<u>THE EMOTIONAL CONTENT OF DIVIDEND BEHAVIOUR</u>

By Daryl Guppy

When dealing with dividends there are four periods of interest to traders. The first is the announcement of the dividend amount. Prices often rise in expectation of the dividend announcement. If the dividend is below expectations, then the price tends to fall very rapidly.

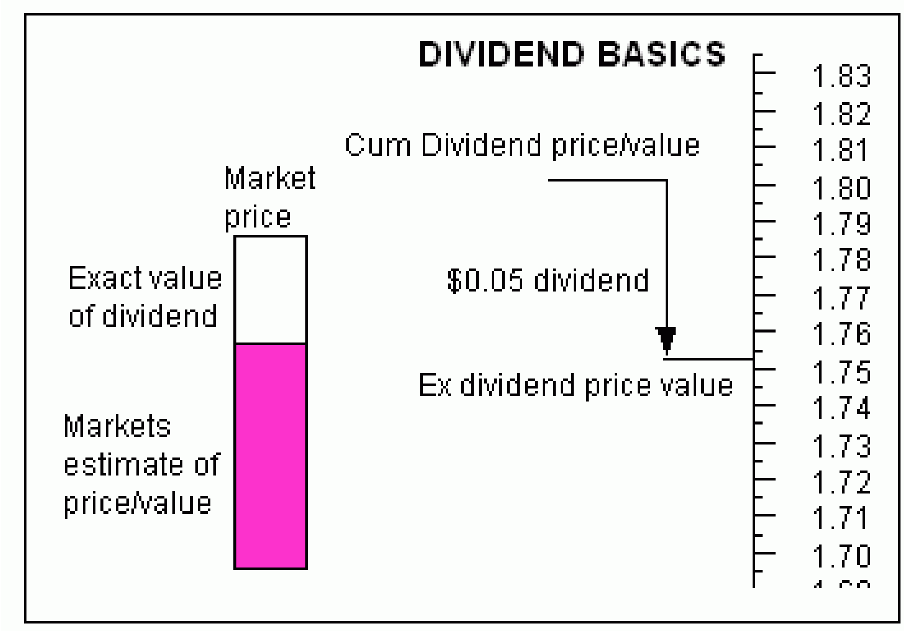
The second period is called the cum-dividend period. Although this really extends from the period starting as soon as the stock goes ex-dividend, other traders become aware of their entitlement to a dividend when the half yearly results are released. This means that all people who hold the shares are entitled to receive the dividend. This tends to keep the price up, because a $10.00 share with a $1.00 dividend is really 'worth' at least $11.00 ($10.00 plus $1.00 dividend). Any shares sold in this cum-dividend period transfers the right to receive the dividend to the new share holder. The old shareholder loses the right to collect the dividend.

The third period is when the shares go ex-dividend. From this time on all shares sold do not carry an entitlement to receive the current dividend. The old shareholder retains the right to collect the dividend, even though they have sold the shares, while the new shareholder does not have a right to collect the dividend. Using the example above, we would expect the share price to decline by the value of the 'lost' dividend. i.e. fall from $11.00 to $10.00.

The fourth period is the book closing date. This simply means that this is the final date by which all share transactions during the cum-dividend period should be registered. The objective is to make sure that every one who is entitled to the dividend receives it. This book closing date has no impact on the share price.

We start with the basic of stock prices and ex- dividend days. While the stock holder is entitled to a dividend the market price of his share reflects two components. The first is the market's estimate of value. The second is the exact level of value added by the dividend. In this example the dividend value is $0.05. This value is only known for certain once the dividend has been announced.

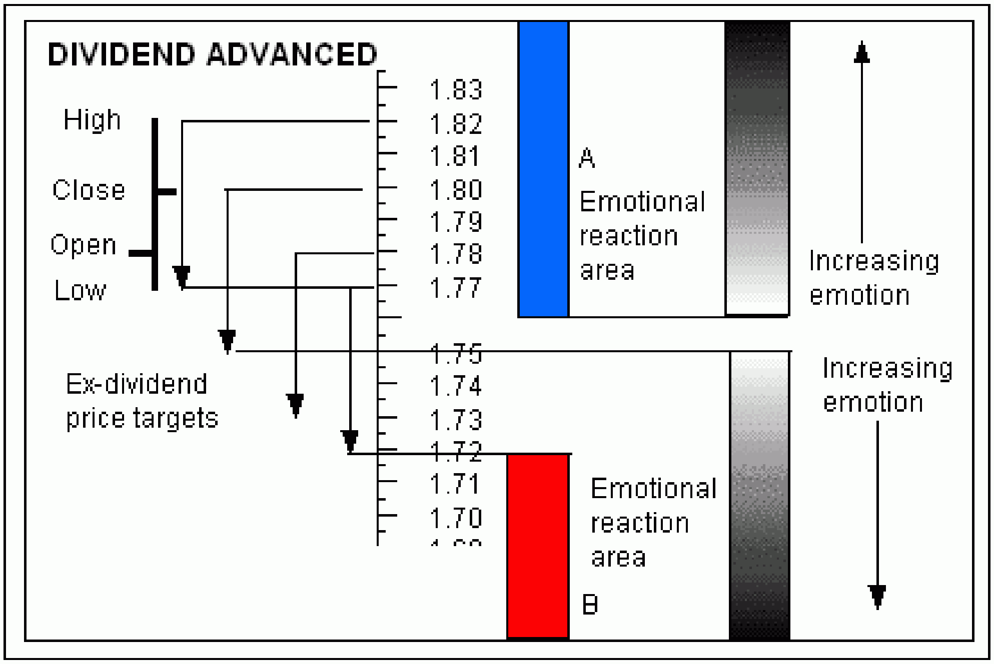
As soon as the stock goes ex-dividend those who wish to become new stockholders immediately 'lose' $0.05 because they are not entitled to the dividend. This known exact value is stripped from the market price of the stock. If the stock was trading at $1.80, then the next day the price should be $1.75 because the $0.05 dividend is no longer available to new stockholders.



