Vaasan yliopisto
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Dividends and share repurchases from investor's perspective

School of Accounting and Finance
Bachelor's Thesis, Finance
Accounting and Finance

Vaasa 2025

UNIVERSITY OF VAASA
School of Accounting and Finance

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Title of the thesis:	Dividends and share repurchases from investor’s perspective
Degree:	Bachelor of Science in Economics and Business Administration
Discipline:	Finance
Supervisor:	Veda Fatmy
Year:	2025 **Pages:** 37

ABSTRACT:

The purpose of this thesis is to examine whether dividends or share repurchases are a better option for the investor. More specifically, focusing on whether investors prefer one over the other and possible stock reactions to share repurchase announcements. During the past few decades, the dominant payout method has evolved greatly with repurchases exceeding traditional dividends. Understanding how these methods impact investor perception and interpretation of firms is crucial. The study aims to shed light on why payout decisions may impact stock prices despite the dividend irrelevance proposition. A review of empirical literature shows that share repurchase announcements frequently occur with positive abnormal stock returns. While a major segment of investors seem to prefer share repurchases, dividends remain important to many which suggests that a mix of both dividends and share repurchases seems to be the preference of investors.

KEYWORDS: Dividends, Repurchases, payout policy, investor preference

VAASAN YLIOPISTO
School of Accounting and Finance

Tekijä:	Niko Usvajärvi
Tutkielman nimi:	Dividends and share repurchases from investor’s perspective
Tutkinto:	Kauppatieteiden kandidaatti
Oppiaine:	Laskentatoimen ja rahoituksen kandidaattiohjelma
Työn ohjaaja:	Veda Fatmy
Valmistumisvuosi:	2025 **Sivumäärä:** 37

TIIVISTELMÄ:

Tämän tutkielman tavoitteena on selvittää ovatko osingot vai omien osakkeiden takaisinostot sijoittajalle parempi vaihtoehto. Tarkemmin ottaen tarkastellaan suosivatko sijoittajat jompaakumpaa menetelmää ja miten osakekurssit reagoivat omien osakkeiden takaisinostoilmoituksiin. Viime vuosikymmenenä pääoman jakotapa on kehittynyt valtavasti ja omien osakkeiden takaisinostot ovat ohittaneet perinteiset osingot. On tärkeää ymmärtää, miten nämä menetelmät vaikuttavat sijoittajien käsityksiin ja tulkintoihin yrityksistä. Tutkimuksen tavoitteena on selvittää, miksi voitonjakopäätökset voivat vaikuttaa osakekursseihin osinkojen merkitsemättömyysteoriasta huolimatta. Empiirinen kirjallisuus osoittaa, että osakkeiden takaisinostoja koskevat ilmoitukset johtavat usein positiivisiin epänormaaleihin tuottoihin. Vaikka suuri osa sijoittajista näyttää suosivan osakkeiden takaisinostoja, on osingonjako monelle edelleen tärkeä. Tämä viittaa siihen, että sijoittavat näyttävät suosivan sekä osinkojen että takaisinostojen yhdistelmää.

AVAINSANAT: Osingot, Takaisinostot, maksupolitiikka, sijoittajien mieltymykset

Contents

Figures

1 Introduction

The methods by which corporations return profits to shareholders remain a central topic in corporate finance. Especially regarding whether a firm decides to pay dividends, buy back shares or neither. Firms are often criticised for paying dividends, whereas share repurchases are typically seen as a better option due to tax advantages. Black (1976) refers to dividend policy decisions as the "dividend puzzle". In addition, it is unclear why firms pay dividends, and there is no consensus on this topic. This is later supported by Al-Najjar and Kilincarslan (2019) suggesting that even though a lot of research has been done, no clear consensus exists. However, several theories seek to explain why firms distribute their earnings to shareholders through dividends and share repurchases.

Jensen and Meckling (1976) introduced agency theory concerning free cash flow problems. In this theory, dividends and share repurchases serve a purpose by reducing the free cash flow. Ross (1977) finds that the signalling approach could explain the decisions behind payout decisions, suggesting that management has better information about the status of the firm, and therefore, payouts could signal confidence in future earnings. Lintner (1956) finds that corporate managers are more reluctant to cut dividends than increase them because a dividend cut could signal weakness. Later, Baker et al. (2002) suggest that managers stress the importance of positive signalling behind paying dividends. This shows the importance of payout policy in corporate decision-making, which could help explain the shift from dividends to share repurchases.

While it is strongly suggested that management emphasises the positive signalling of dividends, firms typically aim to act in the best interests of shareholders. Therefore, firms tend to change their payout policy to match investor preferences over time. Over the past couple of decades, share repurchases have overtaken dividends as the primary way of distributing cash to shareholders (Fama & French, 2001). Even though share repurchases are more common nowadays, dividends are still a huge part of the total payout. It is essential to understand why some investors prefer dividends while others favours share repurchases. Typically, investors needing income for consumption tend to prefer dividends (Graham & Kumar, 2006). Whereas some investors may prefer share buybacks due to tax advantages (Brennan & Thakor, 1990).

