

Dividend Decision and Share Price Volatility: Linking Financial Theories with Event-Based Incidences from Indian Stock Market

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Abstract

Dividend decisions have long been central to financial management and shareholder value creation. The relationship between dividend decisions and share price volatility is influenced by firm fundamentals, investor psychology, and macroeconomic events. This study provides a theoretical and event-based analysis of how dividend declarations influence share prices in the Indian stock market. Drawing upon signaling hypothesis, agency theory, Walter model, bird-in-hand hypothesis, and Modigliani–Miller (MM) irrelevance theorem, the paper explores the behavioral and structural mechanisms through which dividend announcements affect investor sentiment and price volatility. It synthesizes evidence from major Indian corporate events and policy changes including liberalization (1991), the global financial crisis (2008), dividend distribution tax (DDT) reforms (2016), the COVID-19 pandemic (2020), and the DDT abolition (2021) to demonstrate that dividend decisions act as both informational and psychological signals. While theory suggests neutrality, empirical patterns reveal that dividends in India continue to shape price reactions due to market imperfections and behavioral biases.

Keywords: Dividend Decision, Relevance Theorem, Irrelevance Theorem, Share Price Volatility, Indian Stock Market, Behavioral Finance, Indian Stock Market

1. Introduction

The relationship between a company's dividend decision and its share price volatility has long intrigued economists, investors, and policymakers. In India, where retail participation is strong and information asymmetry remains prevalent, dividend declarations often evoke immediate share price responses. These reactions stem from investors interpreting dividends as signals of financial health and managerial confidence (Anjali & Raju, 2017). The dividend decision, how much to distribute versus how much to retain, reflects management's confidence, growth prospects, and liquidity considerations (Bihari & Chandak, 2011).

Historically, markets have perceived stable or increasing dividends as a signal of strong fundamentals, while cuts or omissions have triggered uncertainty and price declines. However, the intensity and direction of these reactions depend on broader economic conditions and investor psychology. In the Indian context, dividends have been used as a means of signaling confidence during uncertainty. For instance, during the 2020 pandemic, companies like Infosys and HUL maintained stable payouts despite macroeconomic turmoil. Conversely, dividend cuts have occasionally triggered temporary sell-offs even when fundamentals remained sound, underlining the market's behavioral response to dividend information. This behavioral tendency is amplified during volatile periods when investors seek tangible assurances from firms' payout consistency.

Accordingly, this paper explores how dividend decisions affect price volatility in the Indian stock market, and examines how dividend declarations shape price reactions in India, using theoretical underpinnings and event-based insights rather than statistical analysis.

2. Literature Review

Dividend policy theory traces back to the classic irrelevance proposition of Modigliani and Miller (1961). It argues that in a perfect market, dividend policy is irrelevant to firm value, *i.e.*, investors can replicate cash flows through personal portfolio adjustments. It also assumes that in a perfect capital market, a firm's value depends only on its earnings and

investment policy, and not on dividend distribution. Yet, real-world imperfections make this proposition less applicable to markets like India.

Information asymmetry, behavioral biases, and regulatory changes make dividends highly relevant to valuation and volatility in Indian context. Empirical evidence from Indian studies demonstrates that dividends carry strong informational content, affecting price volatility. For instance, Bihari & Chandak (2011) and Kumari & Pathak (2024) found that dividend declaration events generated significant abnormal returns around announcement windows, supporting the signaling hypothesis. In similar vein, Anjali & Raju (2017) and Gupta & Aggarwal (2018) observed that Managers use dividends to signal information about future earnings. Alex & Latheef (2017) concluded that investors prefer current dividends to uncertain future capital gains, which is in-line with bird-in-hand hypothesis and found distinct price reactions around ex-dividend dates, emphasizing investors' behavioral biases. Behavioral and market reaction studies like Pal & Garg (2020) observed that dividend-to-price ratios influenced market behavior more strongly during macroeconomic shocks. Similarly, Chatterjee & Dutta (2017) observed strong abnormal returns around ex-dividend dates, amplified by dividend taxes. Anwar *et al.* (2017) found that dividend announcements by Indian manufacturing firms generated short-term positive abnormal returns. In support of agency theory, Das & Pattanayak (2009) concluded dividend policy reduces agency costs by limiting managerial discretion over retained earnings.

