CHAPTER 19

Shareholders and Managements: Dividend Policy

*E*ver since 1934 we have argued in our writings for a more intelligent and energetic attitude by shareholders toward their managements. We have asked them to take a generous attitude toward those who are demonstrably doing a good job. We have asked them also to demand clear and satisfying explanations when the results appear to be worse than they should be, and to support movements to improve or remove clearly unproductive managements. Shareholders are justified in raising questions as to the competence of the management when the results (1) are unsatisfactory in themselves, (2) are poorer than those obtained by other companies that appear similarly situated, and (3) have resulted in an unsatisfactory market price of long duration.

In the last 36 years practically nothing has actually been accomplished through intelligent action by the great body of shareholders. A sensible crusader—if there are any such—would take this as a sign that he has been wasting his time, and that he had better give up the fight. As it happens our cause has not been lost; it has been rescued by an extraneous development—known as takeovers, or take-over bids.* We said in Chapter 8 that poor manage-

* Ironically, takeovers began drying up shortly after Graham's last revised edition appeared, and the 1970s and early 1980s marked the absolute low point of modern American industrial efficiency. Cars were "lemons," televisions and radios were constantly "on the fritz," and the managers of many publicly-traded companies ignored both the present interests of their outside shareholders and the future prospects of their own businesses. All of

ments produce poor market prices. The low market prices, in turn, attract the attention of companies interested in diversifying their operations—and these are now legion. Innumerable such acquisitions have been accomplished by agreement with the existing managements, or else by accumulation of shares in the market and by offers made over the head of those in control. The price bid has usually been within the range of the value of the enterprise under reasonably competent management. Hence, in many cases, the inert public shareholder has been bailed out by the actions of "outsiders"—who at times may be enterprising individuals or groups acting on their own.

It can be stated as a rule with very few exceptions that poor managements are not changed by action of the "public stockholders," but only by the assertion of control by an individual or compact group. This is happening often enough these days to put the management, including the board of directors, of a typical publicly controlled company on notice that if its operating results and the resulting market price are highly unsatisfactory, it may become the target of a successful take-over move. As a consequence, boards of directors have probably become more alive than previously to their fundamental duty to see that their company has a satisfactory top management. Many more changes of presidents have been seen in recent years than formerly.

Not all companies in the unsatisfactory class have benefited from such developments. Also, the change has often occurred after a long period of bad results without remedial action, and has depended on enough disappointed shareholders selling out at low prices to permit the energetic outsiders to acquire a controlling position in the shares. But the idea that public shareholders could really help themselves by supporting moves for improving management and management policies has proved too quixotic to war-

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this began to change in 1984, when independent oilman T. Boone Pickens launched a hostile takeover bid for Gulf Oil. Soon, fueled by junk-bond financing provided by Drexel Burnham Lambert, "corporate raiders" stalked the landscape of corporate America, scaring long-sclerotic companies into a new regimen of efficiency. While many of the companies involved in buyouts and takeovers were ravaged, the rest of American business emerged both leaner (which was good) and meaner (which sometimes was not).

rant further space in this book. Those individual shareholders who have enough gumption to make their presence felt at annual meetings—generally a completely futile performance—will not need our counsel on what points to raise with the managements. For others the advice would probably be wasted. Nevertheless, let us close this section with the plea that shareholders consider with an open mind and with careful attention any proxy material sent them by fellow-shareholders who want to remedy an obviously unsatisfactory management situation in the company.

Shareholders and Dividend Policy

In the past the dividend policy was a fairly frequent subject of argument between public, or "minority," shareholders and managements. In general these shareholders wanted more liberal dividends, while the managements preferred to keep the earnings in the business "to strengthen the company." They asked the shareholders to sacrifice their present interests for the good of the enterprise and for their own future long-term benefit. But in recent years the attitude of investors toward dividends has been undergoing a gradual but significant change. The basic argument now for paying small rather than liberal dividends is not that the company "needs" the money, but rather that it can use it to the shareholders' direct and immediate advantage by retaining the funds for profitable expansion. Years ago it was typically the weak company that was more or less forced to hold on to its profits, instead of paying out the usual 60% to 75% of them in dividends. The effect was almost always adverse to the market price of the shares. Nowadays it is quite likely to be a strong and growing enterprise that deliberately keeps down its dividend payments, with the approval of investors and speculators alike.*

There was always a strong theoretical case for reinvesting prof-

* The irony that Graham describes here grew even stronger in the 1990s, when it almost seemed that the stronger the company was, the less likely it was to pay a dividend–or for its shareholders to want one. The "payout ratio" (or the percentage of their net income that companies paid out as dividends) dropped from "60% to 75%" in Graham's day to 35% to 40% by the end of the 1990s.

its in the business where such retention could be counted on to produce a goodly increase in earnings. But there were several strong counter-arguments, such as: The profits "belong" to the shareholders, and they are entitled to have them paid out within the limits of prudent management; many of the shareholders need their dividend income to live on; the earnings they receive in dividends are "real money," while those retained in the company may or may not show up later as tangible values for the shareholders. These counter-arguments were so compelling, in fact, that the stock market showed a persistent bias in favor of the liberal dividend payers as against the companies that paid no dividends or relatively small ones.[1]

In the last 20 years the "profitable reinvestment" theory has been gaining ground. The better the past record of growth, the readier investors and speculators have become to accept a low-pay-out policy. So much is this true that in many cases of growth favorites the dividend rate—or even the absence of any dividend—has seemed to have virtually no effect on the market price.*

A striking example of this development is found in the history of Texas Instruments, Incorporated. The price of its common stock rose from 5 in 1953 to 256 in 1960, while earnings were advancing from 43 cents to $3.91 per share and while no dividend of any kind was paid. (In 1962 cash dividends were initiated, but by that year the earnings had fallen to $2.14 and the price had shown a spectacular drop to a low of 49.)

