

Dividends

by O. Emre Ergungor

Dividends are back in vogue. After the bear market and corporate mishaps of the past few years, investors have begun to pay more attention to the health of companies' bottom lines instead of focusing solely on growth opportunities and future capital gains.

As the Wharton economist Jeremy Siegel explained in a *Wall Street Journal* article, paying dividends is the old-fashioned, time-tested way companies show investors their earnings are real and their bottom line is strong.¹ A company can use accounting tricks to fake its earnings, but, so the argument goes, it cannot fake its dividend check. The earnings have to be real and cash must be in the bank before the checks can be mailed. The financial press seems to have accepted this view, and the benefits of dividends are touted almost without exception, and investors are urged to pressure company boards to initiate dividends or pay higher ones.

Dividends can indeed be useful to company insiders, who can use the dividend policy to convey information to investors about the future prospects of the firm. But the information dividends send is not always clear cut, and investors need to consider some important factors when evaluating dividend announcements.

■ Does Dividend Policy Really Matter?

In a perfect market, where firms are transparent and investors can clearly see how a business will perform today and in the future, and where there are no taxes, bankruptcy costs, or transaction costs, dividend policy does not matter. What matters for firm value is expected earnings and business risk, as Franco Modigliani and Merton Miller demonstrated in their now classic 1961 paper. The way a company splits its earnings between dividends and retained earnings affects nothing.²

To see why this is so, suppose that after all the profitable investments are made, a firm still has some cash left over, which can be distributed to shareholders in part or in full. The firm may even raise additional funds by issuing new shares or bonds and distribute the receipts to the shareholders as dividends in excess of the leftover cash. But Modigliani and Miller show that shareholders gain nothing from the management of dividend payments. All dividend policies are equivalent; management cannot create wealth by slicing and dicing the firm's earnings.

By paying a dividend, the firm effectively puts its cash into investors' pockets. The value of the firm declines by the dividend amount because an asset (cash) has left the firm. But shareholders are not bet-

In recent years, there has been increasing pressure on U.S. corporations to distribute earnings to shareholders in the form of dividends. This *Commentary* explains that dividends are important, but investors can err by reading too much into them.

ter or worse off because they are the recipients of the cash; the dividend payment exactly offsets the decline in share value. In other words, paying a dividend is like transferring cash from one pocket of the shareholder to another; it has no impact on the shareholder's wealth. And of course, the same principle applies if the firm raises additional funds from the market to pay dividends, so this approach has no impact on shareholder wealth either.

But what if a particular group of shareholders has a strong preference for cash in the pocket rather than the company vault—say, as a source of income—would dividend policy matter then? The answer is still no. Recall that in this perfect world, there are no transaction costs. So any shareholder who prefers cash can obtain it by selling some of his shares at no cost. Conversely, if a firm is paying dividends, a shareholder who does not want to hold cash can undo the dividend payment by reinvesting it in

the firm through a share purchase. If investors can costlessly replicate any dividend policy, investors' valuation of a firm would not be affected by that policy.

Dividend policy may be irrelevant in a perfect market, yet we know that many of these perfect-market assumptions do not hold in today's world. After all, we observe transactions costs, taxes, costly bankruptcy, and most importantly, private information. Any of these so-called "frictions" could lead to an optimal dividend policy for individual firms, but to illustrate the subtleties involved in interpreting the information dividends provide, we will focus on the implications of private (inside) information for dividend policy.

■ Dividends and Inside Information

Investors' uncertainty about a company's value is not limited to their uncertainty about the quality of current earnings. Insiders of a firm—its managers and directors—are likely to have more information than shareholders about the future of the business as well. But getting this information to shareholders is not straightforward. Insiders may choose not to reveal more information to the market directly because doing so might require divulging trade secrets, which could benefit competitors. Or, if it is too costly to verify the truthfulness of insider comments about a firm's future prospects, shareholders don't consider such statements credible. Economic theory says that dividend policy may be relevant in cases like this because dividends may allow insiders to signal—credibly—their beliefs about the future performance of the firm to the market.

To see where the credibility comes in, consider the following example. Suppose a firm's managers anticipate that the business will do well in the future but find it too costly to explain all the details to the shareholders directly. In addition, assume that the optimal investment strategy of the firm over time involves holding a certain level of cash assets on its balance sheet. One way to signal the managers' posi-

tive assessment of the firm's future performance prospects is to distribute a "sizeable chunk" of the firm's cash as dividends. The theory gives no precise definition for what a "sizeable chunk" is, nor does it tell us how the cash should be distributed: as one lump-sum payment or as higher annual dividends over a long time horizon. But it does say that the right-size chunk will be a credible signal because a firm will pay high dividends only if its management anticipates that future cash flows will be strong. If a firm is not successful, and internally generated funds are not enough to restore its cash position, managers may have to raise more funds from the market. Tapping the market for fresh funds is costly because of investment bank and legal fees and the amount of managerial time it consumes. So only those firms whose managers anticipate strong future cash flows will pay high dividends. Firms uncertain about their future or sure that future cash flows won't be sufficient to restore their cash position will choose a dividend policy that preserves cash holdings. By observing a firm's dividend policy in the context of other publicly available information on the firm, investors can infer the management's private information about the business's future prospects.³

But investors should not automatically cheer every dividend announcement or penalize firms for not paying dividends. As is often the case in economics, the theory brushes away a number of important factors to make a simple point about dividend policy. These factors need to be explicitly accounted for before the information content of dividends can be evaluated properly.