This is dividends 101. More advanced dividend analysis reveals more detail about the emotional behaviour of the market. We find this component by looking at the impact of the dividend on all the significant aspects of price. During the day we have four price elements – open, high, low and close. This gives the trader four price targets when a stock goes ex-dividend. They are found by taking each element of the price bar on the day before the stock goes ex-dividend. The down arrows show the projected price targets for trading when the stocks sheds the $0.05 of value due solely to the dividend entitlement. These are the range of 'rational' adjustments to price.

The solid blue and red boxes show the zones of emotional price reaction. This is not the same as irrational. People who buy or sell in these areas are very rational. They act after careful thought, but their analysis is influenced by factors other than the value of the dividend. These investors make a decision about the future prospects of the company and this is reflected in the price they do business at.

We can make this discussion more complicated by setting up a matrix that includes all price elements on the day the stock goes ex-dividend. However, analysis based on the closing price on the ex-dividend day is still very useful. Strip the dividend from the previous day's high price of $1.82 and we end up with an ex-dividend target of $1.77.



The rational ex-dividend price based on the close is $1.75. If prices close higher than $1.76, as shown by the blue box A, then the price contains an emotional component. It tells us investors are prepared to pay a higher price for the stock because they believe the value of the stock is going to increase. They missed out on this dividend, but they are confident the dividend will be just as large, or larger, next time. Their confidence is so high that they disregard the 'lost value' of the dividend.

The absolute lowest the ex-dividend price could fall, based on the previous low at $1.77 is a low of $1.72. Price falls below this level are very emotional. Investors have lost faith in the stock. They take the dividend and run. They do not believe things will get better. Prices in these areas add an emotional component to the current market price (it's actually more intelligent for these investors to strip the value of the dividend from the stock price before it goes ex-dividend, but that is another analysis and trading method).

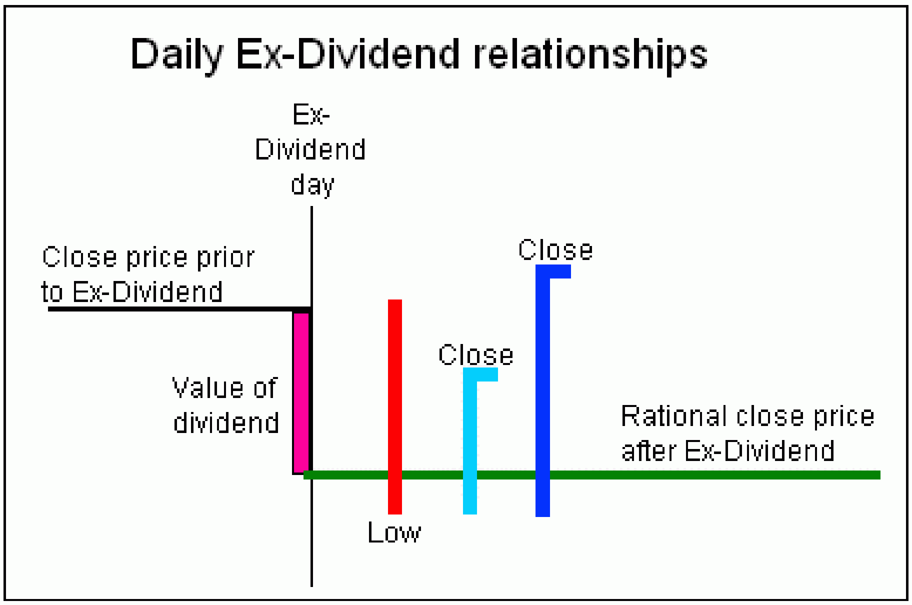
We continue to believe that the closing price is the 'smart' price and as such, it is the most significant price for the day. The lower shaded bar shows how the emotional component of the ex-dividend price increases as the price moves away from the 'rational' ex-dividend value. The upper shaded bar shows the same impact in a bullish scenario. It starts from the high ex-dividend target because the bullish rise is about adding value rather than losing it. The smart money sets the close and knows they have definitely lost $0.05. The bullish buyers hope to make money. Hope is a different creature from certainty, hence the different starting point for measurement.