Another extreme illustration is provided by Superior Oil. In 1948 the company reported earnings of $35.26 per share, paid $3 in dividends, and sold as high as 235. In 1953 the dividend was reduced to $1, but the high price was 660. In 1957 it *paid no dividend*

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* In the late 1990s, technology companies were particularly strong advocates of the view that all of their earnings should be "plowed back into the business," where they could earn higher returns than any outside shareholder possibly could by reinvesting the same cash if it were paid out to him or her in dividends. Incredibly, investors never questioned the truth of this patronizing Daddy-Knows-Best principle–or even realized that a company's cash belongs to the shareholders, not its managers. See the commentary on this chapter.

at all, and sold at 2,000! This unusual issue later declined to 795 in 1962, when it earned $49.50 and paid $7.50.*

Investment sentiment is far from crystallized in this matter of dividend policy of growth companies. The conflicting views are well illustrated by the cases of two of our very largest corporations—American Telephone & Telegraph and International Business Machines. American Tel. & Tel. came to be regarded as an issue with good growth possibilities, as shown by the fact that in 1961 it sold at 25 times that year's earnings. Nevertheless, the company's cash dividend policy has remained an investment and speculative consideration of first importance, its quotation making an active response to even *rumors* of an impending increase in the dividend rate. On the other hand, comparatively little attention appears to have been paid to the *cash* dividend on IBM, which in 1960 yielded only 0.5% at the high price of the year and 1.5% at the close of 1970. (But in both cases stock splits have operated as a potent stock-market influence.)

The market's appraisal of cash-dividend policy appears to be developing in the following direction: Where prime emphasis is not placed on growth the stock is rated as an "income issue," and the dividend rate retains its long-held importance as the prime determinant of market price. At the other extreme, stocks clearly recognized to be in the rapid-growth category are valued primarily in terms of the expected growth rate over, say, the next decade, and the cash-dividend rate is more or less left out of the reckoning.

While the above statement may properly describe present tendencies, it is by no means a clear-cut guide to the situation in all common stocks, and perhaps not in the majority of them. For one thing, many companies occupy an intermediate position between growth and nongrowth enterprises. It is hard to say how much importance should be ascribed to the growth factor in such cases, and the market's view thereof may change radically from year to year. Secondly, there seems to be something paradoxical about

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* Superior Oil's stock price peaked at $2165 per share in 1959, when it paid a $4 dividend. For many years, Superior was the highest-priced stock listed on the New York Stock Exchange. Superior, controlled by the Keck family of Houston, was acquired by Mobil Corp. in 1984.

requiring the companies showing slower growth to be more liberal with their cash dividends. For these are generally the less prosperous concerns, and in the past the more prosperous the company the greater was the expectation of both liberal and increasing payments.

It is our belief that shareholders should demand of their managements either a normal payout of earnings—on the order, say, of two-thirds—or else a clear-cut demonstration that the reinvested profits have produced a satisfactory increase in per-share earnings. Such a demonstration could ordinarily be made in the case of a recognized growth company. But in many other cases a low payout is clearly the cause of an average market price that is below fair value, and here the shareholders have every right to inquire and probably to complain.

A niggardly policy has often been imposed on a company because its financial position is relatively weak, and it has needed all or most of its earnings (plus depreciation charges) to pay debts and bolster its working-capital position. When this is so there is not much the shareholders can say about it—except perhaps to criticize the management for permitting the company to fall into such an unsatisfactory financial position. However, dividends are sometimes held down by relatively unprosperous companies for the declared purpose of expanding the business. We feel that such a policy is illogical on its face, and should require both a complete explanation and a convincing defense before the shareholders should accept it. In terms of the past record there is no reason a priori to believe that the owners will benefit from expansion moves undertaken with their money by a business showing mediocre results and continuing its old management.

Stock Dividends and Stock Splits

It is important that investors understand the essential difference between a stock dividend (properly so-called) and a stock split. The latter represents a restatement of the common-stock structure—in a typical case by issuing two or three shares for one. The new shares are not related to specific earnings reinvested in a specific past period. Its purpose is to establish a lower market price for the single shares, presumably because such lower price range would be more acceptable to old and new shareholders. A stock split may be carried out by what technically may be called a stock dividend, which involves a transfer of sums from earned surplus to capital account; or else by a change in par value, which does not affect the surplus account.*

What we should call a *proper stock dividend* is one that is paid to shareholders to give them a tangible evidence or representation of *specific* earnings which have been reinvested in the business for their account over some relatively short period in the recent past—say, not more than the two preceding years. It is now approved practice to value such a stock dividend at the approximate value at the time of declaration, and to transfer an amount equal to such value from earned surplus to capital accounts. Thus the amount of a typical stock dividend is relatively small—in most cases not more than 5%. In essence a stock dividend of this sort has the same overall effect as the payment of an equivalent amount of cash out of earnings when accompanied by the sale of additional shares of like total value to the shareholders. However, a straight stock dividend has an important tax advantage over the otherwise equivalent combination of cash dividends with stock subscription rights, which is the almost standard practice for public-utility companies.

