How accurate is the statement that “The dividend policy of a firm is irrelevant”.

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By

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THIS PAPER IS PREPARED IN RESPONSE TO A RELEVANT QUESTION TO HELP STUDENTS TAKING CORPORATE FINANCE COURSE.

NO PART OF THIS THESIS IS TO BE USED FOR ANY PURPOSES, OTHER THAN ACADEMIC REFERENCE, WITHOUT THE OFFICIAL CONSULTATION WITH THE AUTHOR.
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1.0 EXECUTIVE SUMMARY

Various studies suggest that the question of whether dividend policy affects the value of the firm has puzzled researchers and corporate managers for many years. It is evidence that dividend policy is one of the most widely researched topics in finance. Yet, researchers have different views about whether the percentage of earnings that a firm pays out in dividends materially affects its long-term share price, Dempsey et al, (1993).

This essay tried to identify the various studies on the dividend puzzle. It is outlined in this essay that dividend payment by corporate organisations is influenced by various factors. Some of the factors discussed here include legal restraints, shareholders’ expectations, taxation and the cash-flow uncertainty effect. This essay established the fact that these factors play a very vital role in corporate managers’ decision to pay dividend.

On the relevance of the dividend policy, the discussion focused on the Miller and Modigliani’s hypothesis of 1961, which was supported by several other researchers like Miller and Scholes (1978), Jose and Stevens (1989). There were, however some criticisms to Miller and Modigliani’s hypothesis from other researchers like Sterk and Vandenberg (1990), Farrelly, Baker, and Edelman (1986), who believed that there exist some correlation between firm’s dividend policy and its share value.

Finally, the essay discussed the relevance of the clientele effect on dividend policy. The study by Elton and Gruber (1970) was discussed and various criticisms on their findings was also discussed. The essay identified the work of other researchers such as Kalay (1982) and Barclay (1987), who criticised Elton and Gruber (1970). It was however agreed by the researchers that the clientele effect has a relevant correlation on corporate dividend policy.
2.0 DIVIDEND POLICY

Dividend policy is the decision to pay dividend versus retaining funds to invest in the firm. In theory, if the firm reinvests capital now, it will grow and can pay higher dividend in future. Nobel economic laureates Miller and Modigliani empirically, in their 1961 studies, showed that dividend policy should not matter to the value of the firm. While financial theory is unequivocal on the irrelevance of dividend policy in perfect capital markets, there is widespread recognition that payout policy in practice is controversial and not well understood. In the presence of taxes and transaction costs, the payment of a dividend by the firm is regarded as something of a puzzle. Nonetheless, most firms pay dividends. Brealey and Myers (1991, p. 918) list dividend policy as one of their “10 unresolved problems in finance.” Brigham and Gapenski (1991, p. 549) describe it as “one of the most judgmental decisions that a manager must make,” and Van Horne (1989, p. 344) claims that the “lack of firm footing for predicting the long-run effect of a specific dividend policy on valuation makes the dividend decision more difficult in many ways than either the investment or financing decisions.”

Despite an inability by researchers to cast dividend policy in terms of a neat theoretical model, evidence from various sources suggests empirical regularities in dividend payouts. For example, Lintner's (1956) classic work finds that growth prospects of the industry and the firm, earnings of the firm, and cyclical variation of investment opportunities are important factors affecting firms’ dividend policies.

2.1 DIVIDENDS PAYMENTS

The payment of dividend is set by firm’s board of directors and announced at Annual General Meeting (AGM). The announcement of the dividend states that the payment will be made to all those stockholders who are registered on a particular record date. The company is not free to declare whatever dividend it chooses, because some restrictions may be imposed by some lenders, who are concerned that excessive dividend payments would not leave enough for the company to pay its debts. State
law also helps to protect the company’s creditors against excessive dividend payments. For example, companies are not allowed to pay dividend out of legal capital, which is generally defined as the par value of outstanding shares. Dividends are normally paid out of cash reserves but companies could also compensate shareholders by offering them more shares instead of cash dividend payouts. While some corporate managers decide the amount of dividend payout for an accounting period, others prefer some form of target payout ratios to determine the amount payable to shareholders. According to Brealey & Myers (2003) some corporate managers, especially those of growth companies do not pay dividend at all.

