
The Relevance of Bird-in-Hand Theory to Shariah-Inclined Investors: A Case Study of Malaysia

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Abstract — The purpose of this study is to identify whether the wealth of Shariah-inclined investors is affected by dividend policy. This study is different from other studies because earlier studies do not differentiate between Shariah-compliant and non-Shariah compliant stocks, creating a gap for dividend signaling theory and bird-in-hand theory on Shariah-compliant financial products. This study employs panel data analysis and multiple linear regression with the most recent data representing eight (8) out of twelve (12) sectors in the Malaysian stock market. Dividend per share and retained earnings per share are used as a proxy for dividend policy while market price per share is used as a proxy for shareholders' wealth. It was found that for Shariah-compliant stocks, both dividend per share and retained earnings per share are insignificant in affecting shareholders' wealth. Unlike other studies on dividend policy which do not discriminate between Shariah-compliant and non-Shariah compliant stocks, this study finds that dividend policy to be irrelevant to Shariah-inclined investors.

Keywords – Dividend policy, dividend relevance theory, bird in hand theory, Shariah-compliant firms, Islamic capital market

I. Introduction

Despite tremendous growth of Islamic finance products, there is a shortage of Shariah-compliant alternatives to cater and fulfil the need of local investors (Noordin, 2016). Local investors are reliant on Shariah-compliant stocks, making the instrument an important component in their investment portfolio. Hence the wealth of Shariah-inclined investors is affected by both dividend payouts and capital gain.

Unlike the dividend irrelevance theory proposed by Miller and Modigliani (1961), Gordon (1959) propositioned that investors do in fact have a preference for dividends - establishing what is now known as the dividend relevance theory. His proposition, together with Lintner (1956) and Walter (1963) converged into the bird-in-hand theory where both contend that investors prefer the certainty of dividends compared to uncertain higher future capital gains.

There are vast number of literatures dedicated to dividend policy and the bird-in-hand theory. However, to our knowledge, there are limited studies that tests the bird-in-hand theory and its relevance to Shariah-inclined investors. With that in mind, this paper aims to identify whether Shariah-inclined investors are affected by a firm's dividend policy. The findings from this study can be used not only by Shariah-compliant firms as an indicator to provide dividends but also be used as a comparison with the behavior of Shariah-inclined investors for other countries.

II. Background of the Study

Religious-inclined investors are motivated to abide by teachings of Islam and find it necessary to invest in Shariah-compliant investments (Omran, 2009). In the current Islamic financial market, there are very few instruments that are able to provide high returns for long-term investment horizons such as equities. Both individual and institutional investors rely on the stock market as a means to diversify risk and earn high returns on their investments.

In June 1997, the Shariah Advisory Council (SAC) of the Securities Commission first introduced the list of Shariah-compliant securities for Bursa Malaysia. The SAC uses a quantitative and qualitative methodology in determining whether a security is Shariah-compliant and twice a year, a report would be published to inform the

public on securities that are on the Shariah-compliance list. This list become a reference for investors to buy, hold or sell their investments; those who are Shariah-inclined will only hold shares that have been determined as Shariah-compliant by the SAC.

Shariah-compliant stocks currently make up the majority of shares in Bursa Malaysia and due to the wealth of data available in the Malaysian stock market, we should be able to document the behavior and preference of investors in regards to dividend payout, especially Shariah-inclined investors.

III. Review of Literature

The bird-in-hand theory was established based on the saying “a bird in the hand is worth two in the bush.” The theory counters the dividend irrelevance theory by Miller and Modigliani (1961) and claim that investors prefer to receive dividends now rather than wait for capital gains in the future. It was proposed by Lintner (1956) and Walter (1963) and supported by the dividend relevance theory proposed by Gordon (1959) – investors prefer the certainty of dividends compared to the uncertainty of future capital gains. Hence both theories claim that investors’ behavior are affected by dividend payouts i.e. firms that provide higher dividend payout are sought by investors and subsequently command a higher market price.