Dividends and share repurchases continue to play a significant role in evaluating firms. In theory, the firm's value is equal to all its future dividends discounted at a desired discount rate. Additionally, the firm could choose to repurchase its shares instead of paying dividends, which reduces the outstanding share count. As the share count decreases, the remaining shares account for a larger proportion of the firm. However, if the firm opts for share repurchases, it reduces the free cash flow available for dividends, and therefore, the per-share dividend would be lower (Brealey et al., 2022, p. 441-445). Furthermore, Miller and Modigliani (1961) argue that dividends are irrelevant and that investment policy is the driving factor behind firm value. Overall, it is not necessarily straightforward how dividends and share repurchases affect firm valuation, even though they play a crucial role in financial modelling. Therefore, understanding how firms make payout decisions is essential, as these decisions impact not only shareholder returns but also investment strategies, capital structure, and employee compensation.

1.1 Purpose of the study

The purpose of this thesis is to examine whether investors should prefer dividends or share repurchases, with special attention to their possible influence on firms' stock prices. Previous empirical research has documented positive abnormal returns surrounding repurchase announcements, suggesting that buyback announcements affect stock prices positively (Comment & Jarrell, 1991; Chan et al., 2004). There is a substantial amount of literature on the impact of share repurchases on stock prices. Hence, the first hypothesis follows:

H1: Share buyback announcements have a positive impact on stock prices

Secondly, if positive effect is found, the thesis examines whether investors favour one over the other. According to Grullon and Michaely (2002); Allen and Michaely (2002) the shift from dividends to share repurchases is the result of tax benefits, flexibility for firms and positive investor sentiment towards buybacks. Although dividends once dominated the payouts of firms, a growing trend of share repurchases suggests that buybacks are more appealing for investors. This leads to the second hypothesis, which follows:

H2: Investors prefer share repurchases over dividends

The hypotheses are based on previous literature, which mostly suggests that share buy-backs do impact share price and, therefore, indicate investor preference. The motivation for this thesis is to study whether investors should prefer dividends or share repurchases.

1.2 Structure of the study

The thesis is organized into four main chapters. The purpose and the hypotheses are presented in the first chapter. Chapter two introduces the central theories related to payout policy. In addition, the two main methods of payouts are explained. Chapter three is a literature review and reviews the empirical findings that are most relevant to the hypotheses. Mainly focusing on share repurchase announcements affect stock prices and how different investor groups perceive dividends and share repurchases. Finally, chapter four concludes the findings and discusses potential areas for future research.

2 Theoretical perspectives on payout policy

Payout policy is a central topic in corporate finance, and several theories in the literature seek to explain the reasoning behind firms' payout policies. This section covers three well-known and closely related theories on payout policy: the Dividend Irrelevance Proposition, Agency Theory, and Signalling Theory. Furthermore, it also discusses the main payout policies. While Agency Theory and Signalling Theory are recognised outside of finance, they serve an important purpose in this field as well. This chapter aims to briefly discuss the background of each theory and the main payout policy methods.

2.1 Dividend irrelevance proposition

One of the classic theories in finance by Miller and Modigliani (1961) shows that, under perfect, frictionless capital markets, a firm's payout policy does not affect its overall market value. Furthermore, it suggests that the firm's investment policy drives market value. Miller and Modigliani rely on the fundamental principle that the firm's total value is all future cash flows discounted to present value. Thus, profitable investments and the expected cash flows that come from these investments generate wealth and drive the firm's value. Even if the firm decides to invest half of its earnings and distribute dividends with the other half, it does not affect the sum of future cash flows if the investment policy stays the same. The payout ratio is irrelevant and does not affect firm value under these assumptions (1) perfect capital markets, (2) Rational behaviour and (3) Perfect certainty.

The perfect capital markets assumption is relatively broad and encompasses several details regarding the frictionless nature of the market. Firstly, no market participant should be large enough to influence the current market price. This implies that there must be numerous buyers and sellers of securities, none of whom can individually impact the price. Furthermore, all market participants should have equal access to information about the current price and other factors influencing it, without any associated costs.

Symmetrical information ensures that every participant can make decisions based on this information in real time, as it is immediately available to all. Finally, there should be no transaction costs, brokerage fees, or taxes of any kind. This means that there should be no costs associated with buying, selling, or issuing securities (Miller & Modigliani, 1961). Market participants ought to be free to make decisions; the presence of transaction costs and taxes could negatively impact the decision-making process.

The rational behaviour assumption expects that every market participant behaves rationally. Rational behaviour means that investors aim to increase their wealth even if it would be against their values. This means investors are solely focused on maximizing returns and do not have personal preferences for different brands or firms. Therefore, investors do not have any behavioural biases such as loss aversion or overconfidence. Decision-making is purely based on logic and rationality, and no emotions exist. Rational behaviour also assumes that investors do not have preferences whether they receive dividends or capital gains through share price appreciation (Miller & Modigliani, 1961). Later these assumptions regarding rational investor behaviour are used in other financial theories. According to Fama (1970) the efficient market hypothesis requires investors to behave rationally. This supports Miller's and Modigliani’s findings that if investors behave rationally and markets are efficient, payout policy does not affect shareholder returns.

Perfect certainty means that every investor is sure of every firm’s investment projects and the future profits that follow these investments. Therefore, investors do not have to consider investing risk, earnings fluctuations or volatility because the firm's future is known. Perfect certainty is a crucial part of frictionless capital markets as it removes the perceived risk component between bonds and stocks. Normally investors would want higher expected returns from stocks over bonds but with perfect certainty, this premium is gone and therefore there is no additional required return on stocks (Miller & Modigliani, 1961).