In their studies of corporate industries in the United State, Baker and Powell (1999) stated that researchers have developed many different models for explaining dividend behaviour. In Lintner’s (1956) classic study, managers perceived that shareholders were entitled to a fair share of the firm’s earnings through dividends. Although managers advocated a long-range target payout ratio, they believed that shareholders preferred a steady increase of dividends. Managers sought to avoid making changes in their dividend rates that might have to be reversed within a year or so. Therefore, they tended to make partial adjustments toward a target payout ratio rather than dramatic changes (ibid). This behavioural model suggests that the change in dividends is a function of the target dividend payout less the last period’s dividend payout multiplied by the speed of an adjustment factor. The target dividend payout is a fraction of the current period's earnings (ibid).

Other studies such as one by Jose and Stevens (1989) have confirmed the dividend policy beliefs of managers, as described by Lintner. Based on an extensive empirical analysis of changes in dividends, Benartzi, Michaely, and Thaler (1997, p. 1032) concluded that “...Lintner’s model of dividends remains the best description of the dividend setting process available.”
2.2.0 FACTORS AFFECTING DIVIDEND POLICY

There are so many factors that affect companies’ dividend policies. Among these factors are legal restraints, expectations or reaction of shareholders, taxation and cash-flow uncertainty.

2.2.1 LEGAL RESTRAINTS

In the UK, the Companies Act 1985 provides that companies may only make distributions by way of dividends or share buy-backs out of profits available for the purpose. For a private company, distributable reserves are accumulated realised profits not previously utilised by distribution or capitalisation less accumulated realised losses so far as not previously written off. For a public company, distributable reserves are anything other than share capital, share premium, capital redemption reserve and any excess of unrealised profits over unrealised losses, French (2003).

In the United State, for example, a unique characteristic of all Real Estate Investment Trusts is their exemption from federal income tax on net income, provided that they satisfy certain IRS requirements. The primary requirement is that they limit their investments to the purchase, sale and maintenance of real estate properties. The second important restriction is that they pay out at least 95% of their net income in the form of a dividend, Allen (2004).

2.2.2 SHAREHOLDERS EXPECTATIONS

Various studies hypothesised that shareholders prefer stability and predictability above rapid change in dividends payments. Marsh and Merton (1987) stated that most companies do actually provide shareholders with stable and predictable dividends and since this is what some shareholders have been led to re-assess the value of their shares. According to them, most shareholders view dividends as solid evidence of performance and in the absence of information to the contrary will expect performance to continue along recent lines, but at least reflecting general economic trends.
Lintner’s seminal work on dividend payout practices (1956) finds that managers believe that shareholders prefer stable dividends and that the market puts a premium on such stability. According to Lintner (1956), firms in target payout ratios reflect judgments based on factors such as prospects for growth of the industry and the individual firm, cyclical movements of investment opportunities, and earnings prospects for the firm. Myers (1984) described managers’ pecking order preferences for internal financing to include a link between dividend payout and factors such as investment opportunities and fluctuations in firm profitability.

2.2.3 TAXATION

Tax is a major reason why shareholders may be regarded as belonging to a clientele. A common feature of tax regimes is that for a typical shareholder, capital gains are more lightly taxed than dividends, creating what might seem to be an incentive for firms to reduce dividend payments and finance more of their new investments internally, Dempsey et al (1993).

The relationship between dividends and taxes is one subject of much study and debate in the financial economics literature, Brealey and Myers (1991). Campbell and Beranek (1955) observed that because the ex-dividend day share price decline is less than the amount of the dividend on average, tax-induced dividend clienteles may exist. Elton and Gruber (1970) use dividends and price changes on ex-dividend days to document the tax clientele effect more rigorously, as well as to compute marginal tax rates. They find that as the dividend yield increases, the ex-dividend day price drop increases relative to the dividend.

