHB Capital Berhad</td>
<td>55.80</td>
<td>1201363</td>
<td>5.11</td>
<td>0.92</td>
</tr>
</tbody>
</table>


Price-Earnings ratio (P/E ratio) is another tool used to find out the value of a firm’s stock. Brigham and Houston (2007, pp. 116) stated that this ratio expressed how much the investors are willing to pay for each Ringgit of the firm’s earnings. It is the result of current stock price over earnings per share. High P/E ratio indicates

\(^4\) The share price is based on the adjusted close price on December 31, 2010 which retrieved from Yahoo Finance Malaysia (2011).
\(^5\) Price earnings ratio is the result of stock prices over company’s earnings per share.
that the market is more willing to pay for the firm’s earnings but it may also indicate that the stock is overpriced and vice versa. This signifies that the stock is a risky investment especially for those young firms which are still under the early growth stage in the business. Nevertheless, stocks with high P/E ratio can also be a great investment. Table 3 reveals that RHB Bank has the lowest P/E ratio of 0.92 while Maybank, who owned the lowest EPS, has the highest P/E ratio of 5.36 among all the local banks. This shows that more people are willing to pay for the stocks of Maybank with the hope for its earnings. In fact, majority believes that Maybank has a good long term prospect over and above its current position due to its experience of operating in the banking world for more than 50 years.

1.3 Market Capitalization

Market capitalization is a measurement of a size of a corporation which represents the equity owned by the company and thus determines the stock valuation. As stated in Investopedia (2011), market capitalization is resulting from multiplying the outstanding share of a company with the current stock price of the company. It is important for investors to gain such information before making any investment decision whereby it presents better picture of the company’s size and also the level of the risk involved.
However, the method used in the calculation of market capitalization in FBM KLCI is different from the method mentioned above. Its calculation is based on free float market capitalization which means that stocks with greater free float\(^6\) will gain greater weight in the index. Since the free float factor is hard to be determined, the market capitalization in this research will use the first method mentioned above. Table 4 indicates the market capitalization of ten local banks. Since Maybank, CIMB Bank and Public Bank have acquired approximately 73 percent of the market share in the country’s banking industry in 2009, therefore this three banks will be used as the samples in this study.

\(^6\) For more information about free float, please refer to the website of Bursa Malaysia, http://www.bursamalaysia.com/website/bm/market_information/fbm_klci.html.