The New York Stock Exchange has set the figure of 25% as a practical dividing line between stock splits and stock dividends. Those of 25% or more need not be accompanied by the transfer of their market value from earned surplus to capital, and so forth.† Some companies, especially banks, still follow the old practice of

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* Today, virtually all stock splits are carried out by a change in value. In a two-for-one split, one share becomes two, each trading at half the former price of the original single share; in a three-for-one split, one share becomes three, each trading at a third of the former price; and so on. Only in very rare cases is a sum transferred "from earned surplus to capital account," as in Graham's day.

† Rule 703 of the New York Stock Exchange governs stock splits and stock dividends. The NYSE now designates stock dividends of greater than 25% and less than 100% as "partial stock splits." Unlike in Graham's day, these stock dividends may now trigger the NYSE's accounting requirement that the amount of the dividend be capitalized from retained earnings.

declaring any kind of stock dividend they please—e.g., one of 10%, not related to recent earnings—and these instances maintain an undesirable confusion in the financial world.

We have long been a strong advocate of a systematic and clearly enunciated policy with respect to the payment of cash and stock dividends. Under such a policy, stock dividends are paid periodically to capitalize all or a stated portion of the earnings reinvested in the business. Such a policy—covering 100% of the reinvested earnings—has been followed by Purex, Government Employees Insurance, and perhaps a few others.*

Stock dividends of all types seem to be disapproved of by most academic writers on the subject. They insist that they are nothing but pieces of paper, that they give the shareholders nothing they did not have before, and that they entail needless expense and inconvenience.† On our side we consider this a completely doctrinaire view, which fails to take into account the practical and psychological realities of investment. True, a periodic stock dividend—say of 5%—changes only the "form" of the owners' investment. He has 105 shares in place of 100; but without the stock dividend the original 100 shares would have represented the same

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* This policy, already unusual in Graham's day, is extremely rare today. In 1936 and again in 1950, roughly half of all stocks on the NYSE paid a so-called special dividend. By 1970, however, that percentage had declined to less than 10% and, by the 1990s, was well under 5%. See Harry DeAngelo, Linda DeAngelo, and Douglas J. Skinner, "Special Dividends and the Evolution of Dividend Signaling," *Journal of Financial Economics,* vol. 57, no. 3, September, 2000, pp. 309–354. The most plausible explanation for this decline is that corporate managers became uncomfortable with the idea that shareholders might interpret special dividends as a signal that future profits might be low.

† The academic criticism of dividends was led by Merton Miller and Franco Modigliani, whose influential article "Dividend Policy, Growth, and the Valuation of Shares" (1961) helped win them Nobel Prizes in Economics. Miller and Modigliani argued, in essence, that dividends were irrelevant, since an investor should not care whether his return comes through dividends and a rising stock price, or through a rising stock price alone, so long as the total return is the same in either case.

ownership interest now embodied in his 105 shares. Nonetheless, the change of form is actually one of real importance and value to him. If he wishes to cash in his share of the reinvested profits he can do so by selling the new certificate sent him, instead of having to break up his original certificate. He can count on receiving the same cash-dividend rate on 105 shares as formerly on his 100 shares; a 5% rise in the cash-dividend rate without the stock dividend would not be nearly as probable.*

The advantages of a periodic stock-dividend policy are most evident when it is compared with the usual practice of the public-utility companies of paying liberal cash dividends and then taking back a good part of this money from the shareholders by selling them additional stock (through subscription rights).† As we mentioned above, the shareholders would find themselves in exactly the same position if they received stock dividends in lieu of the popular combination of cash dividends followed by stock subscriptions—except that they would save the income tax otherwise paid on the cash dividends. Those who need or wish the maximum annual cash income, with no additional stock, can get this result by selling their stock dividends, in the same way as they sell their subscription rights under present practice.

The aggregate amount of income tax that could be saved by substituting stock dividends for the present stock-dividends-plus-subscription-rights combination is enormous. We urge that this

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* Graham's argument is no longer valid, and today's investors can safely skip over this passage. Shareholders no longer need to worry about "having to break up" a stock certificate, since virtually all shares now exist in electronic rather than paper form. And when Graham says that a 5% increase in a cash dividend on 100 shares is less "probable" than a constant dividend on 105 shares, it's unclear how he could even calculate that probability.

† Subscription rights, often simply known as "rights," are used less frequently than in Graham's day. They confer upon an existing shareholder the right to buy new shares, sometimes at a discount to market price. A shareholder who does not participate will end up owning proportionately less of the company. Thus, as is the case with so many other things that go by the name of "rights," some coercion is often involved. Rights are most common today among closed-end funds and insurance or other holding companies.

change be made by the public utilities, despite its adverse effect on the U.S. Treasury, because we are convinced that it is completely inequitable to impose a second (personal) income tax on earnings which are not really received by the shareholders, since the companies take the same money back through sales of stock.*

Efficient corporations continuously modernize their facilities, their products, their bookkeeping, their management-training programs, their employee relations. It is high time they thought about modernizing their major financial practices, not the least important of which is their dividend policy.