Miller and Scholes (1978) argued that the Elton and Gruber analysis does not take into account such factors as short-term trading activity and the impact of tax-exempt investors, such as pension funds. They suggest that the positive relationship between dividend yield and ex-dividend day relative price changes can be explained and demonstrate that individual investors need not pay more than the capital gains tax rate on cash dividend receipts.
Other researchers have attempted to replicate Elton and Gruber's findings with mixed results. For example, Kalay (1982) removes two potential biases from the Elton and Gruber methodology and obtains a similar outcome. Barclay (1987) examines the ex-dividend behaviour of U.S. shares before and following the implementation of the U.S. federal income tax in 1913. According to Barclay (1987), using a variation of the Elton and Gruber methodology, was one of the tools which led his findings to generally support the tax clientele hypothesis.

2.2.4 CASH-FLOW UNCERTAINTY

In their recent studies of cash-flow effect on dividend pay out, Bradley, M et al (1998), examined the link between cash-flow volatility and dividend payout and provided a novel method for distinguishing between the agency-cost and signalling theories of dividends. According to the agency-cost hypothesis, dividend payouts serve to reduce agency costs, (ibid). By distributing free cash flows in the form of a dividend, management can divert fewer funds to projects that are in their best interests, but not necessarily in the interests of their shareholders. Firms with high cash-flow volatility are also those with the greatest potential agency costs (ibid).

Bradley et al also postulated that, when cash flows are variable, it is difficult for investors to accurately attribute deviations in cash flows to the actions of corporate managers or to factors beyond management’s control. Thus, the higher the expected variance in cash flows, the greater the potential agency costs, and the greater the reliance on dividend distributions. The value of dividend payout as a guarantee against non-value-maximizing investments should be greatest for those firms with the greatest cash-flow uncertainty. Therefore, the agency-cost theory predicts that firms with volatile cash flows will, on average, pay out a greater proportion of their cash flows in the form of a dividend (ibid).

In contrast, Bradley et al also found that the information-content or signalling hypothesis predicts a relation of the opposite sign. They said, “in a signalling equilibrium where there is a discrete stock price or shareholder wealth penalty associated with cutting dividends, entrepreneurs and managers have incentives to
avoid these penalties. One way to do so is to choose a dividend policy where announced dividends are less than expected income, which allows managers to maintain dividends even if subsequent cash flows are lower than anticipated. This leads to the prediction that when future cash flows are more volatile, dividend payout ratios will be lower” (ibid).

3.0 DIVIDEND POLICY RELEVANCY

According to Dempsey et al (1993), various studies suggest that the question of whether dividend policy affects the value of the firm has puzzled researchers and corporate managers for many years. Some empirical studies such as Black and Scholes (1974), Miller and Scholes (1978), Jose and Stevens (1989) appear to support Miller and Modigliani’s (1961) classic dividend irrelevance proposition. However, other researchers like Long (1978), Sterk and Vandenberg (1990) objected to this view. Interestingly, however, a survey research by Farrelly, Baker, and Edelman (1986) shows that corporate managers typically believe that dividend policy affects a firm’s value and that an optimal level of dividend payout exists. Thus, empirical evidence on whether dividend policy affects a firm’s value offers contradictory advice to corporate managers.

3.1.0 EXPLANATIONS OF DIVIDEND RELEVANCE

Given that managers typically believe in dividend relevance, the second question is “What explanations of dividends do managers tend to favour?” Researchers have offered four common explanations of dividend relevance: the bird-in-the-hand, signalling, tax preference, and agency explanations.

