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Dividend

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What is a Dividend

A dividend is the distribution of reward from a portion of company's earnings, and is paid to a class of its shareholders. Dividends are decided and managed by the company's board of directors, though they must be approved by the shareholders through their voting rights. Dividends can be issued as cash payments, as shares of stock, or other property, though cash dividends are the most common. Along with companies, various mutual funds and exchange traded funds (ETF) also pay dividends.

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What Is A Dividend?

BREAKING DOWN Dividend

Dividend is a token reward paid to the shareholders for their investment in company’s equity, and it usually originates from the company's net profits. While the major portion of the profits is kept within the company as retained earnings which represent the money to be used for company’s ongoing and future business activities, the remainder can be allocated to the shareholders as a dividend. However, at times companies may still make dividend payments even when they don’t make suitable profits. They may do so to maintain their established track record of making regular dividend payments.

The board of directors can choose to issue dividends over various timeframes and with payout rates. Dividends can be paid at a scheduled frequency, like monthly, quarterly or annually. For example, world’s leading retailer Walmart Inc. (WMT) and FMCG major Unilever PLC ADR (UL) make regular quarterly dividend payments. Additionally, companies can also issue non-recurring special dividends either individually or in addition to a scheduled dividend. Backed by a strong business performance and an improved financial outlook, technology major Microsoft Corp. (MSFT) declared a special dividend of $3.00 per share in

Dividend Paying Companies

Larger, established companies with more predictable profits are often the best dividend payers. These companies tend to issue regular dividends as they seek to maximize shareholder wealth in ways aside from normal growth. Companies in the following industry sectors are observed to be maintaining a regular record of dividend payments: basic materials, oil and gas, banks and financial, healthcare and pharmaceuticals, and utilities. Companies structured as master limited partnerships (MLP) and real estate investment trusts (REIT) are also top dividend payers since their designations require specified distributions to shareholders. Funds may also issue regular dividend payments as stated in their investment objectives.

Start-ups and other high-growth companies, such as those in the technology or biotech sectors, may not offer regular dividends. Since such companies may be in the early stages of development and may incur high costs (as well as losses) attributed to research and development, business expansion and operational activities, they may not have sufficient funds to issue dividends. Even profit-making early- to mid-stage companies avoid making dividend payments if they are aiming for higher-than-average growth and expansion, and may like to invest the profits back in business instead of paying dividends.

Important Dates Linked with Dividend

Dividend payment procedure follows a chronological order of events, and the associated dates are important to determine the shareholders who qualify for receiving the dividend payment.

- **Announcement Date**: Dividends are announced by the company management on the announcement date, and must be approved by the shareholders before they can be paid.
- **Ex-dividend Date**: The date on which the dividend eligibility expires is called the ex-dividend date or simply the ex-date. For instance, if a stock has an ex-date of Monday, May 5, then shareholders who buy the stock on or after that day will NOT qualify to get the dividend as they are buying it on or after the dividend expiry date. Shareholders who own the stock one business day prior to the ex-date - that is on Friday, May 2, or earlier - will receive the dividend.
- **Record Date**: The record date is the cut-off date, established by a company, in order to determine which shareholders are eligible to receive a dividend or distribution.
- **Payment Date**: The company issues the payment of the dividend on the payment date, which is when the money gets credited to investor's account.

Impact of Dividends on Share Price

Since dividends are irreversible, their payments lead to money going out of the company's books and accounts of the business forever. Therefore, dividend payments impact share price – it rises on the announcement approximately by the amount of dividend declared, and reduces by a similar amount at the opening session of the ex-date. Say, a company is trading at $60 per share and it declares a $2 dividend on the announcement date. As soon as the news becomes public, the share price will shoot up by around $2 and hit the level of $62. Say the stock trades at $63 one business day prior to the ex-date. On the ex-date, it will come down by similar $2, and will start trading at $61 at the start of trading session on the ex-date, because anyone buying on ex-date will not receive the dividend.

Why Companies Pay Dividend?

Companies pay dividend for a variety of reasons, and the developments can have different implications and interpretations. Dividends are expected by the shareholders as a reward for their trust in a company, and the company management aims to honor this sentiment by maintain a robust track record of dividend payments. Dividends payments reflect positively about company's working, and help maintain investors' trust. Dividends are also preferred by shareholders as they are treated as tax-free income for shareholders in many jurisdictions, while the capital gains realized through increase in share price is taxable.

A high value dividend declaration can indicate that the company is doing well and has generated good profits, but it can also indicate that the company is not having suitable projects to generate better returns and is instead paying shareholders with excess cash that is lying unutilized.

If a company has a long history of past dividend payments, reducing or eliminating the dividend amount may signal to investors that the company could be in trouble. When one of the largest American industrials company General Electric Co. (GE) announced a financial plan that included decreasing its dividend by approximately 50%, it was accompanied by a decline of more than seven percent in GE's stock price on November 13, 2017.

However, a reduction in dividend amount or a decision against making any dividend payment may not necessarily mean that a company is having problems. Being better informed about the business, operations and marketplace, a company's management may have better plans for investing the money in a high return project which may have the potential to make shareholders better off in the long run compared to the petty gains they will realize through dividend payments.

A Note About Fund Dividends

Dividends paid by funds are different from dividend paid by companies. Companies usually pay dividends whose funds are sourced from profits that are generated from its business operations. Funds work on the principle of net asset value (NAV) which reflects the valuation of their holdings or the price of asset(s) a fund may be tracking. Since funds don't have any intrinsic profits, they pay dividends which are sourced from their NAV.

Due to the NAV-based working of funds, regularly and high frequency dividend payments should not be misunderstood as a stellar performance by the fund. Say a bond investing fund may pay monthly dividend as it receives money in the form of monthly interest on its interest-bearing holdings. It is merely transferring the interest income fully or partially to the fund investors. A stock investing fund may also pay dividends, which may come from the dividend(s) it receives from the stocks held in its portfolio, or by selling certain quantity of stocks. Essentially, the investors receiving the dividend from the fund are reducing their holding value which gets reflected in the reduced NAV on the ex-date.

Is Dividend Irrelevant?