A central argument in Miller's and Modigliani's dividend proposition is that it does not matter what payout ratio the firm has because investors can match the desired payout ratio by either buying more shares or selling shares of the firm. If the firm pays out too much, the investor can buy more shares with excess cash that is paid out. On the other hand, if the firm pays out too little, the investor could sell shares of the firm and receive cash this way (Miller & Modigliani, 1961). This comes down to the basic assumption of no transaction costs. These investor self-directed actions can be done without paying extra costs and therefore do not leave the investor any worse off than if the firm paid out the desired ratio straightaway. Black and Scholes (1974) find that a firm's payout policy alone does not lead to higher or lower returns for shareholders while taking into consideration taxes and transaction costs. In addition, while tax considerations might influence the decision-making of some investors it is not considered a dominant factor. However, a dividend policy could signal strong financial health, and on the other hand, firms might pay dividends to distribute surplus cash and avoid spending it on unprofitable investments. These implications are covered later in this chapter.

2.2 Agency Theory

Agency theory is a widely known theory in economics and finance. The separation of ownership and control allows the creation of a principal-agent relationship. An agency relationship occurs when one or more people (principals) delegate the decision-making power to another person (agent) to perform tasks on their behalf. Expecting that both parties are trying to maximize their interest, agency costs could occur as the agent could have incentives to not always work in the favour of principals. In the context of this thesis, we can think of principals as the shareholders of a firm and agents as the management. For instance, the agent might not make the best decisions to maximize firm value, i.e. shareholder wealth, if there are incentives to do otherwise (Jensen & Meckling, 1976).

According to Jensen and Meckling (1976) three types of agency costs that occur from the agency relationship are as follows: (1) monitoring expenditures by the principal (2) bonding expenditures by the agent, and (3) residual loss. The last term is considered a cost experienced by the principal when there is a divergence between the decisions that the agent is making and the decisions that would be best for the principal. This is expressed as money equivalent, but it does not necessarily affect cash flows. Therefore, in the context of this thesis, the focus is on monitoring and bonding expenditures.

Monitoring expenditures are costs that follow from the need to mitigate problems associated with using an agent. Principals (shareholders) want to ensure that the agent (management) acts in the best interests of shareholders. Possible monitoring costs include information gathering regarding what the agent is doing. Typical examples of monitoring costs include auditing, producing financial statements and performance-based compensation (Jensen & Meckling, 1976).

Bonding expenditures, in contrast, are voluntarily suffered by the agent. These costs occur because the agent wants to build trust with the principal to avoid conflicts. The agent is trying to signal credibility and commitment to the principal. These actions often require the agent to make contracts or take on insurance from which costs are incurred (Jensen & Meckling, 1976). Stock ownership is a bonding expenditure that closely relates to the topic of this thesis. If the management (agent) owns shares of the firm, then the agent is also tied to the performance of the firm. Thus, the agent has an incentive to drive the firm value upwards.

The relevant agency problem in this thesis focuses on managers who prefer to retain free cash flow in the firm and not distribute it to the shareholders. Jensen (1986) finds that debt could help reduce agency costs related to free cash flow. The underlying problem in the agency costs of free cash flow is that managers have incentives to spend the excess in suboptimal growth investments below the cost of capital or in other inefficient projects. Managers often benefit from growth as with growth comes more resources and possibly decision-making power. If the firm raises cash by issuing debt and uses this cash to do share repurchases to reduce the number of shares outstanding would lead to the debt-to-equity ratio increasing. With debt replacing equity, the shareholders and management have aligned views, and the debt payments are mandatory. Therefore, managers would have less cash to use on unprofitable investments. Furthermore, Easterbrook (1984) suggests that firms that pay dividends could reduce agency costs. In addition, paying dividends or doing share repurchases would lead firms to seek external funding which would activate monitoring. Later, Nohel and Tarhan (1998) finds that firms with limited growth opportunities experienced significant operating performance improvements after doing share repurchases. Firms sold off unprofitable assets and avoided investing in unprofitable projects, and used the cash to do share repurchases. Supporting Jensen's (1986) view of markets rewarding firms doing share repurchases and avoiding the agency problems concerning free cash flow.

2.3 Signalling Theory

Miller and Modigliani (1961) assumed that investors and managers have the same information (symmetric information). In contrast, Ross (1977) suggests that managers of a firm often have superior information compared to investors (asymmetric information). This is key in signalling theory as it assumes that managers would make decisions with better information. These decisions signal either weakness or strength, depending on what kind of decisions are made. Thus, rational managers would (1) sell stock if the stock is overvalued and (2) sell bonds if the stock is undervalued.

Both scenarios assume that the management has compensation incentives related to the stock price. In scenario (1), selling the stock is the same as issuing new shares. Managers would act this way because they know that the future looks negative. Therefore, it is often wise to raise capital by issuing new equity while the stock is overpriced. The firm raises the needed capital to survive and now shares the upcoming losses with a larger shareholder base of the firm. If the firm raises debt, it will likely face bankruptcy as it would increase the fixed costs meanwhile sales are expected to decline. (Ross, 1977). However, equity issues often lead to negative share price reactions (Asquith & Mullins, 1986).

In contrast, in scenario (2), selling bonds is the same as issuing debt. Management knows that the future is positive, and the current share price does not reflect its intrinsic value. Therefore, management wants to issue debt to raise the capital needed and only ties to the coupon and debt payments. This arrangement allows the management and current shareholders to fully enjoy the potential increase in the share price. If the firm raises capital by issuing equity, this would dilute the current shareholders, and the future earnings would be shared with new shareholders as well (Ross, 1977).