3.1.1 THE BIRD-IN-THE-HAND EXPLANATION

One argument that a relationship exists between firm value and dividend payout is that dividends represent a sure thing relative to share price appreciation. Because dividends are supposedly less risky than capital gains, firms should set a high dividend payout ratio and offer a high dividend yield to maximize share price. Miller
and Modigliani (1961) disagree and call the theory that a high dividend payout ratio will maximize a firm’s value the bird-in-the-hand fallacy. Bhattacharya (1979) also argues that the reasoning underlying the bird-in-the-hand explanation for dividend relevance is fallacious. He argued that the riskiness of a project’s cash flows determines a firm’s risk. An increase in dividend payout today will result in an equivalent drop in the share’s ex-dividend price. Thus, increasing the dividend today will not increase a firm’s value by reducing the riskiness of future cash flows (ibid).

3.1.2 THE SIGNALLING EXPLANATION

Another possible reason for paying dividends is the use of dividend policy to communicate information about a firm’s future prospects to investors. Miller and Modigliani (1961) realize that in the real world a change in the market price often follows a change in the dividend rate. According to the information content of dividends or signalling explanation, cash dividends announcements convey valuable information about management’s assessment of a firm’s future profitability that other means cannot fully communicate. Lintner (1956). Information asymmetry suggests that corporate managers have an information advantage over outside investors. If managers have information that investors do not have, managers may use a change in dividend as a way to signal this private information and thus reduce information asymmetry (ibid). In turn, investors may use dividend announcements as information to assess a firm’s share price. On balance, much empirical evidence supports the view of dividend as a signalling device, John and William (1985).

Although managers can use dividend actions to convey useful information, dividend changes may not be perfect signals. According to Easterbrook (1984), dividend increases may be ambiguous signals unless the market can distinguish between growing firms and disinvesting firms, i.e., those with a lack of investment opportunities. For example, Soter, Brigham, and Evanson (1996) noted that FPL Group, the parent company of Florida Power & Light Company in the USA, announced a 32 percent reduction in its quarterly dividend on May 9, 1994 for strategic reasons, not problems in cash flow. The stock market’s initial reaction to FPL’s announcement was negative, with an initial drop of about 20 percent in value. After carefully reviewing the reasons for the reduction, analysts concluded that the
action was not a signal of financial distress. Instead, the dividend decrease was a strategic decision designed by management to improve the firm’s long-term financial flexibility and growth prospects. After the financial community adopted this view, FPL’s shares began to recover (ibid).

3.1.3 THE TAX-PREFERENCE EXPLANATION

Another explanation of why dividend policy matters involves the tax effect. According to the tax-preference theory, investors may favour retention of funds over the payment of dividends because of tax-related reasons. The favourable treatment of capital gains over dividends may lead investors to prefer a low dividend payout to a high payout. This theory suggests that firms should keep dividend payments low if they want to maximize share prices, Elton and Gruber (1970).

According to Elton and Gruber (1970), because the tax effect differs among various types of investors, investors may be attracted to firms that have dividend policies appropriate to their particular tax circumstances. Researchers call this notion the tax clientele effect. Other things being equal, shares with low payouts should attract investors in high tax brackets, leaving high payout shares to investors subject to low or zero tax rates, (ibid). The empirical evidence on the tax-preference explanation of dividends is inconclusive.

3.1.4 THE AGENCY EXPLANATION

Another popular view of dividend relevance, advanced by Jensen and Meckling (1976), and extended by Rozeff (1982), is agency theory. This theory derives from the conflict of interests between corporate managers (agents) and outside shareholders (principals). For example, management can consume excessive perquisites out of undistributed corporate earnings and invest the retained funds sub-optimally. This conflict leads to agency costs, Rozeff (1982). According to Jensen and Meckling (1976), the agency theory postulates that the dividend mechanism provides an incentive for managers to reduce the costs related to the principal/agent relationship. One way to reduce agency costs is to increase dividends. Paying larger dividends reduces the internal cash flow subject to management discretion and forces the firm to
seek more external financing (ibid). Raising costly-outside-capital subjects the firm to
the scrutiny of the capital market for new funds and reduces the possibility of sub-
optimal investment, (ibid). This monitoring by outside suppliers of capital also helps
to ensure that managers act in the best interest of outside shareholders. This implies
that dividend payments may serve as a means of monitoring or bonding management
performance.