Later, dividend signaling theory was introduced by Poterba (1983a, 1983b) and Poterba and Summers (1984). The theory state that dividends signal some private information about profitability of the firm. The authors hypothesize that firms paying higher dividends are more profitable compared to identical firms paying smaller dividends. Thus the theory claims that stock prices would increase after an announcement of an increase in dividend payments and accordingly stock prices fall when firms announce that dividend payments are lower.

Dividend are part of profits that are disseminated by the firm to their shareholders (Sullivan & Sheffrin, 2003). Firms have to maximize the flow of dividends over time in order to maximize shareholders’ wealth (Arnold, 2008). The maximization of shareholders’ wealth is a key financial goal to the firm (Karbhari, Sori, & Mohamad, 2004) and dividend policy is said to be optimal when the policy has maximized the company’s share price and shareholders’ wealth (Azhagaiah & Priya, 2008).

Black and Scholes (1974) state that dividends only give a temporary effect to stock prices and the effect would disappear once the signal on future profitability wanes. Black (1976) reiterates that it would be impossible to determine whether it is investors who prefer dividends or those who avoid dividends have a stronger effect on share price. However according to Gordon (1959, 1962), dividend policy is relevant to security valuation, where based on dividend signaling theory – dividend payouts reveal information about firm’s profitability and future growth prospects. This is supported by a number of authors (Ansar, Butt, & Shah, 2015; Azhagaiah & Gejalakshmi, 2015; Bar-Yosef & Kolodny, 1976; Lintner, 1956; Varghese, 2017). According to them knowledge of a firm’s dividend policy is significant in explaining the return received from holding a security. The authors state that investors have a net preference for receiving their returns in the form of dividends to receiving it in the form of capital gains.

Recent studies on dividend policy have investigated the relationship between shareholders’ wealth and dividend policy, using market price per share (Ansar et al., 2015; Varghese, 2017) or earnings per share (Azhagaiah & Gejalakshmi, 2015; Farrukh, Irshad, Shams Khakwani, Ishaque, & Ansari, 2017) as a proxy for shareholders’ wealth. Dividend per share and retained earnings per share are used as a proxy for dividend policy. Findings have been found to be contradictory, a number of studies (Ajibade, Amuda, & Olurin, 2019; Ansar et al., 2015; Azhagaiah & Gejalakshmi, 2015; Azhagaiah & Priya, 2008; Farrukh et al., 2017; Iqbal, Waseem, & Asad, 2014; M. S. Sarwar, 2013; Singh & Tandon, 2019) have found dividend per share and retained earnings per share to have a significant positive impact on shareholders’ wealth whereas other studies (Varghese, 2017) have found dividend per share to be significantly negative with shareholders’ wealth.

In regards to dividend policy studies conducted on Malaysian firms, an earlier study by Pandey (2003) found Malaysian companies to regularly pay dividends regardless of how small the dividend amount. According to him, Malaysian firms are reluctant to omit dividends except when they suffer losses. Contrariwise, a study by Qammar, Ibrahim, & Alam (2017) find that not all Malaysian firms prefer to pay dividends and state that firm profitability, size and liquidity are important determinants of dividend payment.

To our knowledge, there are very few studies on dividend policy that discriminate between Shariah-compliant and non-Shariah compliant firms. This is echoed by Yaacob and Yakob (2002), there is a lack of study that measures the comparative performance between Shariah compliant and non-Shariah compliant stocks in Malaysia. In their study, Farooq & Tbeur (2013) found Shariah-compliant firms from the MENA region have higher payout ratios and higher likelihood to pay dividends compared to non-Shariah compliant firms. This is supported by Guizani (2017) who found that Shariah-compliant firms in the GCC region are more likely to design dividend policies that encourage more appropriate investment of corporate resources. According to the

authors, these firms are less likely to overinvest or misuse free cash flow as they pay more of the free cash flow out as dividends compared to non-Shariah compliant firms. Conversely, another study by Sarwar & Hussan (2015) on factors affecting stock returns of all non-financial listed companies in the Karachi stock exchange find dividend yield to be insignificant in affecting the stock returns of Shariah-compliant firms.