This signalling theory can be applied to the firm's payout policy. Bhattacharya (1979) suggests that dividends serve as a positive signal in an asymmetric information environment. Later, Miller and Rock (1985) argue that if there is an informational asymmetry in the market, dividend announcements could serve as positive signals of firms' future unknown profits. Asquith and Mullins (1986) show evidence that distributions as dividends or share repurchases lead to positive permanent abnormal stock returns. Although dividends seem to have a smaller effect, but still have positive abnormal returns.

2.4 Types of payout methods

Firms make decisions about whether to pay out cash by distributing dividends or doing share repurchase programs. The firm's management considers these options and will try to choose the most optimal one while also considering liquidity needs, investors' preferences, capital structure, debt, and investment opportunities. According to Lintner (1956) dividends are the primary payout procedure. However, firms should prioritize investing in growing future cash flows, if possible, to maximize shareholder value. If no projects or investments with positive net present value (NPV) are found, the firm should consider paying out the excess cash to shareholders (Brealey et al., 2022, p.434-452).

Therefore, payout policy is closely related to a firm's investment policy. According to Miller and Modigliani (1961) the firm's value depends merely on its investment policy and not on how the firm decides to distribute its profits. However, DeAngelo and DeAngelo (2006) argue that MM's theory is based on unrealistic assumptions such as frictionless markets, and therefore, payout policy does affect firm value. Many firms go through a life cycle that requires precise decision-making, and payout decisions often come into question later in the firm's lifecycle. DeAngelo et al. (2008) show that mature firms are more likely to have a higher payout ratio due to having positive free cash flow. In contrast, firms in the early phases of their lifecycle often have negative free cash flow, which means they spend and invest more than they generate earnings.

As mentioned earlier, share repurchases have become the main way to distribute cash to shareholders (Fama & French, 2001). Several factors explain this shift. According to Grullon and Michaely (2002) share repurchases are funded with cash that could otherwise have been allocated to raising the dividend. Brav et al. (2005) support the findings of Fama and French, 2001; Grullon and Michaely, 2002's studies that dividends are less common. Secondly, the rise in the popularity of share repurchases is explained by management's desire for flexibility. In addition, management is incentivised to use share repurchases due to changes in executive compensation. This is supported by Farre-Mensa et al (2014) suggesting that managers getting compensated through stock options have the incentive to favour share repurchases due to having significantly less dilution effect on the share price. However, dividends still account for a significant part of the profits distributed to shareholders. As said, managers are careful with dividend increases because dividend cuts often lead to negative share price reactions. Dividends are often seen as stable and slowly growing. Figure 1 illustrates this shift from dividends to share repurchases and the stable growth of dividends.

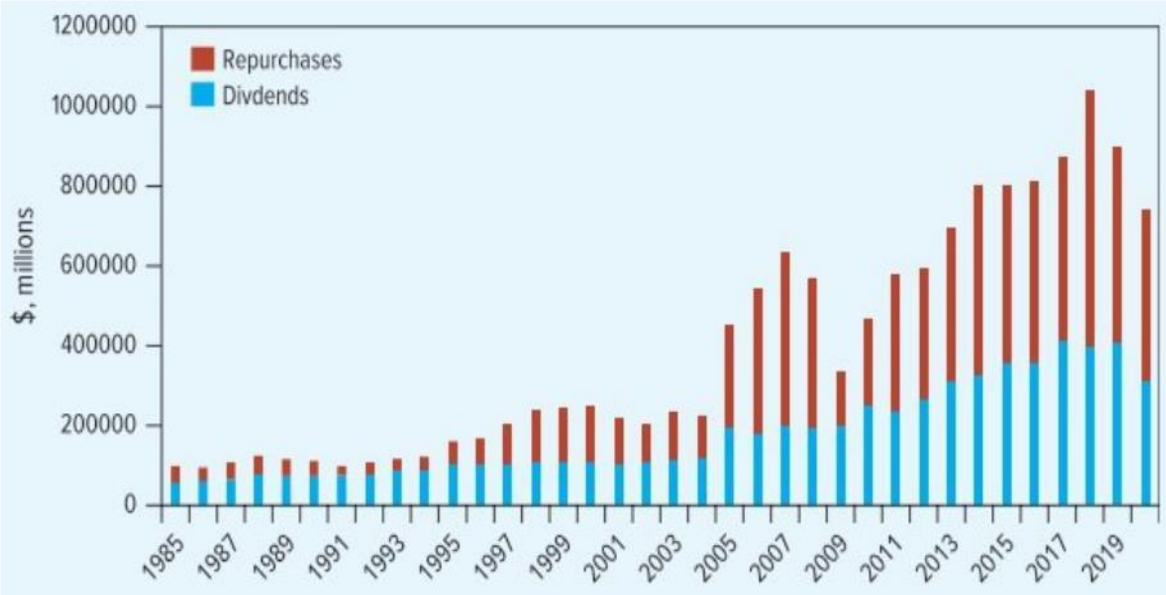

Figure 1. Dividends and stock repurchases by non-financial companies in the United States 1985-2020 (Brealey et al., 2022, p.435).

2.4.1 Dividends

Firms distribute cash by paying dividends. Firms typically begin issuing dividends as they grow larger and generate more cash flow than is needed for operational purposes. This aligns with DeAngelo et al.'s (2008) view that firms at the later stages of their lifecycle are more likely to pay dividends. A dividend represents a portion of the firm’s profits (after taxes) distributed to shareholders. The board of directors determines whether to pay dividends and, if so, the amounts. The general annual meeting then either accepts or declines the proposal made by the board of directors. Firms may also issue special or additional dividends, often one-time payments. These special dividends are given in addition to the regular dividends that firms aim to increase steadily. Firms do not always use cash to pay dividends; one alternative is to initiate a stock dividend, where, for example, a shareholder is given one new share for every ten shares currently held. This functions similarly to stock splitting, as the firm's total value remains unchanged while the per-share values decrease. However, stock dividends are rarely seen in the US markets today (Brealey et al., 2022, p. 435-437).

