

The Information Content of Dividends: Safer Profits, not Higher Profits*

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Abstract

A large body of empirical literature suggests that dividend changes are not followed by like changes in future earnings. We show theoretically that dividends may signal safer, rather than higher future profits, i.e., dividends signal the second moment of future profits rather than the first moment. We use the Campbell (1991) decomposition to estimate changes in cash flow volatility around dividend events from data on stock returns. We find that cash flow volatility is significantly lower after dividend increases and higher after dividend decreases. Crucially, consistent with our model, larger changes in dividends are associated with larger changes in cash flow volatility in the expected direction; and larger changes in volatility following a dividend change are associated with larger announcement returns. We also find that for the same dollar of dividend paid there are larger changes in cash flow volatility for firms with smaller current earnings, consistent with the model's prediction that the cost of the signal is foregone investment opportunities. Finally, our methodology can be applied to overcome empirical problems in testing theories of corporate financing more generally.

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I Introduction

Dividends represent one of the major financial decisions of corporations and one the main puzzles for academic economists. Understanding why firms pay dividends has bearings for theories of asset pricing, capital structure, capital budgeting, cost of capital, and also for public economics, in particular for the effects of tax policy. Yet, despite extensive research we still do not fully understand why some firms pay dividends and some others do not. Even firms with very similar observable characteristics such as earnings and level of cash display stark differences in terms of their dividend policies.

One hypothesis, initially postulated by Miller and Modigliani (1961), and later formalized by Miller and Rock (1985) and others, holds that dividends signal future profits. If managers have superior information about the level of firms' future profits, the decision to pay dividends can convey such information to the market. This very appealing and intuitive idea was initially very popular, as it is consistent with the extensive empirical evidence that stock prices systematically increase at the announcement of dividend initiations or increases; and systematically decrease at the announcement of dividend omissions or decreases.¹ Accordingly, a large theoretical literature has formalized the dividend payment decision as one in which firm insiders with superior positive information (e.g., about the firm's future earnings or productivity) pay a dividend at some cost (e.g., foregone investment or deadweight losses due to taxes), to convey such information to the market.²

While initially very popular, the dividend signaling idea lost considerable traction in the face of the mounting evidence that, following dividend changes, actual earnings do not change in the same direction. In fact, as stated in several reviews of the literature (see, e.g., Allen and Michaely (2003) and DeAngelo, DeAngelo, Skinner, et al. (2009)), a necessary condition for the dividend signaling hypothesis to explain dividend policy is that dividend changes predict future changes in earnings or cash flows in the same direction. Yet, studies by Watts (1973), Gonedes (1978), Penman (1983), DeAngelo,

¹See, e.g., Pettit (1972), Pettit (1977), Charest (1978), Asquith and Mullins Jr (1983), Brickley (1983), and Eades, Hess, and Kim (1985).

²See, e.g., Bhattacharya (1979), Bhattacharya (1980), John and Williams (1985), Miller and Rock (1985), and Bernheim (1991).

DeAngelo, and Skinner (1996), Benartzi, Michaely, and Thaler (1997), Grullon, Michaely, and Swaminathan (2002), among others find little or no evidence that dividend changes predict abnormal changes in earnings. DeAngelo et al. (2009) summarize the empirical evidence as follows: “We conclude that managerial signaling motives [...] have at best minor influence on payout policy”

Yet, the notion that dividends convey information about some firm’s prospects is intuitive and remains popular. First, Brav, Graham, Harvey, and Michaely (2005) report that almost 80% of managers believe dividend policy convey information. But information about what? Empirical evidence suggest it is not about the level of earnings or cash flows.

In this paper we propose, in the spirit of Lintner (1956), that dividends do not signal the first moment of future profits, that is, the average of expected future profits, but rather their second moment, that is, the volatility of expected future profits. Managers increase dividends when they believe the chance for future cuts are lower, in the spirit of Lintner (1956) and Brav et al. (2005) observations. If dividend initiations or increases signal safer profits going forward, then it is natural to expect future dividend payments to remain stable once they are initiated or increased. Furthermore, if there is a cost to omit or discontinue dividends then naturally when earnings are more stable the risk of having to omit or discontinue dividends is low.

To develop our hypothesis more formally we provide a theoretical framework in which managers have superior information about the volatility of future cash flows relative to investors. Investors care about future cash-flow volatility, because they are risk averse. In the spirit of Miller and Rock (1985), paying dividends is costly to firms because by doing so the firm foregoes future investment opportunities, the more so for the firms with riskier cash flows. In this context, safer firms have an incentive to pay a dividend to signal their low future cash-flow volatility, and riskier firms find it too costly to do the same. In such a separating equilibrium, the market perfectly learns the firm’s true type. As a result, dividends perform two functions in our model. First, dividends signal smoother future cash flows, thereby increasing the share price today. Second, dividends help investors meet their liquidity needs, at least partially.

The main prediction of our framework is that cash flow volatility should decrease

following a dividend increase (or initiation), and should increase following a dividend decrease (or omission); furthermore, larger dividend payments should carry more information, in the sense that larger dividend increases should be followed by both larger decreases in cash flow volatility and larger cumulative abnormal returns at the announcement.

Our framework allows us for another important insight regarding the economic channel driving these results. Since the cost of the signal is foregone investment opportunities, then following a dividend change we should expect a larger change in future cash flow volatility for firms with smaller current earnings. The intuition for this cross-sectional implication is straightforward. The smaller the current earnings, the larger the foregone future investment opportunities at a given level of dividend. As a result, the same dividend should carry a larger information content. The model yields a similar prediction about the level of cash.

We test the model's predictions empirically. We begin by observing that corporate earnings are not stationary.³ This observation is akin to the observation by Fama (1965) and others that stock prices are not stationary, which prompted the field of asset pricing to focus empirically on stock returns rather than on levels of stock prices. Because earnings are not stationary, a naive approach of comparing the realized variance of earnings before and after a dividend event would be uninformative, as the results of such an approach would reflect such non-stationarity rather than any information content of dividends.