* The administration of President George W. Bush made progress in early 2003 toward reducing the problem of double-taxation of corporate dividends, although it is too soon to know how helpful any final laws in this area will turn out to be. A cleaner approach would be to make dividend payments tax-deductible to the corporation, but that is not part of the proposed legislation.

COMMENTARY ON CHAPTER 19

> The most dangerous untruths are truths slightly distorted.
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> —*G. C. Lichtenberg*

WHY DID GRAHAM THROW IN THE TOWEL?

Perhaps no other part of *The Intelligent Investor* was more drastically changed by Graham than this. In the first edition, this chapter was one of a pair that together ran nearly 34 pages. That original section ("The Investor as Business Owner") dealt with shareholders' voting rights, ways of judging the quality of corporate management, and techniques for detecting conflicts of interest between insiders and outside investors. By his last revised edition, however, Graham had pared the whole discussion back to less than eight terse pages about dividends.

Why did Graham cut away more than three-quarters of his original argument? After decades of exhortation, he evidently had given up hope that investors would ever take any interest in monitoring the behavior of corporate managers.

But the latest epidemic of scandal—allegations of managerial misbehavior, shady accounting, or tax maneuvers at major firms like AOL, Enron, Global Crossing, Sprint, Tyco, and WorldCom—is a stark reminder that Graham's earlier warnings about the need for eternal vigilance are more vital than ever. Let's bring them back and discuss them in light of today's events.

THEORY VERSUS PRACTICE

Graham begins his original (1949) discussion of "The Investor as Business Owner" by pointing out that, *in theory,* "the stockholders as a class are king. Acting as a majority they can hire and fire managements and bend them completely to their will." But, *in practice,* says Graham,

> the shareholders are a complete washout. As a class they show neither intelligence nor alertness. They vote in sheeplike fashion for whatever the management recommends and no matter how poor the management's record of accomplishment may be. . . . The only way to inspire the average American shareholder to take any *independently* intelligent action would be by exploding a firecracker under him. . . . We cannot resist pointing out the paradoxical fact that Jesus seems to have been a more practical businessman than are American shareholders.[1]

Graham wants you to realize something basic but incredibly profound: When you buy a stock, you become an owner of the company. Its managers, all the way up to the CEO, work for you. Its board of directors must answer to you. Its cash belongs to you. Its businesses are your property. If you don't like how your company is being managed, you have the right to demand that the managers be fired, the directors be changed, or the property be sold. "Stockholders," declares Graham, "should wake up."[2]

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[1] Benjamin Graham, *The Intelligent Investor* (Harper & Row, New York, 1949), pp. 217, 219, 240. Graham explains his reference to Jesus this way: "In at least four parables in the Gospels there is reference to a highly critical relationship between a man of wealth and those he puts in charge of his property. Most to the point are the words that "a certain rich man" speaks to his steward or manager, who is accused of wasting his goods: 'Give an account of thy stewardship, for thou mayest be no longer steward.' (*Luke,* 16:2)." Among the other parables Graham seems to have in mind is *Matt.,* 25:15–28.

[2] Benjamin Graham, "A Questionnaire on Stockholder-Management Relationship," *The Analysts Journal,* Fourth Quarter, 1947, p. 62. Graham points out that he had conducted a survey of nearly 600 professional security analysts and found that more than 95% of them believed that shareholders have the right to call for a formal investigation of managers whose leadership does not enhance the value of the stock. Graham adds dryly that "such action is almost unheard of in practice." This, he says, "highlights the wide gulf between what should happen and what does happen in shareholder-management relationships."

THE INTELLIGENT OWNER

Today's investors have forgotten Graham's message. They put most of their effort into buying a stock, a little into selling it—but none into owning it. "Certainly," Graham reminds us, "there is just as much reason to exercise care and judgment in *being* as in *becoming* a stockholder."[3]

So how should you, as an intelligent investor, go about being an intelligent owner? Graham starts by telling us that "there are just two basic questions to which stockholders should turn their attention:

1. Is the management reasonably efficient?
2. Are the interests of the average *outside* shareholder receiving proper recognition?"[4]

You should judge the efficiency of management by comparing each company's profitability, size, and competitiveness against similar firms in its industry. What if you conclude that the managers are no good? Then, urges Graham,

> A few of the more substantial stockholders should become convinced that a change is needed and should be willing to work toward that end. Second, the rank and file of the stockholders should be open-minded enough to read the proxy material and to weigh the arguments on both sides. They must at least be able to know when their company has been unsuccessful and be ready to demand more than artful platitudes as a vindication of the incumbent management. Third, it would be most helpful, when the figures clearly show that the results are well below average, if it became the custom to call in outside business engineers to pass upon the policies and competence of the management.[5]

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[3] Graham and Dodd, *Security Analysis* (1934 ed.), p. 508.

[4] *The Intelligent Investor,* 1949 edition, p. 218.

[5] 1949 edition, p. 223. Graham adds that a proxy vote would be necessary to authorize an independent committee of outside shareholders to select "the engineering firm" that would submit its report to the shareholders, not to the board of directors. However, the company would bear the costs of this project. Among the kinds of "engineering firms" *(cont'd on p. 501)*

THE ENRON END-RUN

Back in 1999, Enron Corp. ranked seventh on the *Fortune* 500 list of America's top companies. The energy giant's revenues, assets, and earnings were all rising like rockets.