■ Caveats

The most crucial factor investors must recognize is that paying dividends represents a choice among alternatives, and the alternatives have different costs and benefits. Dividends are not the only way to inform shareholders about a business's potential. Share repurchases, stock splits, the amount of debt carried on the balance sheet, the level of capi-

tal investment, and the purchase and sale of the firm's stock by insiders are some of the other ways the information can be transmitted. Dividends are not necessarily the cheapest or the best way to convey information.⁴ Share repurchases and dividends, for example, are very similar in purpose but are used quite differently by managers. Surveys of chief financial officers indicate that both techniques are used primarily to convey positive information to the market. But firms pay the same dividend amount every period, and the market interprets any deviation from this regular amount as a signal from management. Repurchases, on the other hand, are unanticipated events; the timing and size of the repurchases do not follow any pattern. Moreover, firms often repurchase shares for reasons unrelated to information signaling. For instance, a firm may repurchase shares for its employee stock ownership plan or for use in executive compensation.

Economists cannot yet fully explain why firms choose one method of distributing cash to shareholders over another, but the important point for investors to keep in mind is that each method provides one piece of a giant information puzzle. Dividends can help investors see the big picture if they can tie all the other bits and pieces of information together.^{5, 6} A dividend increase or initiation alone does not make a good firm. Neither does a lack of dividends necessarily make a bad firm.

The availability of alternative communication techniques is not the only reason investors should not expect every firm to pay dividends. After all, a critical factor in the decision to pay dividends is the relationship between the level and variability of the firm's cash flows and the set of profitable investments available to the firm. For example, the shareholders of a growth company may be better off if the company preserves its earnings to fund a multitude of investments rather than paying dividends. For growth companies, internally generated funds may not be sufficient to fund all of their future investment opportunities, and paying dividends would

only increase the amount of outside funds that would need to be raised. The shareholders of a company in a mature industry—one in which internally generated cash exceeds what the company needs to reinvest in its operations—may be better off if the firm distributes the cash. After all, managers of the firm are no better at investing excess cash than shareholders. It is wrong to deduce that the mature firm has more good news than the growth firm just because it is paying dividends and the growth firm is not. What matters is not the dividend announcement but how the announcement fits the big picture.

The importance of paying attention to the big picture becomes especially apparent when one remembers that managers may know a lot about their company, but they can't predict the future. Managers can make mistakes; they may be subjective and wrong in their estimation of future earnings. A dividend increase may seem like a good decision at first, based on the information available to the manager at the time, but it may turn out to be less wise as time goes by and new information comes in. In other words, a change in dividend policy may convey the upbeat information managers have at the time the change is made, but tell us nothing about the quality (precision) of that information. Evidence suggests that managers sometimes send inaccurate signals to the market using dividends.

Occasionally, companies raise their dividends only to cut them back at a later time, once management realizes that the new level is not sustainable in the long run. Sometimes managers make optimistic announcements and increase their companies' dividends, but the companies continue to perform poorly for many years to come.⁷ Because managers may send both accurate and erroneous information using dividends and investors cannot discern between the two, a dividend initiation or increase should not be interpreted as a sure sign a firm's performance will improve.

Another danger of focusing too much on dividend announcements is if investors put too much emphasis on dividends, firms have an incentive to cut back on investments and pay high dividends instead. Firms that invest too little in order to pay high dividends will eventually be discovered by the market. The long-run result will be a reduction in the market's forecast of the firm's future earnings and a consequent drop in its stock price. Overemphasis on dividends may reduce firm value.⁸

■ It Takes More than Dividends

Paying dividends is one way firm insiders can put cash in the hands of shareholders and convey some information that may be too costly to communicate directly. The usefulness of dividend policy as a signaling device is well-established, but its message may be misleading if the emphasis is solely on whether or not a firm is paying dividends or whether the dividends are high or low. Dividend policy is a useful communication tool in the corporate toolbox but not the only tool. Consequently, the message dividends send is best understood when a dividend policy is viewed as a complement to all the other available information.

■ Footnotes

1. Jeremy J. Siegel. 2002. "The Dividend Deficit," *Wall Street Journal*, February 13, A20.

2. Merton H. Miller and Franco Modigliani. 1961. "Dividend Policy, Growth, and the Valuation of Shares," *Journal of Business* 34, 411–33.

3. Sudipto Bhattacharya. 1979. "Imperfect Information, Dividend Policy, and the 'Bird in the Hand' Fallacy," *Bell Journal of Economics* 10, 259–70.

4. Ramasastry Ambarish, Kose John, and Joseph Williams. 1987. "Efficient Signaling with Dividends and Investments," *Journal of Finance* 42, 321–43.

5. John Kose and Larry H.P. Lang. 1991. "Insider Trading around Dividend Announcements: Theory and Evidence," *Journal of Finance* 46, 1361–89.

6. Larry H.P. Lang and Robert H. Litzenger. 1989. "Dividends Announcements: Cash Flow Signaling vs. Free Cash Flow Hypothesis," *Journal of Financial Economics* 24, 137–54.

7. Harry DeAngelo, Linda DeAngelo, and Douglas J. Skinner. 1996. "Reversal of Fortune: Dividend Signaling and the Disappearance of Sustained Earnings Growth," *Journal of Financial Economics* 40, 341–71.


8. Merton H. Miller and Kevin Rock. 1985. "Dividend Policy under Asymmetric Information," *Journal of Finance* 40, 1031–51.

■ Recommended Reading

For more detailed discussion on dividends, I recommend the articles cited in the footnotes as well as:

John B. Carlson. 2001. "Why Is the Dividend Yield So Low?" Federal Reserve Bank of Cleveland, *Economic Commentary*, April 1.

Ronald C. Lease, Kose John, Avner Kalay, Uri Loewenstein, and Oded H. Sarig. 2000. *Dividend Policy: Its Impact on Share Value*. Boston: Harvard Business School Press.


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