Although, multiple studies were conducted on dividend decisions, studies integrating finance theory and event-based evidence to explore how company's dividend decision policy impact stock price movement in India are still limited. The current study addresses this gap.

3. Financial Theories

The dividend decision – price volatility relationship can be understood through multiple lenses:

3.1. Signaling Hypothesis & Behavioral Theory: Dividend increases convey positive expectations about future earnings; reductions indicate caution or distress. Similarly, dividends also satisfy a “*psychological income*” need among investors. Investors interpret dividend declarations emotionally, associating them with management credibility. This leads to *asymmetric market reactions* even without corresponding earnings changes (Gupta & Aggarwal, 2018). Behavioral finance expands these models by recognizing that investors interpret dividends emotionally. Dividend continuity is perceived as managerial reassurance, while dividend omission can be seen as distress even when rational fundamentals remain intact (Dash & Mishra, 2023).

3.2. Dividend Irrelevance Theory (MM Model): MM's dividend irrelevance proposition assumes perfect capital markets and no taxes. However, real-world deviations, such as, transaction costs, taxes, and information asymmetry, make dividends relevant in emerging markets. Indian evidence contradicts strict irrelevance: investors often interpret dividends as indicators of performance credibility, especially during volatile periods (Pal & Garg, 2019).

3.3. Dividend Relevance Theory (Walter's & Gordon's Models): These propositions argues that dividend policy does affect firm's value due market imperfections, making dividends price-relevant. In Indian markets, where many investors seek stable cash flows, higher payout ratios reduce uncertainty and perceived risk. Thus, companies with consistent dividend policies often exhibit lower volatility and attract long-term investors. Similarly, Indian companies in high-growth sectors like IT or pharma historically retained their earnings, while mature industries like FMCG emphasized payouts, creating sectoral differences in volatility patterns.

4. Event-Based Analysis in the Indian Context

The following incidences are the major events impacting Indian stock market.

4.1. Post-Liberalization and the Early Reform Era (1991–2000): Post-liberalization, dividend behavior became a key corporate signal amid deregulation. Firms used dividend declarations as a credibility tool to attract investors unfamiliar with corporate transparency. Firms in the banking and FMCG sectors maintained high payout ratios to attract investors amid market volatility. This phase validated the bird-in-hand theory as investors valued regular income over

speculative growth. Companies like HUL and ITC maintained consistent payouts to attract investors wary of market volatility.

4.2. The Global Financial Crisis (2008–2009): During the crisis, most Indian companies either maintained or slightly reduced dividends despite falling profits, signaling resilience. Pal and Garg (2019) noted that Indian markets responded more to dividend consistency than to earnings volatility, reflecting investors' preference for stability in turbulent periods, supporting the Gordon hypothesis.

4.3. Dividend Distribution Tax (DDT) Reform (2016): The re-introduction of Dividend Distribution Tax shifted the burden from shareholders to firms. Some firms reduced dividends to conserve liquidity, while others maintained payouts to signal robustness. The volatility spike post-announcement reflected uncertainty, aligning with the MM model's prediction that taxes influence dividend preference. Bihari and Chandak (2011) observed similar behavioral adjustments after earlier tax reforms, reinforcing that policy event can reshape dividend trends and influence volatility across sectors.

4.4. COVID-19 Pandemic (2020): The pandemic tested corporate resilience. It disrupted earnings, liquidity, and investor confidence. While many firms suspended dividends, blue-chip companies like TCS and Infosys maintained distributions to project financial strength. Gurung (2025) found that markets rewarded firms demonstrating payout stability, associating it with risk management and governance quality across South Asian markets.