We address this challenge by borrowing a methodology from asset pricing and by showing how this methodology can be applied to overcome empirical problems in testing theories of corporate financing. We use a methodology initially proposed by Campbell (1991), Campbell and Shiller (1988a), and Campbell and Shiller (1988b) to study aggregate market return predictability. They argue that unexpectedly high returns come either from positive news about future cash flow or news about lower future discount rates. Vuolteenaho (2002) extends this framework and applies it at the individual firm level. We follow Vuolteenaho (2002) to construct cash-flow and discount-rate news and we examine whether they vary around dividend events.

³As mentioned above, a large accounting literature has proposed a variety of adjustments for linear or non-linear trends in corporate earnings. There is currently no consensus on which adjustment to make.

At the firm level we identify four “dividend events”: dividend initiations, omissions, increases, and decreases. Then, for each one of such events we estimate two firm-level vector autoregressions to isolate return and cash-flow news, one for the 60 months before the event and another for the 60 months afterwards, and we compare the variance of cash flow news before and after the dividend event.

We find that the variance of cash flow news is significantly lower after dividend initiations and dividend increases; and we find that the variance of cash-flow news is significantly higher after dividend omissions and dividend decreases. Crucially, consistent with theory, larger changes in dividends are associated with larger changes in cash flow variance in the expected direction; and announcements of larger changes in dividends are associated with larger cumulative abnormal returns in the same direction. We also confirm the model prediction that the signal should be more informative for firms with larger volatility. Dividend changes for firms with higher volatility are associated with larger changes in cash-flow volatility and dividend-event returns. We also revisit the earlier evidence on changes in the first moment of earnings following changes in dividends using our new methodology, and we confirm the previous findings that in general corporate earnings do not change in the same direction as dividend changes. Finally, we examine the cross-sectional variation of changes in volatility. Consistent with our framework in which the cost of the signal is foregone investment opportunities, we find that for the same \$1 of dividend paid there are larger changes in cash-flow volatility for firms with smaller current earnings.

The paper proceeds as follows. Section II presents the theoretical framework; Section III presents our method for estimating cash flow and discount rate news and their variances around dividend events; Section IV presents the data; Section V presents our empirical results; Section VI concludes.

II The Theoretical Framework

A. Basic Setting

Consider a corporation run by a manager and operating for three dates ($t = 0, 1, 2$) and two periods. At $t = 0$, the manager chooses the level of investment I_0 . At $t = 1$, the manager decides to pay dividends D_1 . After that, cash flows are realized, $Y_1 = f(I_0) + \theta$, where f is a production function with $f' > 0$, $f'' < 0$, and $f''' > 0$; θ is distributed according to some function G , with expected value $\mathbb{E}(\theta)$ and some variance σ^2 . After dividends are paid and cash flows are realized, the manager invests I_1 . At $t = 2$, the manager realizes and pays out the final cash flows $Y_2 = \beta \cdot f(I_1)$.⁴ The interest rate equals zero, and investors may trade shares continuously between $t = 0$ and $t = 2$.

The manager maximizes the expected utility function

$$\mathbb{E}[U(W)] = \mathbb{E}(W) - \frac{a}{2}\sigma^2(W)$$

where $\mathbb{E}(W)$ is the expected value of the investors' wealth, $\sigma^2(W)$ is the variance of wealth and a is a risk aversion parameter.⁵ We assume that both investors and the manager know that $\mathbb{E}(\theta) = 0$, and that they have asymmetric information about the variance of the firm's cash flows, σ^2 , which is distributed according to some function G over $[0, \sigma_{\max}^2]$.

Consistent with the signaling literature (e.g., Miller and Rock (1985)), we assume that some investors are hit by an idiosyncratic liquidity shock at $t = 1$ and as a result must sell their shares. To be precise, we assume that a fraction k of these investors sell after dividends D_1 are paid and before cash flows Y_2 are realized, while the remaining $(1 - k)$ will hold their shares until $t = 2$.

We assume that the manager acts in the interest of investors who own the firm at $t = 1$. In addition, we assume that the manager learns σ^2 at $t = 1$ before paying dividends, while investors observe only D_1 .

⁴All values I_0, I_1, Y_1, Y_2, D_1 can be thought as being *per share*, wlog.

⁵One way to interpret this is to assume that the firm is owned by institutional shareholders whose risk aversion reflects institutional or legal constraints, such as for example institutional charter and prudent man rule restrictions.

Therefore the manager maximizes:

$$\max_{D_1} D_1 + \mathbb{E}[Y_2] - k \cdot \frac{a}{2} \cdot \sigma^2(D_1) - (1-k) \cdot \frac{a}{2} \cdot \sigma^2,$$

subject to

$$Y_2 = \beta \cdot f(I_1) + \theta$$

$$\mathbb{E}[Y_1] = D_1 + I_1$$

which implies:

$$\max_{D_1} D_1 + f\left(Y - \frac{a}{2} \cdot \sigma^2 - D_1\right) - k \cdot \frac{a}{2} \cdot \sigma^2(D_1) - (1-k) \cdot \frac{a}{2} \cdot \sigma^2$$

where we have denoted $\mathbb{E}[Y_1] = Y$.

B. Solving the Model

The first order condition yields:

$$1 - f'\left(Y - \frac{a}{2} \cdot \sigma^2 - D_1\right) - k \cdot \frac{a}{2} \cdot \frac{\partial \sigma^2(D_1)}{\partial D_1} = 0,$$

which is an ordinary differential equation that uniquely describes the schedule, $\sigma^2(D_1)$, given the boundary condition

$$\sigma^2(D^*) = \sigma_{\max}^2,$$

which says that the lowest type with $\sigma^2(\theta) = \sigma_{\max}^2$ will choose dividends as in the full information case, thereby pinning down the Pareto dominant valuation schedule.