The dividend payment process includes four important dates. Firstly, after the board of directors has decided to pay a dividend, the declaration date follows. This is an official announcement of the firm's intention to pay a dividend. This announcement often includes the dividend amount, payment date, and other important information. The ex-dividend date follows, which is the most important date in the dividend payment process, as it defines the shareholders who are entitled to a dividend. This means any shares bought on the ex-dividend day or after aren't eligible for dividends. The record date is when the firm confirms the eligible shareholders. The ex-dividend date is usually a couple of business days before the record date. Finally, on the payment date, the dividends are paid to the shareholders (Brealey et al., 2022, p. 436). According to Beranek & Campbell (1955) the share price drops less than the dividend amount on an otherwise stable market day. This indicates that tax considerations and transaction costs could affect the share price. In frictionless markets, the drop should be exactly the dividend amount.

In theory, dividends should not influence shareholder value. When a firm pays a dividend, its share price drops by the dividend amount on the ex-dividend date. This occurs because the shares trading after the ex-dividend date are not eligible for dividends. This correlation to firm value can be described as follows. For instance, the firm has total assets of 101 million, and therefore, the firm value is 101 million (ceteris paribus). The firm decides to pay a million in dividends to shareholders, and the firm's value drops to 100 million. Before the dividend payment, shareholders owned a total asset of 101 million, and after the dividend payment, shareholders now own 1 million (the dividend) and the current total assets of 100 million (Brealey et al., 2022, p.440). However, Baker et al. (2002) find that managers believe dividend policy affects the firm's value.

2.4.2 Share repurchases

An alternative way for firms to distribute cash to shareholders is by doing share repurchases (share buybacks). The purchased shares are then either held by the firm as treasury stock or cancelled to reduce the overall number of shares outstanding. If cancelled, the shares are gone completely and do not have voting or cash flow rights. If held as treasury stock, the shares still do not have voting or cash flow rights until reissued (Chen & Obizhaeva, 2022, p. 4).

There are three main ways for firms to buy back their stock. Firms can freely choose which approach they decide to use. The three options are (1) the fixed price tender offer, (2) the Dutch-auction tender offer and (3) the open market buyback program. The fixed-price tender offer is a straightforward way to execute a share buyback program. The firm sets one, fixed, price at which it is willing to buy back stock, and this price often includes a premium, meaning it is above the current market price. The fixed price tender offer is usually available for a restricted period (Grullon & Ikenberry, 2005).

The Dutch-auction offer has some similarities as it is also a fixed-price offer and is open to all shareholders. In this arrangement, the Firm declares a range of prices at which it will consider bids from shareholders. Furthermore, the price range is above the current share price. Shareholders are then free to decide whether to act and make an offer or not take part at all. After the bid period closes, the firm will determine the fixed price by arranging the offers starting from the lower end of the price range and cumulatively adding the number of shares of each offer. The final price will be the price at which the cumulative number of shares meets the desired number of shares. Any offer made at or below this price will be accepted to the program. All accepted offers will receive the same price per share, even the offers made below the final price level (Grullon & Ikenberry, 2005).

In the open market buyback program, firms buy their stock from the open markets by themselves or using a mediator. Share repurchase programs require an announcement but otherwise are quite freely regulated. Typically, open market programs are a lot longer than fixed-price programs due to the nature of the program. Open market programs require a lot of liquidity because often a massive amount of shares are bought back. Open market programs do not require a premium and therefore are often quite cost-effective if the current share price is not overvalued (Grullon & Ikenberry, 2005).

Like dividends, share repurchases do not affect shareholder value theoretically either. For instance, let’s assume that the firm value is 100 and 10 shares outstanding. Each share is worth 10. The firm buys back one share and cancels it. The cost of one share is 10, and therefore the firm value drops to 90, and now there are 9 shares outstanding. Thus, the current share price is 10, because 90/9 equals 10 (Brealey et al., 2022, p.441). However, other factors related to share repurchases could affect the share price.

3 Literature review

The purpose of this chapter is to examine the existing and related literature regarding the hypotheses of this study, focusing on studies of stock market reactions to share repurchase announcements, with an emphasis on both short and long-term effects. Additionally, it covers how investors, particularly individual and institutional investors, perceive different payout methods, highlighting taxes, behavioural biases, and insider information.

As mentioned earlier, in theory, payouts in the form of dividends or share buybacks should not affect firm value. This theory holds in a perfect, frictionless market (Miller & Modigliani, 1961). However, actual stock market conditions involve transaction costs and taxes. Furthermore, agency costs and signalling aspects could elucidate the reactions to payout decisions. Thus, dividends and share repurchases may influence firm value and stock prices.

If dividends and share repurchases impact firm value, they are also expected to influence investors' preferences for different payout methods. Theoretically, investors should favour share repurchases over dividends due to significant tax advantages. Nonetheless, personal preferences, life circumstances, age, and behavioural factors may affect investors' decision-making.

