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A NOTE ON DIVIDEND POLICY

Profit-making corporations return cash to investors through dividends or share repurchases. Market participants label the fraction of profits paid to shareholders as dividends as the "payout ratio" (dividends ÷ net earnings). However, a large number of firms have never paid a dividend. For instance, over half of the listed firms in the United States did not pay a dividend or repurchase shares over the past decade.[1] Only 20 per cent of firms on the Singapore Stock Exchange consistently paid dividends over the same period, with similar rates observed in both the U.S. and European stock markets.[2] The percentage of dividend-paying firms plummeted to a record low of 17 per cent in 2000.[3] In fact, most of the "new economy" firms, such as Amazon, Facebook, and Google, reinvest their entire earnings.

The asymmetric reactions by investors to changes in cash dividends highlight the importance of these consistent payments to shareholders. For instance, a cut in dividends typically leads to a much larger drop in a firm's stock price relative to the price appreciation from an equivalent dividend boost. Consequently, managers often attempt to deliver persistent dividends and increase them only when they are confident dividends can be maintained.

Investors rely on dividends to evaluate a firm's investment prospects. A common view is that an opaque dividend policy creates concerns and uncertainty among investors in the firm. Arguably, investors use corporate dividends to evaluate and forecast the future of the firm.

A plethora of research on corporate payout policies documents several regularities. Yet, it seems that we do not completely understand corporate motivations and investor expectations about dividends. Various academics have offered theories to attempt to explain those motivations and expectations.

RATIONAL DIVIDEND THEORIES

Miller-Modigliani Dividend Irrelevance Theory[4]

The dividend irrelevance theory posits that in perfect markets without agency costs, information asymmetry, taxes, or other frictions, a dividend policy would be irrelevant. In other words, the choice between keeping money in the company (through retained earnings) or paying it out to shareholders (by repurchasing shares or paying dividends) would not affect shareholders' wealth.

From the company's perspective, increased dividends could be offset by either lower share repurchases or higher share issues. From an investor's perspective, Miller and Modigliani suggest that shareholders could create their own synthetic dividends. Specifically, if shareholders received dividends they viewed as too high, they could reinvest part of the dividend proceeds to buy more shares in the company. Similarly, if shareholders received dividends considered to be too low, they could sell a fraction of their shares to create synthetically higher dividends.

Although this theory starts with a very strict set of assumptions, it provides a useful benchmark for comparison purposes. More recent research has relaxed most of these assumptions to derive more realistic scenarios.

Information Content of Dividends[5]

Historically, managers were extremely reluctant to increase or reduce dividends. In terms of the future cash flows of the company, dividend increases conveyed a strong positive signal, while dividend decreases conveyed a strong negative signal. In fact, dividend research showed that the most important informational content in the dividend payout stemmed from *changes* in the firm's dividend.[6]

Survey of financial executives[7] revealed that executives preferred to avoid changing dividends because they were concerned about the likelihood of a dividend cut in the future. Amihud and Li showed an asymmetric effect of dividend changes: dividend increases triggered a 0.5 per cent increase in the stock price, while dividend reductions caused a 2 per cent decrease.[8] However, the sensitivity of the price changes to dividend changes have significantly decreased in recent decades.

Tax Considerations

If dividends and capital gains were taxed at different levels, investors might show a strong preference for the option with lower taxes. Li et al. used the 2012 tax reform in China, which changed investors' dividend tax rates, to examine this hypothesis. They documented that "firms facing a reduction in their individual investors' dividend tax rate are more likely to increase their dividend payouts."[9] Desai and Jin, in their study, documented that high-dividend firms attracted institutional investors with low dividend tax rates.[10]

Financial Flexibility

Jagannathan, Stephens, and Weisbach documented that "stock repurchases are very pro-cyclical, while dividends increase steadily over time."[11] When firms had high *permanent operating* cash flows, they typically paid dividends, while firms with higher *temporary, non-operating* cash flows engaged in stock repurchases. One might argue that higher *temporary, non-operating* cash flows could prompt the firm to pay *special dividends* in addition to, or instead of, stock repurchases.