In this model, dividends are a signal to the market of the volatility of cash flows. Because managers care about risk-averse short-term institutional investors, they would like to signal that their cash flows have low volatility and therefore higher value. For this signal to be credible and thus generate a separating equilibrium, it must be costly, and the more so for the low types than for the high types, thereby preventing imitation. This follows from the concavity of the production function, as riskier firms have more to lose in terms of foregone investment if they pay a larger dividend in an attempt to mimic safer

firms.

C. Comparative Statics and Testable Implications

We derive the main comparative statics, which will guide our empirical analysis in the next section. The first comparative statics,

$$\frac{\partial \sigma^2(D_1)}{\partial D_1} < 0 \quad (1)$$

simply states that larger dividends imply a lower (future) cash flow volatility. The implication is that, defined as t the date of a dividend event, we should expect to find a decrease in cash flow volatility after dividend increases and initiations, and an increase in cash flow volatility following dividend decreases and omissions. More formally, in a regression of changes in cash flow volatility, $\Delta\sigma$, from the interval $(t-1, t)$ to $(t, t+1)$ on the changes in dollar dividends from $t-1$ to t , $\Delta\text{Dividend}$,

$$\Delta\sigma = \alpha + \gamma \cdot \Delta\text{Dividend} + \varepsilon, \quad (2)$$

we should expect to find an estimated coefficient $\hat{\gamma} < 0$.

The second comparative statics provides the more nuanced cross-section prediction of our model, namely,

$$\frac{\partial^2 \sigma}{\partial D \partial Y} > 0, \quad (3)$$

stating that the cross derivative of cash flow volatility w.r. to dividends and (current) earnings is positive. That is, cross-sectionally, following a dividend increase/initiation, we should expect a larger decrease in cash flow volatility for firms with smaller current earnings. The intuition is that, the smaller the current earnings, the larger are the foregone investment opportunities for a given level of dividend payment, which implies that the same dividend should signal a larger decrease in future cash flow volatility. In other words, in the presence of low current earnings firms need a lower dividend to carry the same signaling value for future changes in cash flow volatility. This empirical implication is the most nuanced and the most unique to our framework, relative for example to a pure

precautionary savings story.⁶

More formally, in the cross sectional regression in the pooled sample of all dividend increases and decreases:

$$\Delta\sigma = \alpha + \beta_1 \cdot \Delta\text{Dividend} + \beta_2 \cdot \text{Earnings} + \beta_3 \cdot \Delta\text{Dividend} \times \text{Earnings} + \varepsilon \quad (4)$$

where Earnings is the earnings per share, we should expect to find $\hat{\beta}_3 > 0$, as per our cross-sectional second hypothesis, $\hat{\beta}_1 < 0$ as per our baseline hypothesis, and also $\hat{\beta}_2 < 0$, reflecting a scale effect.

III Method

In this section we outline our methodology to estimate cash flow volatility from stock returns, and to test our hypothesis that around dividend events cash flow volatility changes in the opposite direction as the dividend. Because corporate earnings are not stationary, measuring cash flow volatility using the realized variance of earnings would pick up such non-stationarity rather than any signaling content of dividends. Therefore, we estimate cash flow volatility from data on stock returns.

A firm's stock return is jointly determined by shocks to cash flow news – the numerator – and shocks to discount rate news – the denominator. A large literature in economics and finance employs a VAR methodology first developed in Campbell (1991) to decompose returns into news originating from cash flows and discount rates. Bernanke and Kuttner (2005) find cash flow news are as important for discount rates news for stock returns to monetary policy shocks following FOMC announcements. Vuolteenaho (2002) extends the VAR methodology to the individual firm level and finds cash flow news are the main driver of stock returns at the firm level.⁷

⁶For example, it is easy to show that in a pure precautionary savings story with symmetric information, following dividend changes one should still expect changes in cash flow volatility in the opposite direction, and yet the cross-derivative of cash flow volatility w.r. to dividends and current earnings is zero.

⁷Cash flow news are almost uncorrelated across firms which explains why discount rate news are a main driver for stock returns of broad indices (see Campbell (1991), Cochrane (1992), and Cochrane (2008)).

A. Stock Return Decomposition

We employ the framework Vuolteenaho (2002) lays out to estimate cash-flow news before and after dividend announcements. Because the method has so far not been applied in a corporate finance context, we first review the basic ingredients and closely follow the original notation.

Vuolteenaho (2002) takes the dividend-discount model of Campbell and Shiller (1988a) for the aggregate market return as starting point and applies it to the individual firm. He adapts the present-value formula to accounting data, because many individual firms do not pay dividends. Three main assumptions are necessary to achieve this goal. First, the clean surplus identity holds, that is, earnings (X) equal the change in the book-value of equity (ΔB_t) minus dividends (D). Second, the book value of equity, dividends, and the market value of equity (M) are strictly positive. Third, log book and market equity and log dividends and log book equity are cointegrated.⁸

These assumptions allow us to write the log book-to-market ratio, θ as

$$\theta_{t-1} = k_{t-1} + \sum_{s=0}^{\infty} \rho^s r_{t+s} = \sum_{s=0}^{\infty} \rho^s (roe_{t+s} - f_{t+s}), \quad (5)$$

roe is log return on equity which we define as $roe_t = \log(1 + X_t/B_{t-1})$, r_t denotes the excess log stock return, $r_t = \log(1 + R_t + F_t) - f_t$, R_t is the simple excess return, F_t is the interest rate, f_t is log of 1 plus the interest rate, and k summarizes linearization constants which are not essential for the analysis. The book-to-market ratio can be low, because market participants expect low future discount rates, that is, they discount a given stream of cash flow at a low rate (first component on the right-hand side of equation (5)), or because they expect high future cash flows (second component on the right-hand side of equation (5)).

We can follow Campbell (1991) to get return news from changes in expectations from

⁸We use small letters to denote the log of a variable unless specified otherwise.