Given a lower percentage of outsiders, less need exists to pay dividends to reduce
agency costs Rozeff (1982). Crutchley and Hansen (1989) and Moh’d, Perry, and
Rimbey (1995) concluded in their study that managers make financial tradeoffs such
as paying dividends to control agency costs.

3.2.0 INDUSTRY INFLUENCE ON DIVIDEND POLICY

In their research of some corporate managers in the USA recently, Baker and Powell
(1999) tested the following question: “Do the views of managers about dividend
issues differ among different industry groups?” They found out in their results that the
responses of the three groups of industries selected (utilities, manufacturing and
wholesale/retail trade) differ insignificantly. They suggested that a firm's industry
type has little influence on the views that managers have about theoretical and
empirical issues involving dividend policy. They therefore criticised the conclusion of
Farrelly, Baker and Edelman (1985) that the opinions of the respondents from utilities
differ markedly from those of the manufacturing and wholesale/retail trade industries.
They assert that due to regulator actions, the utility industry has become a riskier
place in which to operate and invest. Today, however, utilities find themselves
increasingly subject to competition.

According to Baker and Powell their respondents from the utilities show a higher
level of agreement on all four of the above explanation of dividend relevance than the
respondents from the other two industry groups. They however suggested that the
results may be due to industry characteristics rather than regulation. In their opinion,
though the utilities have higher payouts than the other two industries (manufacturing
and wholesale/retail trade), such differences are not surprising. They concluded that
managers of utilities are sensitive to how an unexpected change in dividend policy may affect a firm’s share price and shareholder value. In addition, most utility respondents strongly agree that a firm should adequately disclose to investors its reasons for changing dividend policy (ibid). This finding, according to them, is not surprising considering the market reaction to the dividend cut of Florida Power & Light Company reported by Soter, Brigham, and Evanson (1996). Finally they said, “the high level of agreement among utility managers that investors prefer certain, current dividends to possibly higher but riskier future dividends may reflect the characteristics of utilities including investor clienteles” Baker and Powell (1999).

4.0 THE CLIENTELE EFFECT.

As stated above, tax is another major effect on corporate dividend policy. A common feature of tax regimes is that for a typical shareholder, capital gains are more lightly taxed than dividends, creating what might seem to be an incentive for firms to reduce dividend payments and finance more of their new investments internally.

Several studies examine the impact of dividend taxation on equity by examining the fall in share prices on the ex-dividend day. Elton and Gruber (1970) examined the ex-dividend day share price drop in the first empirical test of the clientele effect. In their study, they presented and tested a method of determining marginal shareholder tax brackets and examine the implications of these findings on dividend policy. Elton and Gruber show, under certain assumptions, that the statistic (PBPA)/D (where PB is the price on the day before the share goes ex-dividend, PA is the price of the share on the ex-dividend day, and D is the amount of the dividend) represents a plausible way to estimate the marginal tax rate for the average investor. In order to test for the presence of a dividend clientele effect, the relationship between measures of the firm's dividend policy (yield and payout ratio) and the implied shareholder tax bracket was examined (ibid). Their results indicated that the idea of a dividend clientele appears consistent with the evidence.
Kalay (1982) criticized the Elton and Gruber approach of examining the ex-dividend day price drop as a means of testing for a clientele effect. Kalay (1982) demonstrated that, without additional information, marginal tax rates cannot be inferred from the ratio of the ex-dividend day price to the dividend per share. Thus, the positive correlation of this ratio and the dividend yield may not be the result of a tax-induced clientele. Kalay (1982) argues that the Elton and Gruber approach contains two potential biases. First, the positive relationship between the ratio \((PB-PA)/D\) and the dividend yield of a particular security may be spurious. The positive relationship may be the result of not fully adjusting for the normal daily movement of equity prices and the use of closing prices on the ex-dividend day. Secondly, Kalay argued that because the relative ex-dividend day price drops are not likely to be independent, it is difficult to assess the statistical significance of this measured correlation. After adjusting for these potential biases, however, Kalay finds that, on average, investors pay higher taxes on dividend income than capital gains, Asquith and Mullis (1986).