Agency Considerations[12]

When considering the efficient investment of corporate funds, agency costs are a concern in favour of increasing dividends. Executives with piles of cash might decide to invest in unprofitable projects (over-investment) or consume extravagant perks on the company's account. This approach is also known as the free cash flow hypothesis. To eliminate this excess cash, firms might decide to pay dividends as a way to restrict executives' options.

BEHAVIOURAL DIVIDEND THEORIES

The rational dividend theories assume that managers and investors are rational decision-makers; behavioural dividend theories consider subjective influences in payout policies.

In one of the early documented cases of dividend behaviour that cannot be explained by rational theories, Long studied dividends of the Citizens Utilities Company (now Frontier Communications Corporation).[13] The company had one share class that paid cash dividends and another share class that paid stock dividends. Although the fundamentals were identical (the same company) and cash dividends were *lower* than stock dividends, the cash dividend shares traded at a *higher* price. Further, the premium paid for cash dividend shares varied over time, indicating time-varying behavioural preference for cash dividends.

Investors might like dividends more than capital gains, which could be explained by the classical "bird-in-hand" theory.[14] It predicts that stocks paying dividends—putting money in investors' hands—would be valued higher than non-dividend-paying stocks, which postpone the reward.

Shefrin and Statman conjectured that investors often adopt a strategy of using dividends to fund personal consumption and rely on capital gains to provide future growth.[15] In other words, investors might decide to fund consumption strictly with dividends as a mechanism of self-control; selling shares to fund consumption might tempt an investor to sell more shares than strictly required and overconsume. In a similar vein, Hartzmark and Solomon argued that "investors trade as if they consider dividends and capital gains in separate mental accounts, without fully appreciating that dividends come at the expense of price decreases."[16]

Shefrin and Thaler proposed the behavioural life cycle model in which older investors prefer dividend-paying stocks because dividends complement the investors' reduced income.[17] In agreement, Graham and Kumar found that older investors buy dividend-paying stocks after dividend announcements are made.[18]

Behavioural biases similarly affect managers. The most common types of behavioural bias among managers are overconfidence and hubris. Researchers argue that over-optimistic managers pay lower dividends because they are more optimistic about firm prospects and prefer to invest in future projects rather than pay dividends.[19]

DeAngelo, DeAngelo, and Skinner interpreted some behavioural biases as a special form of agency costs associated with managing the relationship between management and shareholders.[20] According to this theory, if managers have too many resources, they might be more prone to wasteful spending. Consequently, shareholders will require these firms to pay out more to shareholders as a way of constraining managers' behaviour.

Some investors such as pension funds are legally obliged to invest in companies with high dividend yields. Understandably, these funds have a preference for dividends and they value dividend-paying stocks at a premium relative to non-dividend paying stocks. Baker and Wurgler documented managers' decisions to initiate or omit dividends and correlated them with investor demand for dividend-paying stocks.[21] They showed, as well, that a decline in dividend payments over the years roughly corresponded to the decline in a dividend premium. In agreement, Kumar, Lei, and Zhang showed that firms increase dividends when investor sentiment favours purchasing dividend-yielding stock.[22]

Industry herding is another behavioural explanation of dividends.[23] This hypothesis argues that firms in an industry follow random mutations in dividend payouts made by other firms in the industry. Behavioural economists argue that herding is a tendency that evolves from a fear of being left alone. The result is that many firms simply follow policies established by their competitors.

Finally, Ben-David proposed that dividends had an initial use and purpose, but they became a social norm.[24] As a result, managers come under market pressure to distribute dividends due to established social norms. Failure to pay dividends typically leads to a negative impact on stock price, so managers simply continue previous dividend patterns.