$t - 1$ to t and reorganizing equation (5)

$$r_t - \mathbb{E}_{t-1} r_t = \Delta \mathbb{E}_t \sum_{s=0}^{\infty} \rho^s (roe_{t+s} - f_{t+s}) - \Delta \mathbb{E}_t \sum_{s=1}^{\infty} \rho^s r_{t+s}. \quad (6)$$

$\Delta \mathbb{E}_t$ denotes the change in expectations operator from $t - 1$ to t , that is, $\mathbb{E}_t(\cdot) - \mathbb{E}_{t-1}(\cdot)$. Therefore, returns can be high, if we have news about higher current and future cash flows or lower future excess returns.

Let's introduce some notation and write unexpected returns as the difference in cash-flow news, $\eta_{cf,t}$, and discount-rate news, $\eta_{r,t}$

$$r_t - \mathbb{E}_{t-1} r_t = \eta_{cf,t} - \eta_{r,t}. \quad (7)$$

B. Vector Autoregression

A vector autoregression (VAR) provides a simple time series model to infer long-horizon properties of returns from a short-run model and to implement the return decomposition. Let $z_{i,t}$ be a vector at time t containing firm-specific state variables. Let's assume a first-order VAR describes the evolution of the state variables well.⁹ We can then write the system as

$$z_{i,t} = \Gamma z_{i,t-1} + u_{i,t}. \quad (8)$$

We follow Vuolteenaho (2002) and assume Γ is both constant over time and across firms. Σ denotes the variance-covariance matrix of u_{t+1} and we assume it is independent of the information set at time $t - 1$.

Let's assume the state vector z contains firm returns as first component and let's define the vector $\mathbf{e}\mathbf{1}' = [1 \ 0 \ \dots \ 0]$. We can now write unexpected stock returns as

$$r_{i,t} - \mathbb{E}_{t-1} r_{i,t} = \mathbf{e}\mathbf{1}' u_{i,t}. \quad (9)$$

⁹The assumption of a first-order VAR is not restrictive, because we can add lags of the state variables and adjust the notation accordingly.

Discount rate news are

$$\eta_{r,t} = \Delta \mathbb{E}_t \sum_{s=1}^{\infty} \rho^s r_{t+s}, \quad (10)$$

which we can now simply write as

$$\eta_{r,t} = \mathbf{e}\mathbf{1}' \sum_{s=1}^{\infty} \rho^s \Gamma^s u_{i,t+s} \quad (11)$$

$$= \mathbf{e}\mathbf{1}' \rho \Gamma (\mathbb{1} - \rho \Gamma)^{-1} u_{i,t} \quad (12)$$

$$= \lambda' u_{i,t}, \quad (13)$$

where $\mathbb{1}$ is an identity matrix of suitable dimension and last line defines notation.

It now follows we can write cash-flow news as

$$\eta_{cf,t} = (\mathbf{e}\mathbf{1}' + \lambda') u_{i,t}. \quad (14)$$

and the variance of cash-flows as

$$\text{var}(\eta_{cf,t}) = (\mathbf{e}\mathbf{1}' + \lambda') \Sigma (\mathbf{e}\mathbf{1} + \lambda). \quad (15)$$

IV Data

We use balance sheet data from the quarterly Compustat file and stock return data from the monthly CRSP file. We follow Grullon, Michaely, and Swaminathan (2002) and Michaely, Thaler, and Womack (1995) in defining quarterly dividend changes and dividend omissions and initiations and Vuolteenaho (2002) in the sample and variable construction of the state variables of the VAR we defined in Section III. We detail both below. The sample period is 1962 to 2015.

A. Cash Flow and Return News: Sample Screens

We follow Vuolteenaho (2002) and impose the following data screens. A firm must have quarter $t - 1$, $t - 2$, and $t - 3$ book equity, $t - 1$ and $t - 2$ net income and long-term debt data. Market equity must be available for quarters $t - 1$, $t - 2$, and $t - 3$. A valid trade exists during the month immediately preceding quarter t return. A firm has at least one monthly return observation during each of the preceding five years. We exclude firms with quarter $t - 1$ market equity less than USD 10 million and book-to-market ratio of more than 100 or less than 1/100.

B. Cash Flow and Return News: Variable Definitions

The simple stock return is the 3-month cumulative monthly return, recorded from m to $m + 2$ for $m \in \{Feb, May, Aug, Nov\}$. If no return data are available, we substitute zeros for both returns and dividends. We follow Shumway (1997) and assume a delisting return of -30% if a firm is delisted for cause and has a missing delisting return. Market equity is the total market equity at the firm level from CRSP at the end of each quarter. If quarter t market equity is missing, we compound the lagged market equity with returns without dividends.

Book equity is shareholders' equity, plus balance sheet deferred taxes and investment tax credit (item TXDITCQ) if available, minus the book value of preferred stock. Depending on availability, we use stockholders' equity (item SEQQ), or common equity (item CEQQ) plus the carrying value of preferred stock (item PSTKQ), or total assets (item ATQ) minus total liabilities (item LTQ) in that order as shareholders' equity. We use redemption value (item PSTKRQ) if available, or carrying value for the book value of preferred stock. If book equity is unavailable, we proxy it by the last period's book equity plus earnings, less dividends. If neither earnings nor book equity is available, we assume the book-to-market ratio has not changed and compute the book equity proxy from the last period's book-to-market and this period's market equity. We set negative or zero book equity values to missing.

GAAP ROE is the earnings over the last period's book equity, measured according

to the U.S. Generally Accepted Accounting Principles. We use earnings available for common, in the ROE formula. When earnings are missing, we use the clean-surplus formula to compute a proxy for earnings. In either case, we do not allow the firm to lose more than its book equity. Hence, the minimum GAAP ROE is truncated to -100%. We calculate leverage as book equity over the sum of book equity and book debt. Book debt is the sum of debt in current liabilities, total long-term debt (9), and preferred stock.

Each quarter, we log transform market equity, stock returns, and return on equity and cross-sectionally demean it. Log transformation may cause problems if returns are close to -1 or if book-to-market ratios are close to zero or infinity. We mitigate these concerns redefining a firm as a portfolio of 90 percent common stock and 10 percent Treasury bills using market values. Every period, the portfolio is rebalanced to these weights.

