Chapter 17 Notes

* Dividend: cash payout of earnings
* Distribution: payment made from sources other than current or accumulated retained earnings
  + Distribution from capital referred to as a liquidating dividend
* Basic types of cash dividend:
  + Regular cash dividends
    - Commonly paid four times per year
  + Extra dividends
    - Paid with the regular dividend but is an indication from management that it may not be repeated in the future
  + Special dividends
    - Similar to extra but viewed as even more unusual and will likely not happen again
  + Liquidating dividends
    - Comes from some or all of the business being sold off
* Dividend payment chronology
  + Declaration date: board of directors passes resolution to pay dividend
  + Ex-dividend date: if you buy stock BEFORE this date, you are entitled to dividend
    - Two business days before date of record
    - Set by firm and stock exchange
  + Date of record: firm prepares a list of all individuals BELIEVED to be stockholders
    - People on this list referred to as holders of record
  + Date of payment: dividend checks mailed
* We expect stock prices to drop by *about* the dividend amount once it goes ex-dividend
* Argument to be made that dividend policy doesn’t matter because of homemade dividend policy
  + Some companies help investors do this with automatic dividend reinvestment plans and sometimes offer discounts on the stock
* For individual shareholders effective tax rates on dividend income are higher than those on capital gains
* Flotation costs can force firms to periodically sell stock to keep equity up when paying dividends, which will cause share price to go down
* Some bond indentures prohibit dividend payments above a certain level
* Benjamin Graham argued firms should have high dividend payout because:
  + “The discounted value of near dividends is higher than the present worth of distant dividends”
  + Between “two companies with the same general earning power and same general position in an industry, the one paying the larger dividend will almost always sell at a higher price”
* Two more factors supporting high dividends:
  + Desire for current income
    - Argued that groups living on fixed incomes willing to pay a premium for higher dividend yields
    - Not true in our simple case but might be true due to transaction fees
  + Resolution of uncertainty
* While individuals are taxed unfavorably, not everyone is:
  + Corporate investors: receive 50% or more tax exclusion on dividends
  + Tax-exempt investors: pay zero tax
    - Examples:
      * Pension funds
      * Endowment funds
      * Trust funds
* With some consistency, stock prices rise when current dividend is unexpectedly increased and vice versa
* Companies cut dividends only with great reluctance
  + Often a sign firm is in trouble
* Information content effect: reaction of stock price to dividend change
  + Can be attributed to changes in expected amount of future dividends, not necessarily change in dividend payout policy
* Clientele effect: states that different groups of investors desire different levels of dividends
  + When a firm chooses a particular dividend policy, only effect is to attract a particular clientele
* What’s left is simple supply and demand argument
  + If 40% of investors prefer high dividends but only 20% of firms pay high dividends, stock prices of those firms will rise because they’re in short supply
  + Consequently, low-dividend firms will increase dividends until 40% of firms pay high dividends
* Repurchases: another way to distribute cash besides dividends
  + Typically accomplished in three ways:
    - Companies purchase their own stock anonymously
    - Tender offer: firm announces it is willing to buy a fixed number of shares at a specific price
    - Targeted repurchase: repurchasing shares from specific individual investors
* Important note: if there are no imperfections, cash dividend and share repurchase are essentially the same thing
  + Real world imperfections:
    - Repurchase has significant tax advantage over dividend because dividends are taxed and shareholder has no option but to accept the dividend
    - In a repurchase, shareholder pays taxes only if:
      * Shareholder chooses to sell
      * Shareholder has capital gain on the sale
    - Share repurchases reduces number of outstanding shares so it causes EPS to increase
* Percentage of dividend-paying firms has declined due to huge number of newly listed firms, which tend to be younger and less profitable
  + Also because share repurchases have gotten more popular
* Dividend growth lags earnings growth and tends to be much smoother because managers are cautious in increasing or decreasing them
* Summary:
  + Aggregate dividend and stock repurchases are massive, have increased steadily
  + Dividends heavily concentrated among relatively small number of large, mature firms
  + Managers very reluctant to cut dividends, normally doing so due to firm-specific problems
  + Managers smooth dividends
  + Stock prices react to unanticipated changes in dividends
* One reason to pick dividends over repurchase despite tax disadvantages:
  + Sends two-part signal to market that the firm anticipates being profitable, with ability to make payments on an ongoing basis and also that it won’t be hoarding cash
* Drawbacks of fixed repurchase strategy:
  + Verifiability: firms could announce it and then not do it
  + Forces management into making negative NPV investments if they think the stock is overpriced and have to buy it back
* Stock dividend: paid out in shares of stock
  + Not a true dividend because not paid in cash
  + Increases number of shares that each owner holds
  + Commonly expressed in percentages
* Stock split: same thing as stock dividend but expressed as a ratio instead of a percentage
* Small stock dividends: less than 20-25%
* Large stock dividend: greater than 20-25%
* Trading range: when securities are priced above this level, many investors do not have the funds to buy the common trading unit of 100 shares, called a round lot