But what if an investor had ignored the glamour and glittering numbers—and had simply put Enron's 1999 proxy statement under the microscope of common sense? Under the heading "Certain Transactions," the proxy disclosed that Enron's chief financial officer, Andrew Fastow, was the "managing member" of two partnerships, LJM1 and LJM2, that bought "energy and communications related investments." And where was LJM1 and LJM2 buying from? Why, where else but from Enron! The proxy reported that the partnerships had already bought $170 million of assets from Enron—sometimes using money borrowed from Enron.

The intelligent investor would immediately have asked:

- Did Enron's directors approve this arrangement? (Yes, said the proxy.)
- Would Fastow get a piece of LJM's profits? (Yes, said the proxy.)
- As Enron's chief financial officer, was Fastow obligated to act exclusively in the interests of Enron's shareholders? (Of course.)
- Was Fastow therefore duty-bound to maximize the price Enron obtained for any assets it sold? (Absolutely.)
- But if LJM paid a high price for Enron's assets, would that lower LJM's potential profits—and Fastow's personal income? (Clearly.)
- On the other hand, if LJM paid a low price, would that raise profits for Fastow and his partnerships, but hurt Enron's income? (Clearly.)
- Should Enron lend Fastow's partnerships any money to buy assets from Enron that might generate a personal profit for Fastow? (Say what?!)
- Doesn't all this constitute profoundly disturbing conflicts of interest? (No other answer is even possible.)

- What does this arrangement say about the judgment of the directors who approved it? (It says you should take your investment dollars elsewhere.)

Two clear lessons emerge from this disaster: Never dig so deep into the numbers that you check your common sense at the door, and always read the proxy statement before (and after) you buy a stock.

What is "proxy material" and why does Graham insist that you read it? In its proxy statement, which it sends to every shareholder, a company announces the agenda for its annual meeting and discloses details about the compensation and stock ownership of managers and directors, along with transactions between insiders and the company. Shareholders are asked to vote on which accounting firm should audit the books and who should serve on the board of directors. If you use your common sense while reading the proxy, this document can be like a canary in a coal mine—an early warning system signaling that something is wrong. (See the Enron sidebar above.)

Yet, on average, between a third and a half of all individual investors cannot be bothered to vote their proxies.[6] Do they even read them?

Understanding and voting your proxy is as every bit as fundamental

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(cont'd from p. 499) Graham had in mind were money managers, rating agencies and organizations of security analysts. Today, investors could choose from among hundreds of consulting firms, restructuring advisers, and members of entities like the Risk Management Association.

[6] Tabulations of voting results for 2002 by Georgeson Shareholder and ADP's Investor Communication Services, two leading firms that mail proxy solicitations to investors, suggest response rates that average around 80% to 88% (including proxies sent in by stockbrokers on behalf of their clients, which are automatically voted in favor of management unless the clients specify otherwise). Thus the owners of between 12% and 20% of all shares are not voting their proxies. Since individuals own only 40% of U.S. shares by market value, and most institutional investors like pension funds and insurance companies are legally bound to vote on proxy issues, that means that roughly a third of all individual investors are neglecting to vote.

to being an intelligent investor as following the news and voting your conscience is to being a good citizen. It doesn't matter whether you own 10% of a company or, with your piddling 100 shares, just 1/10.000 of 1%. If you've never read the proxy of a stock you own, and the company goes bust, the only person you should blame is yourself. If you do read the proxy and see things that disturb you, then:

- vote against every director to let them know you disapprove
- attend the annual meeting and speak up for your rights
- find an online message board devoted to the stock (like those at http://finance.yahoo.com) and rally other investors to join your cause.

Graham had another idea that could benefit today's investors:

> . . . there are advantages to be gained through the selection of one or more professional and independent directors. These should be men of wide business experience who can turn a fresh and expert eye on the problems of the enterprise. . . . They should submit a separate annual report, addressed directly to the stockholders and containing their views on the major question which concerns the owners of the enterprise: "Is the business showing the results for the outside stockholder which could be expected of it under proper management? If not, why—and what should be done about it?[7]

One can only imagine the consternation that Graham's proposal would cause among the corporate cronies and golfing buddies who constitute so many of today's "independent" directors. (Let's not suggest that it might send a shudder of fear down their spines, since most independent directors do not appear to have a backbone.)

WHOSE MONEY IS IT, ANYWAY?

Now let's look at Graham's second criterion—whether management acts in the best interests of outside investors. Managers have always told shareholders that they—the managers—know best what to do with

[7] 1949 edition, p. 224.

the company's cash. Graham saw right through this managerial malarkey:

> A company's management may run the business well and yet not give the outside stockholders the right results for them, because its efficiency is confined to operations and does not extend to the best use of the capital. The objective of efficient *operation* is to produce at low cost and to find the most profitable articles to sell. Efficient *finance* requires that the stockholders' money be working in forms most suitable to their interest. This is a question in which management, as such, has little interest. Actually, it almost always wants as much capital from the owners as it can possibly get, in order to minimize its own financial problems. Thus the typical management will operate with more capital than necessary, if the stockholders permit it—which they often do.[8]

In the late 1990s and into the early 2000s, the managements of leading technology companies took this "Daddy-Knows-Best" attitude to new extremes. The argument went like this: Why should you demand a dividend when we can invest that cash for you and turn it into a rising share price? Just look at the way our stock has been going up—doesn't that prove that we can turn your pennies into dollars better than you can?