C. Dividend Changes

We use the CRSP daily file to identify dividend changes and follow Grullon, Michaely, and Swaminathan (2002) in the sample screens and to construct quarterly dividends changes. We use all dividend changes for common stocks of U.S. firms listed on NYSE, Amex, and Nasdaq which satisfy the following criteria. The distribution is a quarterly taxable cash dividend and the previous cash dividend payment was within a window of 20–90 trading days prior to the current dividend announcement. We focus on dividend changes between 12.5% and 500%. The lower bound ensures we include only economically meaningful dividend changes, and the upper bound eliminates outliers. We also ensure no other non-dividend distribution events such as stock splits, stock dividends, mergers, and so on, occurs within 15 trading days surrounding the dividend announcement.

D. Initiations and Omissions

We follow Michaely, Thaler, and Womack (1995) to construct our dividend initiation and omission sample. We require the following criteria for initiations to be in our sample. We focus on common stocks of U.S. companies which have been traded on the NYSE or AMEX for two years prior to the initiation of the first cash dividend. This screen

eliminates new listings of firms which had previously traded on NASDAQ or on another exchange and switched the exchange with the pre-announced intention of paying dividends in the near future.

For omissions, the sample must meet one of the following three criteria: i) the company declared at least six consecutive quarterly cash payments and then paid no cash payment in a calendar quarter; ii) the company declared at least three consecutive semi-annual cash payments and then paid no cash payments in the next six months; iii) the company declared at least two consecutive annual cash payments and then paid no cash payments in the next year.

V Results

We first report the estimates of the VAR and the VAR implied importance of cash-flow news and expected return news for our sample of firms using the method we detail in Section III which closely follows Vuolteenaho (2002).

A. Estimates of the VAR System

Following our discussion in Section III, a central ingredient for our analysis is an estimate of the transition matrix γ of the VAR system and the discount factor ρ . We follow Vuolteenaho (2002) and estimate ρ as a regression coefficient of the excess log ROE minus the excess log stock return, plus the lagged book-to-market ratio on the book-to-market ratio. We find an estimate of 0.986 which is almost identical to the estimate of Vuolteenaho (2002).

Table 1 reports point estimates of a constant VAR across firms and time with t-stats in parenthesis. Consistent with findings in the literature, we find returns are positively autocorrelated, load positively on the log book-to-market ratio, and log profitability. The quarterly book-to-market ratio is highly autocorrelated and loads positively on lagged returns, and negatively on lagged profitability. Profitability is autocorrelated at the quarterly frequency, loads positively on lagged returns, and negatively on the lagged book-to-market ratio. The dynamics of our state variables are broadly consistent with

findings in the literature and especially Vuolteenaho (2002).

B. Dividend Events and Cash-flow Variance

We estimate a VAR before and after each dividend event-quarter using all available firm observations with non-missing balance-sheet data but requiring at least 5 years of data. We then use equation (15) to calculate the cash-flow variance and compare the variability of cash flows after dividend events relative to before. According to our model in Section II, we would expect announcements of dividend increases and dividend initiations to result in lower cash-flow volatility after the announcement relative to before and higher cash-flow volatilities for announcements of dividend cuts and dividend omissions. To ensure overlapping dividend events do not drive our results, we randomly drop one of the two events.¹⁰

Table 2 reports changes in cash flow news and discount rate news after dividend events relative to before separately for dividend increases, decreases, initiations, and omissions. We estimate for each dividend event two VARs before and after the quarter of the event using all firm observation with non-missing data. We then create cash-flow and discount rate news and report the average changes across events in the table.

We see in Panel A positive dividend changes, dividend initiations, negative dividend changes or dividend omissions or pooling across events do not result in a statistically significant change in cash-flow news after the event relative to before consistent with the larger previous literature which does not detect any predictive power of dividend events for the future level of earnings or profits.

In Panel B, we see changes in discount rates also cannot rationalize the evidence from event studies which robustly documents positive returns for dividend increases and initiation and negative event returns for omissions and dividend cuts.

In Panel C, instead, we see dividend increases result in a drop in the variance of cash-flow news in the five years after the event relative to the variance of cash-flow news in the five years before. Similarly, for dividend decreases, we see an increase in the variability of cash-flow news after the event relative to before. Changes in dividends are

¹⁰Results are robust to which event we drop and to not dropping any event.

signals for the future variability of future cash flows consistent with our novel theoretical channel which we introduced in Section II.

The numbers in Panel C are difficult to interpret. We therefore scale the changes in cash-flow news variance around the dividend events by the average variance in cash-flow news before the event in Panel D. We see the variance of cash-flow news drops by on average 20% of the average variance before the event after announcements of dividend increases (see column (1)) but increases by more than 7% after dividend cuts (see column (4)).

Vuolteenaho (2002) argues lots of data is necessary to get precise estimates of the transition matrix Γ of the VAR. So far, we use separate estimates for the transition matrix to get residuals for the five years before and after each dividend event. In Table 3, we impose more stringent restrictions on Γ trading off efficiency with precision. At the same time, we use a limited sample, because we impose the same restrictions as Vuolteenaho (2002), Grullon et al. (2002), Michaely et al. (1995). We now also report results for a specification in which we do not impose some of the restrictions of the initial papers we follow to increase our sample sizes.

The Table directly reports the change in the variance of cash-flow news after the dividend event relative to before as a fraction of the average variance before the event. In Panel A, we estimate one VAR for the whole sample period and then use the estimate for Γ to calculate both residuals in the five years before and after the dividend event and the cash flow news.¹¹ In Panel B, we combine the previous two approaches and estimate one VAR across all firms and events to get an estimate of Γ , but then estimate separate VARs before and after each dividend events to get residuals. Panel C requires only 12 non-missing quarters within five years before and after the dividend event and we do not restrict our sample to non-overlapping event windows within firms. We find the variance of cash flow news decreases for dividend increases, initiations, and both jointly after the event relative to before, whereas the variance increases for cuts in dividends, omissions, and both event types jointly.