3.1 Share repurchase announcements' impact on stock price

Many studies find a positive influence on stock prices following share repurchase announcements. While some observe only a short-lived impact, others demonstrate support for both positive short- and long-term effects of share repurchases. Overall, the effect of share repurchase announcements on stock prices seems mostly positive (Vermaelen, 1981; Comment & Jarrel, 1991; Chan et al., 2004; Akyol & Foo, 2013). In contrast, a few studies present an opposing view, suggesting that share repurchase announcements do not influence stock prices in a statistically significant way. However, while no negative effect is demonstrated, the outcomes are generally less positive compared to the studies mentioned earlier (Drousia et al., 2019; Zhang, 2005). The partially conflicting evidence may be explained by differences between countries and the industries in which these firms operate. These studies primarily focus on announcements at the stock exchange level, rather than on a specific industry level. In addition, countries' stock exchanges could have some cultural differences. However, most of these studies still focus on the US stock exchange.

Several factors could explain why investors view share repurchase announcements positively, such as excess cash distributions, reducing agency costs concerning free cash flow, signalling and capital structure adjustments. However, the signalling hypothesis seems to be accepted as the most prevalent explanation. According to Vermaelen (1981) share repurchase announcements could indicate an undervaluation signal by the firm's management. Providing support for the signalling hypothesis. This means firm management is doing share repurchases because they believe the stock is undervalued. The signalling hypothesis behind the positive stock price reaction to the announcement is also supported by a few other studies (Dann, 1981; Asquith & Mullins, 1986; Comment & Jarrel, 1991). Furthermore, Bhattacharya and Jacobsen (2016) studied why share repurchase announcements which do not require the repurchase of shares see positive stock price reactions. Bhattacharya and Jacobsen find that possibly undervalued firms face positive reactions only from share repurchase announcements. On the other hand, possibly overvalued firms did not see positive reactions even when implementing a buyback program.

Zhang (2005) finds that share repurchasing firms do not see significant abnormal returns. Zhang suggests that there are notable differences between firms. Important factors are firm size and book-to-market value ratios. According to Zhang, smaller firms that have high book-to-market value benefit more from share repurchases, which is in line with previous studies. This indicates that studies that do not see positive abnormal returns in general still provide support for undervalued firms benefiting from share repurchases. In support of Zhang (2005) and Drousia et al. (2019), Kumar Pradhan and Kasilingam (2016) find no significant impact of share buyback announcements at the industry level. Additionally, on a firm level, a partial impact is demonstrated. In both industry and firm levels, the effect is positive in the short and long term. This is later supported by Goyal and Mangala (2025) who find similar positive abnormal returns across different sectors, more specifically in IT and manufacturing. This evidence showcases that there are possibly irrational market pricing in individual firms, whereas such inefficiencies are not as prevalent at the industry level.

Previous studies have accounted for all three share repurchase types. Despite which share repurchase type the firm decided to use, all produced positive abnormal returns on average. Nowadays, open market repurchases are a lot more common than fixed price offers. Bargeron et al. (2022) find that open market programs show positive abnormal returns on authorisation of the program and when continuing a previously suspended program. The returns are lower compared to fixed price offers, but still significant. A recent study by Goyal and Mangala (2025) finds that tender offer repurchases show significantly better abnormal returns compared to open market purchases, suggesting that shareholders of a firm doing open market purchases leave them worse off compared to shareholders of a firm doing fixed price repurchases.

A key insight from these studies is that the signalling effect of repurchase announcements becomes stronger when the level of information asymmetry is high. According to Anolick et al. (2021), abnormal share repurchase returns tend to increase during economic uncertainty. Asymmetric information typically rises during periods of high economic uncertainty. This further supports the view that repurchases serve as a more credible signal in environments with greater information asymmetry. Furthermore, the strength of the repurchase announcement signal also depends on supportive signs related to the announcement. Firm managers' insider buying of stock ahead of a repurchase announcement enhances the credibility of the signal that the firm is undervalued

(Cziraki et al., 2021). Good completion rates in previous share repurchase programmes are also considered an important factor (Kawase et al., 2019). Insider purchases near the time of buyback announcements strengthen perceptions of stock undervaluation, while past completion rates are strong predictors of future repurchase execution.

Many studies highlight that share repurchase announcements have positive abnormal returns. In general, it is believed that investors should prefer share repurchases over dividends due to tax advantages and signalling of undervaluation by the firm management. Additionally, with share repurchases, investors avoid the share price drop that occurs on the ex-dividend date when dividends are paid.

Several studies find evidence against Miller's and Modigliani's (1961) theory of irrelevant payout policy. Studies such as Vermaelen (1981), Comment and Jarrel (1991), and Bhattacharya and Jacobsen (2016) highlight that the positive abnormal returns associated with buyback announcements often signal undervaluation by management. Furthermore, Bhattacharya and Jacobsen provide evidence that markets may misprice firms and post abnormal returns on buyback announcements. The signalling of undervaluation and market mispricing are both factors indicating information asymmetry and imperfect certainty, which contradict the underlying assumptions of Miller's and Modigliani's irrelevance theorem. Additionally, Anolick (2021) suggests that repurchase announcements yield even higher returns when economic uncertainty is high, which strongly challenges Miller's and Modigliani's theory. These findings indicate that, under real-world conditions such as taxes, transaction costs, and existing information asymmetry, stocks, on average, show positive abnormal returns on repurchase announcements.