IV. Methodology

Firstly, the Shariah-compliant list as compiled by the Shariah Advisory Council of the Securities Commission Malaysia on 31 May 2019, provides us with a population of 689 Shariah-compliant shares from the total of 897 securities i.e. 76.81 per cent from the Malaysian stock market. Next, cluster random sampling is adopted, six (6) securities are randomly selected from eight (8) out of (12) twelve sectors in Bursa Malaysia, hence data is collected from a total of 48 securities. The eight sectors are energy, plantation, construction, property, transportation, telecommunication, consumer product and industrial product. The most recent five years data from 2013 until 2017 is utilized, making the total number of observations as 240. Secondary data is collected from Bursa Malaysia, Thomson Reuters database and the company's financial reports.

We refer to the model by Gordon (1959) who states that the market value of a share is equal to the present value of the firm's future stream of dividends and adopt similar models used by Ansar et al. (2015) and Varghese (2017) which uses market price per share as the proxy for shareholders' wealth; dividend per share and retained earnings per share as a proxy for dividend policy; and price earnings ratio and earnings per share to represent firm performance. We utilize the following regression model in this study:

$$\ln MPS_{it} = \beta_0 + \beta_1 PER_{it} + \beta_2 \ln EPS_{it} + \beta_3 \ln DPS_{it} + \beta_4 \ln RE_{it} + \beta_5 LPER_{it} + \beta_6 LMPR_{it} + \varepsilon_{it} \quad (1)$$

Where $\ln MPS$ is natural log of market price per share, PER is price-earnings ratio, $\ln EPS$ is natural log of earnings per share, $\ln DPS$ is natural log of dividend per share, $\ln RE$ is the natural log of retained earnings per share, $LPER$ is lagged price earnings ratio and $LMPR$ is lagged market price ratio. Market price per share is the current price per share of common stock of the firm, price earnings ratio is calculated as the market value per share divided by earnings per share, earnings per share is calculated as the net income minus dividends divided by number of outstanding shares, dividend per share is calculated as the total amount of dividends paid out and interim dividend over a period of time divided by number of outstanding shares, retained earnings ratio is calculated as beginning retained earnings plus net income minus dividends divided by net income, the lagged price earnings ratio is calculated by using current stock price divided by 12-months trailing earnings per share and lagged market earnings ratio is calculated by multiplying price earnings and 12-months trailing earnings per share. This study employs panel data analysis and multiple linear regression. Hausman specification test was also applied to determine whether a fixed effect or random effect model would be most appropriate.

V. Findings and Discussion

All data collected and selected for this analysis was processed using STATA version 13. Table 1 displays the multiple regression result of the model.

Table 1 Multiple Regression Result

Variables	Coefficient	Std. Error	t-Statistic	p-value
Constant	0.1885	0.1675	1.13	0.262
<i>PER</i>	0.2084	0.0589	3.54	0.001***
$\ln EPS$	0.1700	0.0537	3.17	0.002***
$\ln DPS$	0.0349	0.0301	1.16	0.247
$\ln RE$	0.0912	0.0591	1.54	0.125
<i>LPER</i>	0.1514	0.0471	3.21	0.002***
<i>LMPR</i>	0.0104	0.0040	2.60	0.010**
R-square	0.9476			
Adjusted R-square	0.9326			
F-statistic	63.44***			
N	240			
Dependent variable	Market Price per Share			

*, **, *** denotes statistical significance at 10%, 5% and 1% respectively.

From the regression that was made, it is found that price earnings ratio, *PER*, earnings per share, *lnEPS*, and lagged price earnings ratio, *LPER* are significant at ρ -value < 0.01 while lagged market price ratio, *LMPR* is significant at ρ -value < 0.05 . Dividend per share, *lnDPS* and retained earnings per share, *lnRE* were found to be insignificant.

The following is the outcome from this regression:

$$MPS_{it} = 0.1885 + 0.2084PER_{it} + 0.17lnEPS_{it} + 0.0349lnDPS_{it} + 0.0912lnRE_{it} + 0.1514LPER_{it} + 0.0104LMPR_{it} + \varepsilon_{it} \quad (2)$$

The coefficient of determination, R^2 indicates that 95% of the variation in firm share price can be explained by the regression model. This indicates a goodness of fit ($R^2 > 60\%$) of the model towards predicting the dependent variable. The F -statistic at 63.44 is also significant at ρ -value < 0.01 , indicating that all the independent variables are jointly significant in explaining the dependent variable.