All three panels confirm our baseline results. Announcements of dividend increases

¹¹Recall cash-flow news are a function of the transition matrix Γ of the VAR because it is a transformation of the residuals from the VAR.

result in lower volatility of cash flows after the announcement relative to before, whereas announcements of cuts result in an increased cash-flow volatility.

C. Cross-Sectional Heterogeneity

Our results so far confirm the unconditional prediction of our model in Section II. We now want to test the novel cross-sectional predictions of the model: the sensitivity of the variance of cash-flow news to changes in dividends should be larger for larger changes in dividends and for firms with more volatile cash flows.

Table 4 reports the results. In Panel A, we splits the announcements into small and large announcements based on the median change within increases and decreases. We see in column (1), for large increases in dividends, the variance of cash-flow news drops by more than 22% on average after the announcement. The drop in variance is almost 10% smaller in column (2) when we instead study increases in dividends which are below the median increase. Column (3) shows the difference is highly statistically significant. We bootstrap the difference and find it is highly statistically significant. Columns (4) and (5) instead show announcements of large dividend cuts drive the increase in cash-flow news variance. The difference is again highly statistically significant (see column (6)).

In Panel B, we split firms by their idiosyncratic volatility. Specifically, we first calculate a firms' idiosyncratic volatility on a four-quarter rolling basis relative to a Fama & French three factor model. We then assign a firm into the large idiosyncratic volatility sample if it had a volatility above the median firm in the respective Fama & French 17 industry in the quarter before the dividend event. Large heterogeneity exists in firms' idiosyncratic volatility and our procedure ensures we do not simply split our sample based on industry. We see in in columns (1) and (2), dividend increases for firms with large idiosyncratic volatility results in a drop in the average cash-flow variance of 25% which is almost 10% larger than the drop for firms with low idiosyncratic variance. The bootstrapped difference between the changes in variance of cash-flow news within high- and low-volatility firms is again highly statistically significant. Similar to Panel A, we see firms with large idiosyncratic volatility fully drive the increase in cash-flow news variance after announced cuts in dividends with the difference being statistically significant (see

columns (4) to (6)).

The results in Table 4 confirm the cross-sectional prediction of our model. To raise the bar even more, we now want to test whether the amount of funds available to firms mitigates the effect of dividend changes in cash-flow variance. Specifically, we want to estimate the following specification

$$\Delta \text{Var}(\eta_{cf,i,t}) = \alpha + \underbrace{\beta_1}_{-} \Delta D_{i,t} + \underbrace{\beta_2}_{-} \text{eps}_{i,t} + \underbrace{\beta_3}_{+} \Delta D_{i,t} \times \text{eps}_{i,t} + \varepsilon_{i,t}. \quad (16)$$

The model makes the following prediction: first, we still expect to find our baseline result that positive dividend changes result in a drop in the variance of cash-flow news. Second, firms with higher earnings should see a lower variance of cash-flow news. The second prediction is simply a scale effect. Third, the novel prediction is we expect a positive coefficient on the interaction terms between dividend changes and earnings. The variance of cash-flow news should be less sensitive to changes in dividends for firms with higher earnings.

To test this novel prediction, we regress the scaled changes in the variance of cash-flow news on the dividend change, earnings per share from operations, as well as their interaction. Table 5 reports our estimates. Column (1) confirms our baseline finding in a regression framework: positive dividend changes result in a drop in the variance of cash-flow news. In column (2), we add earnings per share (*eps*) as an additional covariate. Adding *eps* slightly increases the drop in variance following dividend increases. Firms with higher *eps* have a smaller variance in cash flow news. Column (3) confirms the novel prediction of our theory: dividend increases result in a drop in the variance of cash-flow news but this drop is muted for firms with higher *eps*. Columns (4) to (6) add year fixed effects and confirms our basic findings.

D. Returns around Dividend Events

So far we have shown that dividends changes are associated with a reduction in future cash flow volatility. Consistent with the model, the extent of the reduction depends on the current level of earnings. We also find that the reduction in cash flow volatility is larger

for larger dividend increases and decreases relative to small dividend changes, and for dividend changes of firms with higher idiosyncratic risk. While it is well documented that on average dividend change announcements are accompanied by like changes in prices, an important and yet unanswered question is whether market participants recognize the link between dividend changes and subsequent changes in cash flow volatility.

To this end, we study the how the immediate market reaction to dividend changes is related to the subsequent change in cash flow volatility (and to the dividend change itself). To construct the dividend events sample, we follow Grullon et al. (2002) and Michaely et al. (1995) but also rely on Vuolteenaho (2002) in the sample definition for the VAR. First, in Table 6 we document the univariate market response to dividend changes. In columns (1) to (3) we find a positive announcement returns for dividend increases, dividend initiations, and the pooled sample ranging between 0.4% and 1.4%. For cuts in dividends, we find a negative announcement returns of 0.33% and a negative return of 0.12% for omissions.¹²

More importantly, Table 7 reports announcement day returns, separately for large and small dividend changes and firms with high and low idiosyncratic volatility. Consistent with our results for the changes in the variance of cash-flow news, we find larger announcement day returns in absolute value for larger dividend increases and decreases relative to small dividend changes and for dividend changes of firms with higher idiosyncratic volatilities.

VI Conclusion

The notion that changes in dividend policy convey information to the market is intuitive and is supported by managers. The strong market reaction to announcements of dividend changes further suggests it *does* contain value-relevant information. But empirical research so far has found no support to this idea. It has found no meaningful relation between dividend changes and future earnings. This paper suggests that perhaps both theories and empirical research were blindsided. We have mostly hypothesized and searched for the

¹²All results are almost identical when we look at market-adjusted returns.

relationship between dividend changes and future increases in earnings—the first moment, rather than between dividend changes and future change in earnings volatility—the second moment (and as so often the case, Lintner (1956) is a notable exception).