Barclay (1987) explores the question of tax effect hypothesis by examining the ex-dividend day behaviour of common equity prices before the enactment of the federal income tax law in the USA. A sample of 762 ex-dividend dates for 146 NYSE firms was drawn from the period 1900-1910. After adjusting for the problems in the Elton and Gruber analysis documented above, Barclay finds that common equity prices fall, on average, by the full amount of the dividend on the ex-dividend day. According to Barclay, this evidence suggests that in the pre-income tax period investors valued dividends and capital gains as perfect substitutes. Furthermore, since the enactment of the federal income tax law, investors have discounted the value of taxable dividends relative to capital gains.

Taking a different track, Pettit (1977) examines the portfolio positions and demographic data of 914 individual investors to test for the clientele effect. Unlike previous studies, he explicitly accounts for both transactions costs and differential tax rates. The results are consistent with a significant dividend clientele effect in that a large portion of the cross-sectional variation in individual portfolio dividend yields can be explained by the systematic risk of the individual portfolio, the age of the individual, the gross family income averaged over the sample period, and the difference between the average marginal dividend tax rate and average marginal
capital gains tax rate (ibid). Furthermore, Pettit (1977) suggested that investor portfolio decisions are affected by transactions costs and differential tax rates only at the margin.

On the other hand, Lewellen, Stanley, Lease, and Schlarbaum (1978) examined a sample drawn from the same database as the Pettit (1977) study, but reach different conclusions. Lewellen et al. (1978) run a multiple regression to explain dividend yields on investor portfolios as a function of various investor characteristics. Although the tax rate variable is related negatively to the dividend yield with a statistically significant coefficient, the results indicate that a 10 percent increase in an investor's marginal tax bracket is associated with only a 0.1 percent decline in the yield of securities held (ibid). This suggests only a very weak clientele effect.

Finally, Blume (1980) presents evidence that is inconsistent with dividend clienteles. In particular, his results indicate that the before-tax returns on stocks with above (below) average anticipated dividend yields are higher (lower), on average, than the before-tax returns on non-dividend paying stocks of equivalent risk. According to Blume, in an environment where dividends are taxed at higher rates than capital gains, one would expect a positive linear relationship between before-tax expected returns and expected dividend yields for a given level of systematic risk. Blume suggested that certain individuals may prefer increases in dividends and decreases in retained earnings to decreases in dividends and increases in retained earnings in spite of the tax consequences. Black (1986) has argued that investors may care directly about dividends and that the solution to the dividend puzzle is to put dividends directly into the utility function. Overall, some methodologies applied to different data sets have found empirical evidence consistent with a dividend clientele effect (ibid).

5.0 CONCLUSION

Dividend policy might have an impact on the financing decisions of a firm. Not only because dividend paid could mean less cash for investment but also because dividend paid affects shareholders’ value in various ways. The decision of corporate managers to pay dividend to shareholders is influenced by many factors as outlined above.
Several studies concluded that, of the four explanations for dividend relevance, most managers generally had the highest level of agreement with statements involving signalling. Though some corporate managers are most uncertain about the tax-preference and bird-in-the-hand explanations of dividend relevance, they remain very important reasons of firm’s dividend policies. Finally, various studies concluded that managers’ views on setting dividend payments today are consistent with those reported by managers interviewed by Lintner (1956). It is also evident that the clientele effects have some positive correlation on firms’ dividend policies.
APPENDIX II: REFERENCES