Incredibly, investors fell for it hook, line, and sinker. Daddy Knows Best became such gospel that, by 1999, only 3.7% of the companies that first sold their stock to the public that year paid a dividend—down from an average of 72.1% of all IPOs in the 1960s.[9] Just look at how

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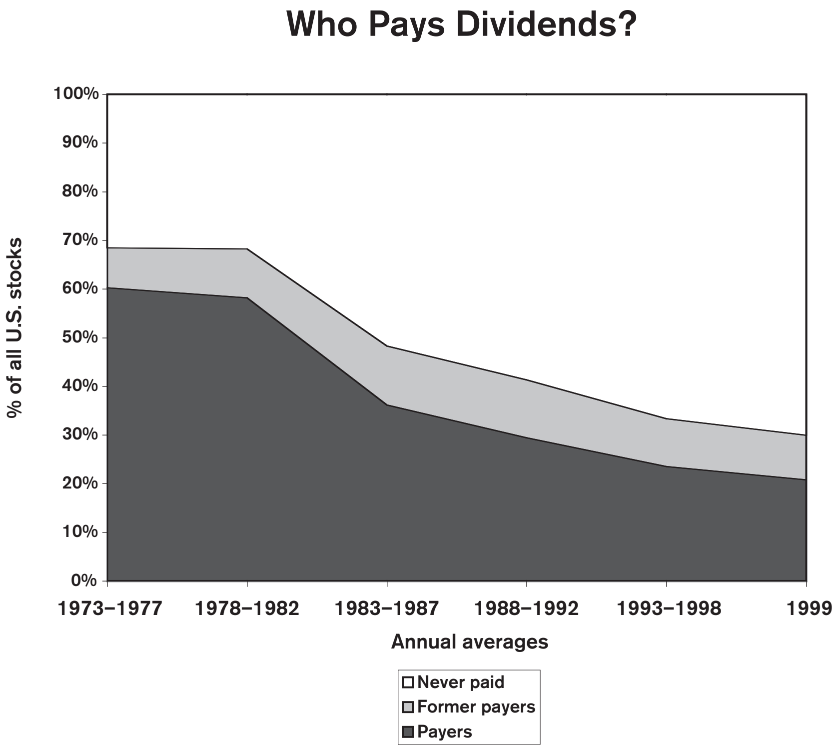
[8] 1949 edition, p. 233.

[9] Eugene F. Fama and Kenneth R. French, "Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay?" *Journal of Financial Economics,* vol. 60, no. 1, April, 2001, pp. 3–43, especially Table 1; see also Elroy Dimson, Paul Marsh, and Mike Staunton, *Triumph of the Optimists* (Princeton Univ. Press, Princeton, 2002), pp. 158–161. Interestingly, the total dollar amount of dividends paid by U.S. stocks has risen since the late 1970s, even after inflation—but the number of stocks that pay a dividend has shrunk by nearly two-thirds. See Harry DeAngelo, Linda DeAngelo, and Douglas J. Skinner, "Are Dividends Disappearing? Dividend Concentration and the Consolidation of Earnings," available at: http://papers.ssrn.com.

the percentage of companies paying dividends (shown in the dark area) has withered away:

FIGURE 19-1



Source: Eugene Fama and Kenneth French, "Disappearing Dividends," Journal of Financial Economics, *April 2001.*

But Daddy Knows Best was nothing but bunk. While some companies put their cash to good use, many more fell into two other categories: those that simply wasted it, and those that piled it up far faster than they could possibly spend it.

In the first group, Priceline.com wrote off $67 million in losses in

2000 after launching goofy ventures into groceries and gasoline, while Amazon.com destroyed at least $233 million of its shareholders' wealth by "investing" in dot-bombs like Webvan and Ashford.com.[10] And the two biggest losses so far on record—JDS Uniphase's $56 billion in 2001 and AOL Time Warner's $99 billion in 2002—occurred after companies chose not to pay dividends but to merge with other firms at a time when their shares were obscenely overvalued.[11]

In the second group, consider that by late 2001, Oracle Corp. had piled up $5 billion in cash. Cisco Systems had hoarded at least $7.5 billion. Microsoft had amassed a mountain of cash $38.2 billion high—and rising by an average of more than $2 million *per hour.*[12] Just how rainy a day was Bill Gates expecting, anyway?

So the anecdotal evidence clearly shows that many companies

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[10] Perhaps Benjamin Franklin, who is said to have carried his coins around in an asbestos purse so that money wouldn't burn a hole in his pocket, could have avoided this problem if he had been a CEO.

[11] A study by *BusinessWeek* found that from 1995 through 2001, 61% out of more than 300 large mergers ended up destroying wealth for the shareholders of the acquiring company—a condition known as "the winner's curse" or "buyer's remorse." And acquirers using stock rather than cash to pay for the deal underperformed rival companies by 8%. (David Henry, "Mergers: Why Most Big Deals Don't Pay Off," *BusinessWeek,* October 14, 2002, pp. 60–70.) A similar academic study found that acquisitions of private companies and subsidiaries of public companies lead to positive stock returns, but that acquisitions of entire public companies generate losses for the winning bidder's shareholders. (Kathleen Fuller, Jeffry Netter, and Mike Stegemoller, "What Do Returns to Acquiring Firms Tell Us?" *The Journal of Finance,* vol. 57, no. 4, August, 2002, pp. 1763–1793.)