3.2 Investors' preferences for payout policy

Firms have different types of shareholders. Some have greater ownership stakes, while others own smaller portions. Some shareholders are entities, and others are private individuals (La Porta et al, 1999). In the context of this thesis, the focus is on individual (retail) and institutional investors. These types of investors typically have differing preferences regarding a firm’s payout policies. Prospect theory is one of the foundational theories in behavioural finance, and Kahneman and Tversky (1979) suggest that an investor's decision is influenced by whether they are experiencing a loss or a profit on their investment. This study laid the groundwork for behavioural finance. Preferences are often shaped by behavioural biases, especially among individual investors.

3.2.1 Individual investors

Although retail investors typically hold smaller stakes than institutional investors, they remain significant market participants. Nearly forty per cent of US common stock was owned by retail investors and non-profit organisations in 2020 (Brealey et al., 2022, p. 372). Therefore, retail investors could impact stock pricing. Investigating behavioural finance biases and aspects of investors could help explain the decision-making process. These same biases could explain the preferences for different payout policies, such as favouring dividends or share buybacks.

Dividends and capital gains are generally considered substitutes if taxes and transaction costs are not considered. However, because taxes and transaction costs exist, investors tend to favour some kind of payout policy. According to Shefrin and Statman (1984) individual investors tend to favour dividends because behavioural biases affect the decision-making process of investors. Investors seem to separate dividends from capital gains or losses. Dividends are seen as extra income, and if investors were to sell shares, it would be seen as consumption of capital. This study highlights that investors would use a large part of this cash for consumption rather than reinvest it. Dividend-paying firms are often seen as stable and therefore relatively safe investments. According to Clark-Murphy and Soutar (2005) long-term investors favour stable dividend-paying firms. This investor group is categorised as a risk-averse group. Dong et al. (2005) suggest that investors have a strong preference for dividends, but behavioural biases do not explain it. However, the study supports the findings of signalling theories (Bhattacharya, 1979;

Miller & Rock, 1985). Investors believe in the strong signalling behind dividends. In addition, investors are keen to receive dividends compared to selling shares due to transaction costs.

Taxation is considered a major factor in investors' decision-making. It is widely understood that dividends carry tax implications at the time the investor receives them, while capital gains taxes are only applied upon selling a stock at a profit. Consequently, it is believed that investors tend to favour share repurchases over dividends due to the associated tax benefits. However, Brennan and Thakor (1990) discover that investors with smaller ownership stakes prefer dividends due to asymmetric information between smaller and larger shareholders. The study suggests that investors with lower ownership are uncertain about when to sell in share repurchase announcements, whereas better-informed (larger ownership) investors have advantages and clearer insights into future earnings. Moreover, individual investors typically favour high dividend-yielding stocks over firms that engage in share repurchases (Jain, 2007). Investors have various motivations for preferring or not preferring dividends. Among individual investors, one common reason for favouring dividends is to rely on them for income. Investors who depend on dividends are generally older and often prefer high-yielding dividend stocks, while younger investors seem to prefer lower-yielding stocks or firms that do not offer dividends (Graham & Kumar, 2006).

The shift from dividends to share repurchases as the dominant payout method is partly the result of a change in investor preferences. Dividends have been favoured by investors in the past and continue to be an important part of firms' payout policy. According to Chazi et al. (2021) firms shift their payout policy to match investor preferences. Firms respond to potential investor pressure by doing share repurchases. However, it is often institutional investors pushing firms to pay out funds (Kahle & Stulz, 2021).

3.2.2 Institutional investors

Institutional investors are financial entities whose primary role is to invest and grow the assets entrusted to them by smaller investors. The core objectives and possible constraints these entities may face can vary widely. These aspects influence the tolerable risk levels, investment horizons and strategies maximising returns. Furthermore, each institution's liabilities can differ significantly. For instance, variations in contract agreements and regulatory matters can potentially affect portfolio management (Davis & Steil, 2001, p.12-14). Institutional investors hold a few major advantages compared to retail investors, such as cheaper transaction costs, taxation and inside information.

Transaction costs can be significantly lower for institutional investors compared to individual investors. Institutional investors are important clients to banks and to other financial institutions willing to sell investment services. Therefore, institutional investors have negotiation power with service providers. With this power, institutions can negotiate about brokerage fees, commissions and spreads (Keim & Madhavan, 1997). Institutional investors typically have a lot of volume compared to retail investors, and banks are willing to offer deals for such volume.

Taxes are another important factor where institutional investors hold an edge over individual investors. In general, institutional investors are subject to the same tax treatment on dividends as retail investors. However, according to Graham (2003), there are several tax-exempt institutions, such as pension funds and private investment corporations, that qualify for dividend received deductions (DRD). Individuals cannot utilize this deduction, and thus, they are at a disadvantage compared to institutions when receiving dividends.

Institutional investors often hold a substantial ownership in the firms they invest in. Therefore, it is believed that institutions hold superior information compared to individuals. Cohen et al. (2008) show that mutual funds, which are considered institutions, typically invest in firms where they have a contact on the board of directors. Furthermore, these investments seem to outperform significantly the ones where no inside contact is available. Cohen et al. also suggest that outperformance is heavily concentrated on the firms' news announcements, which indicates that inside information around important news, especially around the earnings announcements, allows quick decision-making before the market movements. Mutual fund outperformance is also supported by Baker et al. (2010) suggesting that managers can often choose the better stocks on average during earnings announcements.

Among institutions, information asymmetry can be stronger with local firms compared to firms that are mainly managed abroad, including all kinds of institutional investors such as banks, pension funds, and mutual funds. Baik et al. (2010) find that institutional investors who operate locally hold a severe informational advantage over nonlocal institutions. Further, with this information advantage, local institutions are likely to do more profitable transactions. Similarly, to share repurchase announcements, a greater presence of long-term institutional investors strengthens monitoring and enhances information quality. Consequently, lowering agency costs and informational asymmetries (Cleary & Wang, 2017).