The Effect of a Large Shareholder

Many public companies have a dominant shareholder. In the United States, controlling shareholders often own approximately 20 per cent of the stock; this percentage is much larger in Europe, where controlling shareholders in Germany, France, and Italy typically own more than 50 per cent of the stock, and in Asia, where state and sovereign wealth funds own significant shareholdings of firms in China and Singapore.[25]

Research on the impact of controlling a large shareholder's influence on corporate decision-making has often focused on family ownership. Founding family control of public companies has been widespread with these families often holding the bulk of their wealth in the firm.[26] In multi-generation family firms, such as Walmart Inc. in the United States, family owners' income is ultimately based on the firm's dividends.[27]

Academic research has often connected a controlling shareholder to tunnelling, defined as "the transfer of resources out of a company to its controlling shareholder (who is typically also a top manager)."[28] Johnson et al. also provided several examples of firms with a large controlling shareholder engaging in dubious transactions.[29] Related to this issue, Kalcheva and Lins documented that firms that pay higher dividends have higher values in countries with weak legal systems, which implies that investors associate higher dividends with financially ethical behaviour, reducing potential tunnelling.[30]

Finally, a controlling shareholder might not be a top manager but might want to monitor the firm to ensure that funds are appropriately used. In this case, managers might use a "sleeping dogs" policy: managers pay enough dividends to pacify a controlling shareholder, while avoiding close scrutiny of their spending of the remaining funds.[31]

SURVEY EVIDENCE

Academics have argued about the relative importance of behavioural theories of dividend payouts, but a well-known survey of financial executives indicates that they believe dividend payouts do affect investors' behaviour.[32] The survey evidence suggests that managers often view dividends as providing information to investors about firm quality.[33] They see historical level as very important since there is a little reward for increasing dividends and large penalty for decreasing or omitting dividends. Executives think that the most common target is the level of dividend, followed by payout ratio, and growth in dividends. They also believe that tax disadvantage of dividends is of second-order importance and that investors like dividends even if they give them a tax disadvantage.

DIVIDEND STRATEGIES

Most firms follow clear and transparent strategies or decision-rules in setting their dividends. These strategies could broadly be classified into four categories.

Stable (often constant) dividends are used by most public firms. In this strategy, changes to dividend levels are extremely rare and happen only in extraordinary circumstances. As previously mentioned, (positive)

price reactions to dividend increases are typically significantly smaller in magnitude than (negative) price reactions to dividend decreases. Hence, when faced with increased profits, these firms hesitate to increase their dividend level. The price reaction would be small, and a *future decrease* in profits (and dividends) would hurt the company in an asymmetric fashion. Nevertheless, if managers feel confident that increased earnings are sustainable, they may increase the dividends. Criticism of this strategy is based on the concern that managers might engage in earnings management to smooth profits and keep dividends constant.

A strategy of *stable (low) dividends, with occasional special dividends* to correct for the major disadvantage of a constant dividend strategy, is often used by more conservative firms. These firms pay constant dividends unless there is an unexpected cash windfall. In that situation, the firms would distribute a special dividend. Special dividends do not create market expectations in the way that regular dividends do, and omitting special dividends in the future would not punish the company's stock price. However, managers need to be careful not to build market expectations for special dividends.

Some firms follow a *stable (often constant) payout ratio* strategy. In this strategy, firms establish a certain percentage of their earnings to be paid as dividends to shareholders, and this payout ratio remains stable (or constant). The main advantage of this policy is that it is simple and transparent, similar to the "stable (often constant) dividend" policy, but it allows managers more freedom in setting the dividends, especially when profits are low. The main disadvantage of this strategy is that dividends fluctuate with profits. Investors who prefer a stable dividend income (such as pension funds) might find a payout ratio strategy too uncertain because dividends would be low when earnings are low.

Finally, firms that follow a strategy of *residual dividend payouts* make the decision regarding the dividend after making decisions regarding investments. In fact, all projects with positive net present value would be undertaken before a firm declared a dividend out of the residual cash. The main advantage of the residual dividend payout policy is that profits are channelled to their best use. However, this policy is also the most volatile because investment opportunities might change drastically from year to year.

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