[12] With interest rates near record lows, such a mountain of cash produces lousy returns if it just sits around. As Graham asserts, "So long as this surplus cash remains with the company, the outside stockholder gets little benefit from it" (1949 edition, p. 232). Indeed, by year-end 2002, Microsoft's cash balance had swollen to $43.4 billion—clear proof that the company could find no good use for the cash its businesses were generating. As Graham would say, Microsoft's *operations* were efficient, but its *finance* no longer was. In a step toward redressing this problem, Microsoft declared in early 2003 that it would begin paying a regular quarterly dividend.

don't know how to turn excess cash into extra returns. What does the statistical evidence tell us?

- Research by money managers Robert Arnott and Clifford Asness found that when current dividends are low, future corporate earnings also turn out to be low. And when current dividends are high, so are future earnings. Over 10-year periods, the average rate of earnings growth was 3.9 points greater when dividends were high than when they were low.[13]
- Columbia accounting professors Doron Nissim and Amir Ziv found that companies that raise their dividend not only have better stock returns but that "dividend increases are associated with [higher] future profitability for at least four years after the dividend change."[14]

In short, most managers are wrong when they say that they can put your cash to better use than you can. Paying out a dividend does not guarantee great results, but it does *improve* the return of the typical stock by yanking at least some cash out of the managers' hands before they can either squander it or squirrel it away.

SELLING LOW, BUYING HIGH

What about the argument that companies can put spare cash to better use by buying back their own shares? When a company repurchases some of its stock, that reduces the number of its shares outstanding. Even if its net income stays flat, the company's earnings

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[13] Robert D. Arnott and Clifford S. Asness, "Surprise! Higher Dividends = Higher Earnings Growth," *Financial Analysts Journal,* January/February, 2003, pp. 70–87.

[14] Doron Nissim and Amir Ziv, "Dividend Changes and Future Profitability," *The Journal of Finance,* vol. 56, no. 6, December, 2001, pp. 2111–2133. Even researchers who disagree with the Arnott-Asness and Nissim-Ziv findings on future earnings agree that dividend increases lead to higher future stock returns; see Shlomo Benartzi, Roni Michaely, and Richard Thaler, "Do Changes in Dividends Signal the Future or the Past?" *The Journal of Finance,* vol. 52, no. 3, July, 1997, pp. 1007–1034.

per share will rise, since its total earnings will be spread across fewer shares. That, in turn, should lift the stock price. Better yet, unlike a dividend, a buyback is tax-free to investors who don't sell their shares.[15] Thus it increases the value of their stock without raising their tax bill. And if the shares are cheap, then spending spare cash to repurchase them is an excellent use of the company's capital.[16]

All this is true in theory. Unfortunately, in the real world, stock buybacks have come to serve a purpose that can only be described as sinister. Now that grants of stock options have become such a large part of executive compensation, many companies—especially in high-tech industries—must issue hundreds of millions of shares to give to the managers who exercise those stock options.[17] But that would jack

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[15] The tax reforms proposed by President George W. Bush in early 2003 would change the taxability of dividends, but the fate of this legislation was not yet clear by press time.

[16] Historically, companies took a common-sense approach toward share repurchases, reducing them when stock prices were high and stepping them up when prices were low. After the stock market crash of October 19, 1987, for example, 400 companies announced new buybacks over the next 12 days alone—while only 107 firms had announced buyback programs in the earlier part of the year, when stock prices had been much higher. See Murali Jagannathan, Clifford P. Stephens, and Michael S. Weisbach, "Financial Flexibility and the Choice Between Dividends and Stock Repurchases," *Journal of Financial Economics,* vol. 57, no. 3, September, 2000, p. 362.

[17] The stock options granted by a company to its executives and employees give them the right (but not the obligation) to buy shares in the future at a discounted price. That conversion of options to shares is called "exercising" the options. The employees can then sell the shares at the current market price and pocket the difference as profit. Because hundreds of millions of options may be exercised in a given year, the company must increase its supply of shares outstanding. Then, however, the company's total net income would be spread across a much greater number of shares, reducing its earnings per share. Therefore, the company typically feels compelled to buy back other shares to cancel out the stock issued to the option holders. In 1998, 63.5% of chief financial officers admitted that counteracting the dilution from options was a major reason for repurchasing shares (see CFO Forum, "The Buyback Track," *Institutional Investor,* July, 1998).

up the number of shares outstanding and shrink earnings per share. To counteract that dilution, the companies must turn right back around and repurchase millions of shares in the open market. By 2000, companies were spending an astounding 41.8% of their total net income to repurchase their own shares—up from 4.8% in 1980.[18]

Let's look at Oracle Corp., the software giant. Between June 1, 1999, and May 31, 2000, Oracle issued 101 million shares of common stock to its senior executives and another 26 million to employees at a cost of $484 million. Meanwhile, to keep the exercise of earlier stock options from diluting its earnings per share, Oracle spent $5.3 billion—*or 52% of its total revenues that year*—to buy back 290.7 million shares of stock. Oracle issued the stock to insiders at an average price of $3.53 per share and repurchased it at an average price of $18.26. Sell low, buy high: Is this any way to "enhance" shareholder value?[19]

By 2002, Oracle's stock had fallen to less than half its peak in 2000. Now that its shares were cheaper, did Oracle hasten to buy back more stock? Between June 1, 2001, and May 31, 2002, Oracle *cut* its repurchases to $2.8 billion, apparently because its executives and employees exercised fewer options that year. The same sell-low, buy-high pattern is evident at dozens of other technology companies.