Next, Hausman test was conducted to discriminate between a fixed effect or random effect model for our estimate. With ρ -value < 0.01 , the random effects model was found to be inconsistent, holding the fixed effect assumption that the individual-specific effects are correlated with the independent variable to be true. After addressing for normality and heteroskedasticity in the fixed effect model, we find a model with more robust standard errors as shown in Table 2.

Table 2 Fixed Effect Model

Variables	Coefficient	Std. Error	t-Statistic	ρ -value
Constant	0.4145	0.2349	1.76	0.084*
<i>PER</i>	0.2084	0.0767	2.72	0.009***
<i>lnEPS</i>	0.1700	0.0825	2.06	0.045**
<i>lnDPS</i>	0.0349	0.0371	0.94	0.352
<i>lnRE</i>	0.0912	0.0898	1.02	0.315
<i>LPER</i>	0.1514	0.0753	2.01	0.050*
<i>LMPR</i>	0.0104	0.0035	2.98	0.005***
R-square	0.5826			
Adjusted R-square	5.27***			
F -statistic	240			
Dependent variable	Market Price per Share			

*, **, *** denotes statistical significance at 10%, 5% and 1% respectively.

Similar to our first model, it was found that price earnings ratio, *PER*, earnings per share, *lnEPS*, lagged price earnings ratio, *LPER* and lagged market price ratio, *LMPR* as significant while dividend per share, *lnDPS* and retained earnings per share, *lnRE* were found to be insignificant in affecting share price.

The following is the outcome from this regression:

$$MPS_{it} = 0.4145 + 0.2084PER_{it} + 0.17lnEPS_{it} + 0.0349lnDPS_{it} + 0.0912lnRE_{it} + 0.1514LPER_{it} + 0.0104LMPR_{it} + \varepsilon_{it} \quad (3)$$

After considering for heteroskedasticity, our estimate is more efficient in identifying whether dividend policy is relevant to Shariah-inclined investors. Similar to studies conducted by Ansar et al. (2015) and Varghese (2017), we find the R^2 to be smaller i.e. only 59% of the variation in firm share price can be explained by this regression.

VI. Conclusion and Recommendation

Unlike other studies on dividend policy, we find the impact of dividend policy for Shariah-compliant Malaysian firms to be dissimilar to firms in the MENA region firms (Farooq & Tbeur, 2013) or the GCC firms (Guizani, 2017). Our findings are more consistent with Pakistani firms (S. Sarwar & Hussan, 2015) where it was found that dividend policy is irrelevant to Shariah-inclined investors.

The bird-in-hand theory and dividend relevance theory both state that investors find dividends to be important – they prefer current dividends to future capital gains and perceive dividend payout as an indicator i.e.

signal that the firm is profitable. Both theories are consistent with an earlier study by Pandey (2003) that do not discriminate between Shariah-compliant and non-Shariah compliant firms, and dividend payout is found to be an important element to Malaysian firms. However, when only Shariah-compliant firms are selected as the sample, this finding is unable to be hold as true. Our study finds both dividend per share and retained earnings per share to be insignificant in affecting share price of Shariah-compliant firms in Malaysia.

We interpret the results could mean either one of two factors: (1) the bird-in-hand theory and dividend signaling theory are unsuitable in explaining the behavior of Shariah-inclined investors; and/ or (2) there are very few availability of Shariah-compliant investment alternatives, hence investors hold on to Shariah-compliant investments whether or not dividend policy is important to their investment strategies. This also implies that Shariah-compliant firms in Malaysia need to exert more effort than just giving out dividends in order to positively affect their share price and increase shareholders' wealth.

For future studies, to identify if the reaction of Shariah-inclined investors is similar or not, we recommend to increase the sample size and observation period or compare results with firms in other countries.

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