Price moves that carry prices above or below the 'rational' price move triggered by the loss of dividend value are emotional price reactions. The level and type of this emotional reaction help traders to decide if this is a bullish or bearish reaction to an individual stock.

We take the next step and create a framework for these reactions using a group of stocks that have gone ex-dividend in recent months.

Ex-Dividend Market Framework

The analysis that is applied to a single stock when it goes ex-dividend can also be applied to a group of stocks to compare the broad market reaction to ex-dividend announcements. It is not the same as reactions to the company reporting season, but it may provide a guide to how the broad market reacts to profit downgrades and the subsequent impact on dividends.

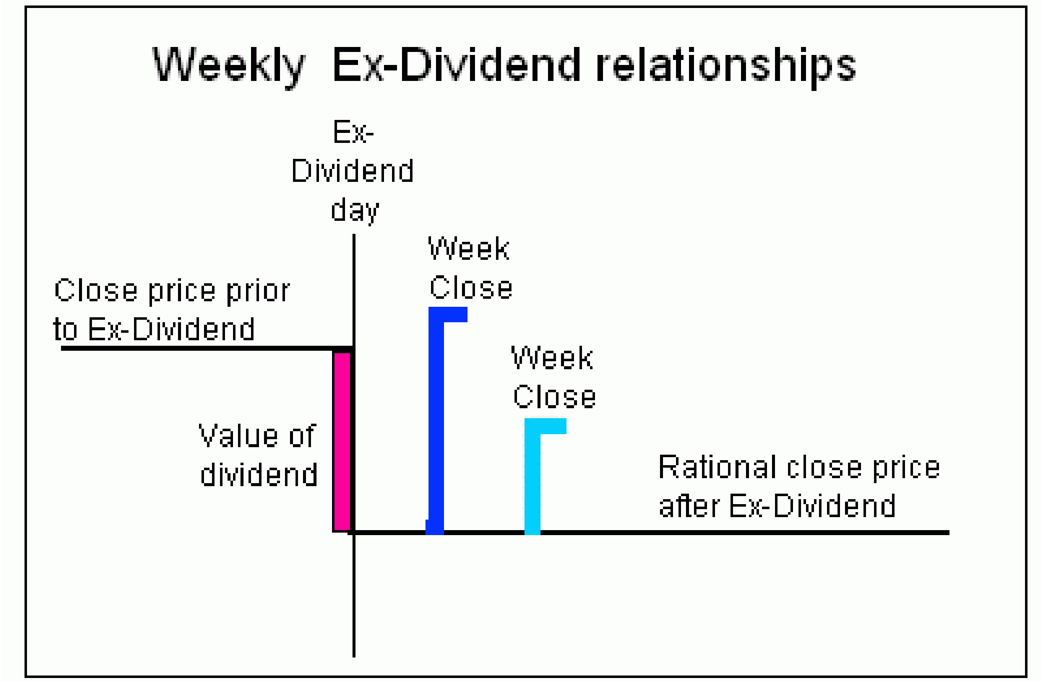


If we hold a stock we need to know how significant a price fall is on the day it goes ex-dividend. Do we need to worry if the price falls below the value of the dividend? We use the 'rational' ex-dividend price as a reference point. Our first stop is to examine the low in relation to the rational ex-dividend price. If it is lower then it suggests there is a strong initial bearish reaction. This is shown by the red bar.

This may just be a short term panic, driven as analysts are suggesting, by the lack of available analysis to put the profit downgrades into context. In a mildly bullish market we expect to see a rebound in price by the close so that it finishes above the rational ex-dividend price. This is shown with the light blue bar.

In a strongly bullish market the price on the ex-dividend day closes above the closing price on the day prior to going ex-dividend. This is shown by the dark blue bar. If many stocks do this on their ex-dividend day then traders can be confident that the immediate ex-dividend price dip is most likely to be temporary.

Traders who do not own the stock can use the intraday dip as a buying point because they have a high probability that the closing price will be significantly higher. This is an intraday strategy that uses derivative instruments such as CFDs and warrants to leverage the impact from the rebound in price.



Traders can also take a longer view by putting the ex-dividend behaviour into a broader context of trading in the following week. The two options we are interested in are the relationships of the close five days after the ex-dividend date. In a strongly bullish market the close at the end of the week is higher than the close on the day prior to the stock going ex-dividend. This hands the trader both capital gain from a continued increase in price and the full value of the dividend. This is shown by the blue bar.

The less bullish outcome is when prices close higher than the rational ex-dividend price, but do not exceed the close prior to the ex-dividend day. This tells the trader that the stock has lost momentum. The value of the dividend is eroded by a decline in the capital value of the stock. In some cases, when confirmed with other indicators, this may suggest a sell condition.

Apply this analysis to broad market behaviour and traders can develop more effective probability based strategies to trade both short term and long term ex-dividend behaviour. It provides a guide to how the broad market may react to the profit – and by inference, dividend and earnings – announcements in the next few weeks.