What's going on here? Two surprising factors are at work:

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[18] One of the main factors driving this change was the U.S. Securities and Exchange Commission's decision, in 1982, to relax its previous restrictions on share repurchases. See Gustavo Grullon and Roni Michaely, "Dividends, Share Repurchases, and the Substitution Hypothesis," *The Journal of Finance,* vol. 57, no. 4, August, 2002, pp. 1649–1684.

[19] Throughout his writings, Graham insists that corporate managements have a duty not just to make sure their stock is not undervalued, but also to make sure it never gets overvalued. As he put it in *Security Analysis* (1934 ed., p. 515), "the responsibility of managements to act in the interest of their shareholders includes the obligation to prevent—in so far as they are able—the establishment of either absurdly high or unduly low prices for their securities." Thus, enhancing shareholder value doesn't just mean making sure that the stock price does not go too low; it also means ensuring that the stock price does not go *up* to unjustifiable levels. If only the executives of Internet companies had heeded Graham's wisdom back in 1999!

- Companies get a tax break when executives and employees exercise stock options (which the IRS considers a "compensation expense" to the company).[20] In its fiscal years from 2000 through 2002, for example, Oracle reaped $1.69 billion in tax benefits as insiders cashed in on options. Sprint Corp. pocketed $678 million in tax benefits as its executives and employees locked in $1.9 billion in options profits in 1999 and 2000.
- A senior executive heavily compensated with stock options has a vested interest in favoring stock buybacks over dividends. Why? For technical reasons, options increase in value as the price fluctuations of a stock grow more extreme. But dividends dampen the volatility of a stock's price. So, if the managers increased the dividend, they would lower the value of their own stock options.[21]

No wonder CEOs would much rather buy back stock than pay dividends—regardless of how overvalued the shares may be or how drastically that may waste the resources of the outside shareholders.

[20] Incredibly, although options are considered a compensation expense on a company's tax returns, they are not counted as an expense on the income statement in financial reports to shareholders. Investors can only hope that accounting reforms will change this ludicrous practice.

[21] See George W. Fenn and Nellie Liang, "Corporate Payout Policy and Managerial Stock Incentives," *Journal of Financial Economics,* vol. 60, no. 1, April, 2001, pp. 45–72. Dividends make stocks less volatile by providing a stream of current income that cushions shareholders against fluctuations in market value. Several researchers have found that the average profitability of companies with stock-buyback programs (but no cash dividends) is at least twice as volatile as that of companies that pay dividends. Those more variable earnings will, in general, lead to bouncier share prices, making the managers' stock options more valuable—by creating more opportunities when share prices will be temporarily high. Today, about two-thirds of executive compensation comes in the form of options and other noncash awards; thirty years ago, at least two-thirds of compensation came as cash.

KEEPING THEIR OPTIONS OPEN

Finally, drowsy investors have given their companies free rein to overpay executives in ways that are simply unconscionable. In 1997, Steve Jobs, the cofounder of Apple Computer Inc., returned to the company as its “interim” chief executive officer. Already a wealthy man, Jobs insisted on taking a cash salary of $1 per year. At year-end 1999, to thank Jobs for serving as CEO “for the previous 2 1/2 years without compensation,” the board presented him with his very own Gulfstream jet, at a cost to the company of a mere $90 million. The next month Jobs agreed to drop “interim” from his job title, and the board rewarded him with options on 20 million shares. (Until then, Jobs had held a grand total of two shares of Apple stock.)

The principle behind such option grants is to align the interests of managers with outside investors. If you are an outside Apple shareholder, you want its managers to be rewarded only if Apple’s stock earns superior returns. Nothing else could possibly be fair to you and the other owners of the company. But, as John Bogle, former chairman of the Vanguard funds, points out, nearly all managers *sell* the stock they receive immediately after exercising their options. How could dumping millions of shares for an instant profit possibly align their interests with those of the company’s loyal long-term shareholders?

In Jobs’ case, if Apple stock rises by just 5% annually through the beginning of 2010, he will be able to cash in his options for $548.3 million. In other words, even if Apple’s stock earns no better than half the long-term average return of the overall stock market, Jobs will land a half-a-billion dollar windfall.[22] Does that align his interests with those of Apple’s shareholders—or malign the trust that Apple’s shareholders have placed in the board of directors?

Reading proxy statements vigilantly, the intelligent owner will vote against any executive compensation plan that uses option grants to turn more than 3% of the company’s shares outstanding over to the managers. And you should veto any plan that does not make option grants contingent on a fair and enduring measure of superior results—

[22] Apple Computer Inc. proxy statement for April 2001 annual meeting, p. 8 (available at www.sec.gov). Jobs’ option grant and share ownership are adjusted for a two-for-one share split.

say, outperforming the average stock in the same industry for a period of at least five years. No CEO ever deserves to make himself rich if he has produced poor results for you.

A FINAL THOUGHT

Let's go back to Graham's suggestion that every company's independent board members should have to report to the shareholders in writing on whether the business is properly managed on behalf of its true owners. What if the independent directors also had to justify the company's policies on dividends and share repurchases? What if they had to describe exactly how they determined that the company's senior management was not overpaid? And what if every investor became an intelligent owner and actually read that report?