Dividend Policy – its importance in the investment process

By Michael Kemp

In 1938 John Burr Williams put his name on the investment map with the release of his classic book, "The Theory of Investment Value". Whilst not the first to conceptualise it Williams stated that share value is determined by the discounted value of anticipated future dividends. If true then why do we often see high valuations placed on low or non-dividend paying companies?

And if value is determined by dividends why has Warren Buffett, the CEO of Berkshire Hathaway, delivered only one dividend to shareholders during his 46-year stewardship of the American company? And this a period that has seen Berkshire's share price increase 6,000-fold. Alternatively why has the share price of Telstra, one of our best dividend-paying companies, fallen by 70% over the last 12 years?

Clearly there should be more to the sophisticated stock picker's armamentarium than simply chasing dividend yield. Some of the unappreciated issues surrounding dividend policy and its impact on wealth creation will be discussed in this article.

Where do returns come from?

In order to resolve the dividend conundrum let's start by considering the factors which contribute to total stock returns. Most investors would appreciate that total returns are delivered from 2 sources - dividends and capital gains. But there are interplays between the two that need to be understood in order to make better investment decisions.

Companies typically pay dividends as a partial distribution of company profits. Retained earnings are reflected in the Statement of Financial Position as an increase in shareholders' equity. Hence a lower payout ratio delivers a larger pool of capital for management to invest. If they put this new capital to good use then larger profits will be generated in the future leading to the potential to deliver larger future dividends. This sounds great in theory.

But empirical studies have demonstrated that enhanced profit retention doesn't automatically lead to greater profits and dividends down the track.

By way of demonstration Arnott & Asness (Financial Analyst's Journal 59:1, 2003) observed a positive linear relationship between higher payout ratios and higher subsequent 10 year real earnings. A later study by Zhou & Ruland (Financial Analyst's Journal 62, 2006) came to a similar conclusion.

For higher earnings growth to follow higher rates of payout would seem to be counterintuitive. What might be going on?

Theory versus reality

The reality is that dividend policy is more commonly an instrument of wealth distribution than it is an instrument of wealth creation. This subtlety escapes most investors. And because dividend policy has the potential to be influenced by a number of conflicting factors the purist's claim that it should be undertaken in order to "maximize shareholder wealth" often gets pushed into the background. Consider the following:

1. Managements can at times be accused of "Empire Building" at the expense of the shareholders' best interests. Earnings are retained rather than distributed so that a war chest of capital is accumulated for the purpose of targeting potential acquisitions. Ben Graham referred to this as "Personal aggrandizement". But if acquisitions are made at excessive prices the resultant low returns on capital will see destruction of shareholder wealth.

2. Also influencing dividend policy is managements' aversion to reducing the dividend when profits are lower. Their fear is that a dividend reduction would send out a negative signal to the market in relation to the company's recent performance and future prospects. Therefore, in order to keep the dividend steady, there is a tendency to increase the payout ratio when profit is down. This typically happens at low points in the economic cycle. And as the economy recovers so too do company profits. Under this scenario profit growth follows a period when there has been a high payout, not low.

3. If management cannot invest retained earnings at a rate of return superior to what shareholders could likely achieve themselves then a full distribution of profits is in the shareholders' best interests. Thus a company paying a high dividend might not be indicative of a successful enterprise. Rather it might reflect a management faced with no suitable options for the investment of new capital.

4. There are times when it is in the shareholders' best interests for no dividend to be paid. If management has the capacity to invest new capital at rates of return higher than the investor's required rate of return then wealth will be created by retaining profits within the company. This is the principal reason why Buffett has chosen for Berkshire not to pay a dividend.

5. The potential for further distortion of dividend policy lies in the use of options as a form of management compensation. If management hold call options and/or have their compensation linked to an increase in the company's share price there will be an incentive for them to retain earnings rather than pay them out as dividends. This might run counter to the best interests of shareholders particularly if the retained profits are invested at low rates of return.

6. Net Profit after Tax, as reported in the financial accounts, is often not a true reflection of what shareholders earn over an accounting period. Despite this it is broadly used in both

valuation formulae and value-based ratio analysis. Indeed most valuation articles and texts actively promote it as the figure to use. But a more appropriate measure of profit is that which remains after deducting the expenditures necessary to maintain the company's competitive position and its economic output. The accounts don't provide this figure hence the investor or analyst needs to calculate it. By way of example consider depreciation expense. Rather than reflecting the capital expenditure necessary to maintain the company's economic and competitive integrity it is a figure defined by accounting principles. The depreciation expense is calculated by applying a defined depreciation rate to capital equipment which is recorded at historical cost. This will usually understate the cost of its replacement hence accounting profit will overstate the real profit due to the owners. In an extreme example a company could be going backwards in an economic sense yet still report an accounting profit. To this end don't consider a dividend in terms of the reported net profit after tax. Rather consider it in terms of what the company can afford to pay whilst maintaining its economic and competitive integrity.

Tax considerations

Fortunately the impost of double taxation on company earnings was removed in 1987 by the Hawke/Keating government. Dividend imputation is not enjoyed universally and this is one of the reasons why lower payout rates are observed in a number of other countries.

Australian retirees enjoy 2 additional benefits – both the reimbursement of tax paid at the company level and the exemption of Capital Gains Tax. It is interesting then to hear many retirees voice their preference for dividends as a source of income. But since neither earnings nor capital gains are taxed in their hands retirees should be indifferent, from a tax perspective, as to which they receive. If profits are retained and reinvested by a management capable of achieving high incremental rates of return on equity then the returns from capital gain potentially outweigh those from dividend distribution.

Countering this argument is that of market volatility. Retirees are loath to sell shares when equity markets are depressed. This might explain their preference for dividends as a source of income. But as long as a significant buffer of cash is maintained their preference for dividend income should be reduced since they now have greater discretion in the timing of sales.

Spotting high-yield companies

Selecting a portfolio of shares based on dividend yield alone has been shown to be a useful "Scatter gun" approach to investing. One investment technique that uses this approach is "The Dogs of the Dow" (see ASX Update February 2011). These broad dividend strategies work because stock returns are based not on earnings growth alone but on growth relative to expectations. Investor pessimism results in a low market valuation which in turn results in a higher dividend yield. Thus investors are offered the potential for an enhanced capital gain as well as a high dividend payment during the time they hold the shares. But the sophisticated stock picker should look beyond a selection process based solely on dividend yield. And in the search for companies capable of delivering a strong, reliable and growing dividend look for companies which demonstrate:

- Strong underlying business fundamentals
- Low debt and good business prospects
- Control over the price of the products and services they provide
- A history of double digit earnings per share growth
- Consistently high returns on equity (>15%)
- A dividend policy that is consistent with the company's underlying earnings
- Growing book value

And avoid companies which
- Borrow to pay dividends
- Have large and ongoing requirements for new capital simply to maintain their economic viability

And remember there are many excellent companies which don't pay high dividends. But just make sure that management continues to invest retained earnings at high incremental rates of return.

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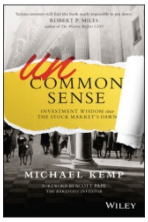

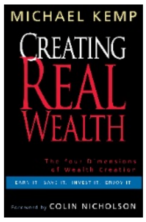

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Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.