In this paper we have proposed a theoretical framework in which firms use dividend policy to signal the riskiness of their future cash flows. To test our predictions, we have used the Campbell (1991) methodology to estimate cash flow volatility from data on stock returns. Consistent with the model's predictions, we have shown that cash flow volatility decreases following dividend increases (and initiations), and cash flow volatility increases following dividend decreases (and omissions). Furthermore, larger dividend changes are followed by larger changes in cash flow volatility in the expected direction. In the cross section, we find that the same dollar of dividend paid carries a larger information content for future changes in cash flow volatility the smaller the current earnings, consistent with the model's prediction that the cost of the signal is foregone investment opportunities.

Crucially, the stock market reactions to dividend announcements support our theoretical notion that expected changes in cash flow volatility represent the information content of dividends. In fact, we find that larger changes in cash flow volatility are associated with larger announcement returns in the expected direction.

More broadly, our paper shows how a methodology to measure the volatility of cash flows and discount rates from data on stock returns, originally developed in the field of asset pricing, can have potentially broad applicability to test theories of corporate finance and potentially shed light on many corporate decisions, well beyond those examined in our paper.

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Table 1: Estimate of Transition Matrix of VAR System

This table reports point estimates of a constant VAR for all firms and the whole sample period from 1963 till 2015.

	r	θ	e
	(1)	(2)	(3)
r	0.01 (2.43)	0.01 (9.30)	0.14 (10.09)
θ	0.05 (1.76)	0.94 (234.38)	-0.29 (-6.21)
e	0.01 (3.28)	-0.01 (-14.10)	0.33 (21.87)

Table 2: Change in Cash-Flow and Discount-Rate News Around Dividend Events

This table reports changes in cash-flow and discount rate news around dividend events using the methodology of Vuolteenaho (2002) which we describe in Section III. Our sample period is 1963 till 2015.

$\Delta Div > 0$	Initiation	Pooled	$\Delta Div < 0$	Omission	Pooled
(1)	(2)	(3)	(4)	(5)	(6)
Panel A. Δ Cash-flow News: $\Delta\eta_{cf}$					
-0.0001	0.0000	-0.0002	-0.0003	0.0000	-0.0003
-(0.46)	(0.01)	-(0.56)	-(0.83)	(0.00)	-(0.88)
Panel B. Δ Discount-rate News: $\Delta\eta_{dr}$					
0.0001	0.0000	0.0001	0.0002	0.0000	0.0001
(0.64)	-(0.41)	(1.19)	(1.19)	-(0.64)	(0.83)
Panel C. Δ Variance Cash-flow News: $\Delta\text{Var}(\eta_{cf})$					
-0.0025	0.0006	-0.0016	0.0007	0.0000	0.0006
-(5.59)	(0.86)	-(3.96)	(2.90)	(0.07)	(2.30)
Panel D. Δ Scaled Variance Cash-flow News: $\Delta\text{Var}(\eta_{cf})/\text{mean}(\eta_{cf})$					
-20.61%	3.62%	-12.36%	7.42%	0.38%	5.63%
-(5.59)	(0.86)	-(3.96)	(2.90)	(0.07)	(2.30)
Nobs	2,815	823	2,813	394	3,003

Table 3: Scaled Change in Variance of Cash-Flow News Around Dividend Events: Robustness

This table reports changes in cash-flow and discount rate news around dividend events using the methodology of Vuolteenaho (2002) which we describe in Section III estimating constrained VAR systems. Our sample period is 1963 till 2015.

	$\Delta Div > 0$	Initiation	Pooled	$\Delta Div < 0$	Omission	Pooled
	(1)	(2)	(3)	(4)	(5)	(6)
Panel A. Constant Gamma						
	-18.65%	-5.57%	-10.44%	14.90%	9.78%	14.20%
	-(9.58)	-(1.57)	-(5.31)	(5.71)	(2.62)	(5.56)
Panel B. Mezzanine Gamma						
	-10.27%	0.72%	-17.54%	15.82%	6.44%	14.10%
	-(5.61)	(0.18)	-(9.55)	(6.94)	(1.26)	(6.55)
Nobs	2,859	823	3,440	2,850	394	3,040
Panel C. Extended Sample						
	-15.32%	-1.47%	-12.18%	6.37%	4.08%	7.81%
	-(5.16)	-(0.21)	-(4.38)	(2.09)	(0.97)	(2.79)
Nobs	5,067	1,102	5,886	4,868	1,980	5,649

Table 4: Scaled Change in Variance of Cash-Flow News Around Dividend Events: Heterogeneity

This table reports changes in cash-flow and discount rate news around dividend events using the methodology of Vuolteenaho (2002) which we describe in Section III. Panel A splits dividend events by the size of the dividend change. Panel B splits events by firms' idiosyncratic volatility. Our sample period is 1963 till 2015.

	$\Delta Div > 0$			$\Delta Div < 0$		
	Large Increase (1)	Small Increase (2)	Δ (3)	Large Cut (4)	Small Cut (5)	Δ (6)
	-22.19%	-12.73%	-9.07%	13.28%	0.98%	12.14%
	-(5.23)	-(3.03)	-(13.98)	(2.75)	(0.22)	(15.49)
Nobs	850	608		749	794	

	$\Delta Div > 0$			$\Delta Div < 0$		
	Large Vol (1)	Small Vol (2)	Δ (3)	Large Vol (4)	Small Vol (5)	Δ (6)
	-24.74%	-15.65%	-13.19%	25.33%	1.88%	25.07%
	-(3.95)	-(4.13)	-(11.86)	(3.52)	(0.47)	(23.23)
Nobs	372	978		423	975	

Table 5: **Regression of Changes in Variance of Cash-Flow News Around Dividend Events**

This table reports results of regressing changes in the variance of cash-flow news around dividend events using the methodology of Vuolteenaho (2002) which we describe in Section III on the dividend change, earnings per share, as well as the interaction with t-statistics in parentheses. Our sample period is 1963 till 2015.

