To pay or not to pay?
The dividend dilemma of the liquid firm

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Abstract

In the presence of trading frictions investors with liquidity needs might have preference for dividend paying stocks. However, this preference should decline as trading frictions in the market decline. Furthermore, lower trading frictions can have an indirect effect on the dividend policies of firms through facilitating more efficient monitoring of large investors and thus reducing asymmetric information and mitigating agency problems. We hypothesize that the probability of firms to pay dividends will be positively related to the trading frictions that investors have to overcome in the stock market. We investigate the issue empirically both in the cross-section and through time. Our cross-sectional analysis lends significant support to the above hypothesis by documenting that firms with more liquid markets are less likely to pay dividends. Additionally, our time-series evidence suggests that periods of lower trading costs and increased market activity are also characterized by fewer dividend payers. Interestingly, the evidence suggests that dividend initiation rates drop following periods of declining trading frictions. The paper contributes to the literature by, first, empirically documenting the impact of market imperfections on firm dividend policy. Second, the results of the paper relate to the findings of Fama and French (2001), who document that firms have a declining propensity to pay dividends over time. Our analyses suggest that the lower propensity of firms to pay dividends in recent years is largely explained by improved market liquidity. Further investigation reveals that market liquidity improves the prediction of the model more notably for large financially liquid firms. These are the firms with higher ability to pay dividends. The results of the paper do not seem to be driven by changes in tax-induced preferences, share repurchase activity, firm conversion policies, or managerial compensation.

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