KEY TERMS

DIVIDEND PAYOUT RATIO: The percentage of earnings paid to shareholders in dividends. Calculated as:

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\text{DIVIDEND PAYOUT RATIO} = \frac{\text{Yearly Dividend per Share}}{\text{Earnings per Share}}
\]

or equivalently:

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\text{DIVIDEND PAYOUT RATIO} = \frac{\text{Dividends}}{\text{Net Income}}
\]

DIVIDEND POLICY: The policy a company uses to decide how much it will pay out to shareholders in dividends.

SHAREHOLDERS' VALUE: The value delivered to shareholders because of management's ability to grow earnings, dividends and share price. In other words, shareholder value is the sum of all strategic decisions that affect the firm's ability to efficiently increase the amount of free cash flow over time.

LINTNER MODEL: A model stating that dividend policy has two parameters: (1) the target payout ratio and (2) the speed at which current dividends adjust to the target.

AGENCY COST: A type of internal cost that arises from, or must be paid to, an agent acting on behalf of a principal. Agency costs arise because of core problems such as conflicts of interest between shareholders and management. Shareholders wish for management to run the company in a way that increases shareholder value. But management may wish to grow the company in ways that maximize their personal power and wealth that may not be in the best interests of shareholders.

DIVIDEND SMOOTHING: A concept that has its genesis in the dividend model proposed by John Lintner (1956). It states that the firms strive towards dividend stability and consistency. The dividend paid during current year is governed by dividend paid during previous year and variations in the earnings should not be reflected in the dividend payout.

INFORMATION ASSYMETRY: A situation in which one party in a transaction has more or superior information compared to another. This often happens in transactions where the seller knows more than the buyer, although the reverse can happen as well. Potentially, this could be a harmful situation because one party can take advantage of the other party’s lack of knowledge.

EVENT STUDY: An empirical study performed on a security that has experienced a significant catalyst occurrence, and has subsequently changed dramatically in value as a result of that catalyst. The event can have either a positive or negative effect on the value of the security. Event studies can reveal important information about how a security is likely to react to a given event, and can help predict how other securities are likely to react to different events.

PECKING ORDER HYPOTHESIS: This hypothesis states that a company which prefers retention of profits for financing the capital expenditure from internal resources distributes fewer dividends compared to a firm which finances the investment expenditure from external sources. Thus, a negative relationship exists between CAPEX and dividend payout.

ENTRENCHMENT HYPOTHESIS: The hypothesis suggests a inverted U shaped relationship between dividends and level of insider ownership. Dividend may act as a substitute for Corporate governance below the entrenchment level insider ownership leading to a negative relationship between these two variables. After such critical entrenchment level, however, when insider ownership increases are associated with additional entrenchment related agency costs, dividend policy may become a compensating monitoring force and accordingly a positive relationship with insider ownership would be observed.
DIVIDEND SIGNALING: A theory that suggests company announcements of an increase in dividend payouts act as an indicator of the firm possessing strong future prospects. The rationale behind dividend signaling models stems from game theory. A manager who has good investment opportunities is more likely to "signal" than one who doesn't because it is in his or her best interest to do so.

ABNORMAL RETURNS: A term used to describe the returns generated by a given security or portfolio over a period of time that is different from the expected rate of return. The expected rate of return is the estimated return based on an asset pricing model, using a long run historical average or multiple valuations.

FACTOR ANALYSIS: Factor analysis is a statistical procedure used to uncover relationships among many variables. This allows numerous intercorrelated variables to be condensed into fewer dimensions, called factors.

PANEL DATA: Panel data is data from a (usually small) number of observations over time on a (usually large) number of cross-sectional units like individuals, households, firms, or governments.

MULTIPLE REGRESSION ANALYSIS: Statistical procedure that attempts to assess the relationship between a dependent variable and two or more independent variables. Example: Sales of a popular soft drink (the dependent variable) is a function of various factors, such as its price, advertising, taste, and the prices of its major competitors (the independent variables)

MARKET EFFICIENCY: Market efficiency has varying degrees: strong, semi-strong, and weak. Stock prices in a perfectly efficient market reflect all available information. These differing levels, however, suggest that the responsiveness of stock prices to relevant information may vary. The efficient market hypothesis (EMH), a controversial principle stemming from the theory of market efficiency, states that a market cannot be outperformed because all available information is already built into all stock prices. Practitioners and scholars alike have a wide range of viewpoints as to how efficient the market actually is

FINANCIAL LEVERAGE: The amount of debt used to finance a firm's assets. A firm with significantly more debt than equity is considered to be highly leveraged.

DIVIDEND CLIENTELES: A group of shareholders who prefer that the firm follow a particular dividend policy. Such a preference may be based on comparable tax situations.

CORPORATE GOVERNANCE: The relationship between all the stakeholders in a company. This includes the shareholders, directors, and management of a company, as defined by the corporate charter, bylaws, formal policy and rule of law

MARKET CAPITALISATION: The total dollar market value of all of a company's outstanding shares. Market capitalization is calculated by multiplying a company's shares outstanding by the current market price of one share. The investment community uses this figure to determining a company's size, as opposed to sales or total asset figure. Frequently referred to as "market cap".

SYSTEMATIC RISK: The risk inherent to the entire market or entire market segment. Also known as "un-diversifiable risk" or "market risk. Interest rates, recession and wars all represent sources of systematic risk because they affect the entire market and cannot be avoided through diversification. Whereas this type of risk affects a broad range of securities, unsystematic risk affects a very specific group of securities or an individual security. Systematic risk can be mitigated only by being hedged. Even a portfolio of well-diversified assets cannot escape all risk.

INTEREST COVERAGE RATIO: A ratio used to determine how easily a company can pay interest on outstanding debt. The interest coverage ratio is calculated by dividing a company's earnings before interest and taxes (EBIT) of one period by the company’s interest expenses of the same period:
DIVIDEND DISTRIBUTION TAX: It is the tax levied by the Indian Government on companies according to the dividend paid to a company's investors. At present, the dividend distribution tax is 15%, according to the Union Budget 2007, India. As per existing tax provisions, income from dividends is tax-free in the hands of the investor. However, this is not to say that there is no tax levied at all. On the contrary, there is a levy of 15% of the dividend declared as distribution tax. This tax is paid out of the profits/reserves of the company declaring the dividend.

DIVIDEND YIELD: A financial ratio that shows how much a company pays out in dividends each year relative to its share price. In the absence of any capital gains, the dividend yield is the return on investment for a stock. Dividend yield is calculated as follows:

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\text{Dividend Yield} = \frac{\text{Annual Dividends Per Share}}{\text{Price Per Share}}
\]

PE RATIO: A valuation ratio of a company's current share price compared to its per-share earnings.

Calculated as:

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\text{P/E Ratio} = \frac{\text{Market Value per Share}}{\text{Earnings per Share (EPS)}}
\]

In general, a high P/E suggests that investors are expecting higher earnings growth in the future compared to companies with a lower P/E. However, the P/E ratio doesn't tell us the whole story by itself. It's usually more useful to compare the P/E ratios of one company to other companies in the same industry, to the market in general or against the company's own historical P/E. It would not be useful for investors using the P/E ratio as a basis for their investment to compare the P/E of a technology company (high P/E) to a utility company (low P/E) as each industry has much different growth prospects.