Advantages that institutions have over individual investors are also closely related to the firm's payout policy. Institutional investors often have negotiation power with firm management concerning payout policy. Crane et al. (2016) find that high institutional ownership of a firm is positively correlated with firms paying higher dividends and engaging in share buybacks. In addition, institutional ownership reduces excess cash reserves and management compensation. Further, an increase in research and development costs suggests that institutions push firms to stay competitive. Crane et al.'s findings support Jensen's (1986) theory of reducing free cash flow to avoid agency problems.

While Crane et al. (2016) provide evidence that firms exhibit a higher and increasing overall payout ratio (combining dividends and share repurchases) when institutional ownership is high, Grinstein and Michaely (2005) do not support an increase in total payout with institutional concentration of holdings. Keasy et al. (2002) suggest a close relationship between dividend payout and institutional ownership. This is moderately supported by Jain (2007), suggesting that institutional investors tend to favour low-yielding dividend stocks or firms that do not pay dividends. Furthermore, Jain finds no evidence that institutional investors prefer share repurchases. Grinstein and Michaely (2005) partially agree with Jain (2007) that institutions tend to prefer firms with low or no dividend payments. However, Grinstein and Michaely also provide evidence that institutions prefer firms that regularly engage in repurchases. These opposing views may arise because institutions have varying tax situations, and regulatory aspects can also influence their decision-making processes.

Several studies show evidence of institutional investors liking firms that pay fewer but stable dividends or not at all (Jain, 2007; Grinstein & Michaely, 2005; Jory et al., 2017). Despite the dividend received deductions that some institutions are eligible for, some studies still provide strong support for institutions favouring share repurchases over dividends. According to Bartov et al., (2005) and Grinstein and Michaely (2005) institutional investors are inclined to hold shares of firms that do regular share repurchases. Preferences for both dividends and share repurchases are showcased. However, it is not clear which is more prevalent.

In contrast, the firm management sees no strong preference for dividends or share repurchases for institutional investors. This suggests that institutions do not have a strong opinion on how firms allocate excess cash in payouts (Brav et al., 2005). Managers are in close touch with institutional investors, especially those considered activist investors. Therefore, firm managers have inside information about institutional investors' preferences. One explanation for not favouring any specific payout method could be that the institutions only invest in firms that already meet their desired payout style.

In summary, individual and institutional investors exhibit somewhat differing preferences regarding payout policy. Whereas individuals tend to lean towards safer, relatively high dividend-yielding stocks, institutions favour non-paying or low-yielding dividend firms that also engage in buybacks. Important factors contributing to these differing opinions include tax treatment, informational inequality, and behavioural tendencies. Individuals perceive dividends as a secure income, and behavioural aspects influence their preference for dividends as well. Furthermore, retail investors are more likely to suffer from transaction costs and lack of information. In contrast, institutions benefit from access to information, lower transaction costs, and occasionally better tax treatment. Institutions do not necessarily favour repurchases over dividends heavily, but they show a significantly lower preference for receiving dividends. Moreover, a slight preference for share repurchases is evident. On average, institutions seem to emphasise efficient cash usage rather than a massive payout of cash. However, the literature is not unambiguous regarding investor preferences. All in all, a mix of both dividends and share repurchases seems to be the desired preference for many.

4 Conclusions

This thesis examines how share repurchases and dividends impact investors' perceptions. It additionally explores whether share repurchase announcements influence stock prices and whether investors prefer share repurchases over dividends. Alongside these hypotheses, the thesis reviews the theoretical background, such as signalling and agency theories, to explain why payout choices could affect stock prices and investor sentiment. In contrast, a theory concerning why payout policy should not affect stock prices or investors' preferences is discussed. Finally, research hypotheses are derived from existing literature, and relevant studies are used to answer both hypotheses.

Multiple previous studies indicate that share repurchase announcements affect a firm's share price. Stock prices typically rise when a firm announces its intention to execute a repurchase program, suggesting that buyback announcements produce more than a neutral market reaction. Furthermore, the reaction appears to be consistently positive in both the short and long term. However, the strength of the reaction may depend on several factors, such as cultural differences and firm size. There is limited evidence of a significant impact on stock prices. These considerations provide strong support for the first hypothesis of the study.

Regardless of positive stock reaction to share repurchase announcements, the second hypothesis examines whether investors prefer share repurchases to dividends. The Literature generally indicates a notable preference for share repurchases. There are several reasons why this preference occurs. Share repurchases are often perceived as a positive signal from management, implying that management believes the stock is undervalued. This signalling effect of undervaluation is well documented in existing research. Additionally, reducing free cash flow via buybacks helps mitigate potential agency conflicts. However, agency considerations are only moderately supported. Furthermore, few studies find strong support for dividend clientele, especially among individual investors who perceive dividend-paying stocks as safer. Likewise, institutional investors' preferences seem to vary. Literature finds preferences for both dividends and share repurchases.

While share repurchases have surpassed dividends being the dominant payout method, dividends remain an important factor for many investors. Therefore, the second hypothesis is partially supported.

This thesis suggests that different cultures, firm variables, sectors, and industries should not be treated as a single group for future research. Much of this existing evidence heavily relies on the US. Other countries are examined but to a much lesser extent. In addition, longer time horizons and behavioural aspects could be studied regarding share repurchase preferences among both individual and institutional investors.

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