	(1)	(2)	(3)	(4)	(5)	(6)
ΔDiv	-0.26 -(5.66)	-0.24 -(5.41)	-0.38 -(6.12)	-0.15 -(5.06)	-0.14 -(4.82)	-0.25 -(5.11)
eps		-0.16 -(1.42)	-0.11 -(1.65)		-0.13 -(1.27)	-0.09 -(1.52)
$\Delta Div \times eps$			0.25 (3.14)			0.20 (2.65)
Constant	0.02 (0.29)	0.10 (1.02)	0.06 (0.77)	-1.11 -(33.93)	-1.03 -(12.99)	-1.05 -(17.97)
Year FE				X	X	X
R2	2.20%	2.80%	3.90%	31.00%	31.40%	32.10%
Nobs	3,208	3,208	3,208	3,208	3,208	3,208

Table 6: **Announcement Returns**

This table reports returns on dividend event days for a sample period from 1963 till 2015.

	$\Delta Div > 0$	Initiation	Pooled	$\Delta Div < 0$	Omission	Pooled
	(1)	(2)	(3)	(4)	(5)	(6)
	0.41%	1.42%	0.63%	-0.33%	-0.12%	-0.28%
	(10.20)	(9.38)	(13.63)	-(6.17)	-(1.26)	-(5.35)
Nobs	4,739	1,232	5,576	4,254	1,700	4,769

Table 7: **Announcement Returns: Heterogeneity**

This table reports returns on dividend event days for a sample period from 1963 till 2015. Panel A splits dividend events by the size of the dividend change. Panel B splits events by firms' idiosyncratic volatility. Our sample period is 1963 till 2015.

	$\Delta Div > 0$			$\Delta Div < 0$		
	Large Increase (1)	Small Increase (2)	Δ (3)	Large Cut (4)	Small Cut (5)	Δ (6)
	0.45%	0.38%	0.08%	-0.43%	-0.12%	-0.31%
	(6.55)	(4.90)	(6.79)	-(3.89)	-(1.52)	-(21.49)
Nobs	1,757	1,292		1,286	1,426	
	$\Delta Div > 0$			$\Delta Div < 0$		
	Large Vol (1)	Small Vol (2)	Δ (3)	Large Vol (4)	Small Vol (5)	Δ (6)
	0.38%	0.39%	-0.01%	-0.45%	-0.11%	-0.37%
	(3.12)	(6.89)	-(0.63)	-(6.14)	-(3.95)	-(21.53)
Nobs	811	1620		818	1,928	

Online Appendix:
The Information Content of Dividends: Safer Profits,
not Higher Profits

Roni Michaely, Stefano Rossi, and Michael Weber

Not for Publication

I Model Proofs

Proof of Single-Crossing. The utility function is:

$$U(D_1, \sigma^2) = D_1 + \beta \cdot f\left(Y_1 - \frac{a}{2} \cdot \sigma^2 - D_1\right) - k \cdot \frac{a}{2} \cdot \sigma^2(D_1) - (1-k) \cdot \frac{a}{2} \cdot \sigma^2$$

Here we prove that this objective function satisfies the single crossing property, in that

$$\frac{\partial U(D_1, \sigma)}{\partial \sigma} < 0 \text{ and } \frac{\partial^2 U(D_1, \sigma)}{\partial D_1 \partial \sigma} < 0$$

Indeed:

$$\begin{aligned} \frac{\partial U(D_1, \sigma^2)}{\partial \sigma^2} &= -\frac{a}{2} \cdot f'\left(Y_1 - \frac{a}{2} \cdot \sigma^2 - D_1\right) - (1-k) \cdot \frac{a}{2} < 0 \\ \frac{\partial^2 U(D_1, \sigma^2)}{\partial D_1 \partial \sigma^2} &= \frac{a}{2} \cdot f''\left(Y_1 - \frac{a}{2} \cdot \sigma^2 - D_1\right) < 0 \end{aligned}$$

Paying more dividends is more costly to a low type - the one with high variance - because it implies larger foregone investment opportunities. ■

Proof of Comparative Statics. The first comparative statics is

$$\begin{aligned} \frac{\partial \sigma^2(D_1)}{\partial D_1} &= -\frac{f''\left(Y - \frac{a}{2} \cdot \sigma^2 - D_1\right) - k \cdot \frac{a}{2} \cdot \frac{\partial^2 \sigma^2(D_1)}{\partial D_1^2}}{\frac{a}{2} \cdot f''\left(Y - \frac{a}{2} \cdot \sigma^2 - D_1\right) - k \cdot \frac{a}{2} \cdot \frac{\partial^2 \sigma^2(D_1)}{\partial D_1 \partial \sigma^2}} \\ &= -\frac{f''\left(Y - \frac{a}{2} \cdot \sigma^2 - D_1\right) - k \cdot \frac{a}{2} \cdot \frac{\partial^2 \sigma^2(D_1)}{\partial D_1^2}}{\frac{a}{2} \cdot f''\left(Y - \frac{a}{2} \cdot \sigma^2 - D_1\right)} \\ &= -\frac{2}{a} + k \cdot \frac{\partial^2 \sigma^2(D_1)}{\partial D_1^2} \cdot \frac{1}{f''\left(Y - \frac{a}{2} \cdot \sigma^2 - D_1\right)} < 0 \end{aligned}$$

whereby the second line follows because $\frac{\partial^2 \sigma^2(D_1)}{\partial D_1 \partial \sigma^2} = \frac{\partial^2 \sigma^2(D_1)}{\partial \sigma^2 \partial D_1} = 0$ as long as $\sigma^2(D_1)$ is single valued, and the third line follows because at the optimum $-\frac{\partial^2 \sigma^2(D_1)}{\partial D_1^2} < 0$.

The second comparative statics is

$$\frac{\partial^2 \sigma}{\partial D \partial Y} = \frac{-k \cdot \frac{\partial^2 \sigma^2(D_1)}{\partial D_1^2} \cdot f''\left(Y - \frac{a}{2} \cdot \sigma^2 - D_1\right)}{\left[f''\left(Y - \frac{a}{2} \cdot \sigma^2 - D_1\right)\right]^2} > 0$$

because $f''' > 0$. ■