4.5. Abolition of Dividend Tax (2021): With the abolition of DDT, dividends became taxable in the hands of investors. The policy encouraged high-net-worth individuals to favor capital gains, leading to mild volatility around announcement seasons in short-term. Over time, as markets adjusted, volatility normalized, supporting the long-run stability argument of MM's neutrality.

5. Company-Based Instances of Dividend Announcements in the Indian Context

Some of the few instances of dividend announcements and financial theories are as follows:

5.1. Infosys Ltd.: Dividend as a Confidence Signal

Infosys provides one of the most consistent examples of dividend-driven price reactions. In April 2020, during the early stages of the COVID-19 pandemic, Infosys announced a special dividend of Rs. 8 per share, leading to a nearly 5% surge in its stock within two trading sessions. The event reaffirmed the signaling hypothesis, as investors interpreted the payout as a display of financial resilience amid global uncertainty. However, a reduced interim dividend in FY2014 had earlier caused temporary selling pressure, demonstrating the sensitivity of investors to payout changes.

5.2. Tata Consultancy Services & Wipro Ltd.: Dividends as Performance Anchors

TCS's 2021 interim dividend of Rs. 7 per share generated a 2% one-day rally, highlighting investor optimism toward consistent dividend-paying companies. As a blue-chip technology firm, TCS exhibits moderate volatility, and dividend declarations often reinforce the Gordon model's premise that stable payouts reduce perceived risk. Analysts noted that investors viewed TCS's dividend pattern as a proxy for predictable corporate performance. In contrast, Wipro's dividend declaration in 2022 coincided with declining quarterly results, leading to a muted price response, showing that investors weigh dividends in context of earnings credibility. This case emphasizes that dividend announcements must align with underlying performance; otherwise, signaling effects weaken.

5.3. ITC Ltd. & HUL: Dividend Stability in Consumer Sectors

Mature sectors such as FMCG display unique dividend dynamics. ITC's average payout ratio has remained above 80%, while Hindustan Unilever (HUL) maintains regular annual dividends. Both firms experienced muted volatility around declaration periods, confirming the Walter Model's suggestion that high-payout companies with lower reinvestment needs use dividends as long-term investor retention tools. During 2016 DDT reforms, the stocks showed resilience compared to peers, reinforcing the Gordon hypothesis.

5.4. HDFC Bank, Public Sector Banks: Dynamics in Financial Sector

Financial institutions, particularly HDFC Bank, have used dividend declarations to project confidence. During the pandemic-driven downturn in 2020–2021, HDFC Bank declared a Rs. 6.50 dividend per share despite earnings pressures, producing an upward adjustment in market sentiment. The event supports the signaling theory, as dividend continuity was interpreted as evidence of robust liquidity management. The dividend behavior of public sector banks reflects regulatory and fiscal dynamics. Between 2017 and 2019, several PSBs suspended dividends amid recapitalization measures, leading to short-term declines and temporary sell-offs. When payouts resumed in 2022, positive corrections followed, consistent with market reinforcement of dividend signaling.

5.5. Coal India Ltd.: The High-Yield Exception

Coal India, one of India's largest dividend payers, illustrates the market's strong reaction to large payouts. Its 2019 interim dividend of Rs. 13.10 per share resulted in a 3.7% gain within 48 hours. Similarly, in December 2023, the firm's Rs. 20.25 dividend announcement led to a sharp upward move, reinforcing its image as a “*dividend aristocrat*.” Such behavior aligns with signaling and clientele theories, as income-focused investors seek predictable, high-dividend yields.

5.6. Reliance Industries Ltd.: The Growth-Oriented Firms

Reliance Industries adopts a conservative dividend policy, emphasizing reinvestment over payouts. Despite relatively low dividend yields, its share prices show minimal volatility post-announcement, consistent with Walter's proposition that firms with rate of return greater than cost of capital ($r > k$) (high reinvestment returns) should retain profits. Investors interpret Reliance's steady, modest dividends as signals of growth confidence rather than weakness.

6. Theoretical Insights and Discussion

The analysis reveals several theoretical insights that advance the understanding of dividend behavior in emerging markets. First, dividend announcements continue to operate as credibility signals, particularly in imperfect and information-asymmetric environments such as India, where investors rely heavily on managerial actions to infer firm quality. This reinforces classical signaling theory while highlighting its heightened relevance in markets with weaker information channels. Second, investor responses exhibit clear behavioral dimensions: the strong preference for stable and predictable payouts reflects bird-in-hand considerations, wherein dividends are perceived as tangible returns that reduce uncertainty and anchor expectations. Third, the findings show that policy shifts—whether regulatory or tax-related—significantly amplify market volatility, supporting the view that institutional frameworks shape investor reactions beyond underlying firm fundamentals. Finally, sectoral heterogeneity is evident; financially stable and traditionally high-dividend sectors like banking and FMCG display muted announcement effects, whereas growth-oriented sectors such as IT and pharmaceuticals experience more pronounced reactions driven by expectations management and uncertainty over reinvestment potential. Collectively, these insights position dividend declarations in India as both informational cues and sentiment anchors, blending rational and behavioral interpretations within a dynamic institutional context.

7. Policy and Managerial Implications

The results carry several important implications for corporate managers, regulators, and market participants. For firms, maintaining clarity, consistency, and continuity in dividend communication is essential, as sudden or poorly articulated changes in payout policy can weaken managerial credibility and destabilize investor confidence. Strengthening internal governance mechanisms around dividend planning—such as integrating payout decisions with long-term cash-flow forecasting and capital allocation frameworks—can help reduce uncertainty and avoid reactive market behaviour. From a regulatory standpoint, SEBI can further enhance transparency by enforcing stricter, standardized disclosure norms and ensuring uniform timelines for dividend announcements, thereby minimizing information asymmetry and reducing avenues for insider-driven speculation. Additionally, market-level initiatives aimed at improving investor literacy should encourage retail investors to evaluate dividend sustainability in conjunction with broader profitability, leverage, and cash-flow metrics, enabling more informed decision-making and mitigating herd-driven volatility. Finally, maintaining stability and predictability in dividend taxation policies is vital, as frequent policy revisions can distort payout preferences and create avoidable market disruptions. Collectively, these measures can help strengthen the credibility of

dividend policies, enhance market efficiency, and promote more resilient investor behavior in India's evolving financial landscape.

8. Conclusion

The interplay between dividend decisions and share price volatility reflects a synthesis of financial fundamentals, market imperfections, and investor psychology. In the Indian context, dividends serve not only as income streams but also as confidence indicators – signals of managerial stability and financial resilience, particularly during periods of economic uncertainty. The Gordon and Walter models find stronger empirical relevance than the Modigliani–Miller (MM) theory, as real-world frictions, such as information asymmetry, taxation, and behavioral biases - render dividends a vital communication tool rather than a neutral financial choice. Historical and contemporary evidence, from the post-liberalization period to the COVID-19 crisis, underscores that dividend decisions in India operate simultaneously as financial strategies and behavioral signals, shaped by evolving investor sentiment and regulatory frameworks. Consistent and transparent payout policies have been shown to enhance market efficiency, reduce volatility, and foster investor trust, while abrupt changes or suspensions often trigger adverse reactions. Ultimately, dividends emerge as a stabilizing force in Indian capital markets, balancing corporate signaling with investor reassurance. The study concludes that, although classical theory suggests neutrality, event-based patterns confirm that dividends in emerging economies carry significant psychological and informational weight. Future research can benefit from integrating behavioral data analytics and textual sentiment analysis of management disclosures to better predict and interpret dividend-driven volatility trends in an increasingly dynamic market environment.

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