The Importance of Dividends: "The More, the Better"

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When valuing a company it is according to conventional Finance Theory indifferent whether earnings are retained or paid out as dividends to shareholders – in fact many analysts or investment advisors would argue that a company will do better to retain most of its earnings to pursue profitable opportunities, hence it should have a relative higher valuation than a similar company which follows a more generous dividend-payout approach.

In this article this mode of thinking is critically analysed with specific reference to some research that investigated this notion. It is suggested that more weight in your investment portfolio should be giving to companies that follow a more generous dividend-payout approach rather than those companies that have high earnings-retention ratios.

Let us start at the beginning – for the *long-term* investor a share price of a company should represent the present value of all future dividend flows, in other words a reasonable assessment of the expected dividend growth implicitly must be made. One could argue that if a company retain most of its earnings to re-invest into profitable ventures that the expected future stream of dividends payable by this company is actually enhanced, and thus will benefit its shareholders in the long run.

No problem with this argument, except that mere intentions are not good enough, what will actually transpire is the ultimate acid-test. Unfortunately, not all projects are going to be profitable, nor is management always the best servant of shareholders' interest (more than enough examples exist in the history of corporate business where nothing more than empire-building transpired), and simply it is much more

"comfortable" to invest in projects when cash is at hand than to go to the market for additional capital with all the public scrutiny attached thereto.

Given that a share price today reflects the best estimate of the present value of all future cash flows (dividends) that a shareholder will receive, is it theoretically possible to calculate the expected return from this investment (the so-called Gordon dividend growth model):

Expected Return	=	Dividend yield + growth factor
R	=	(D/P) + g

Where,

Dividend yield	=	Dividend-payout ratio x Earnings yield
(D/P)	=	(D/E) (E/P)

Thus, in essence there are three components in determining the expected return, the dividend-payout ratio (inverse of the earnings-retention ratio), earnings yield (inverse of the price/earnings ratio) and the dividend growth ratio. A low dividend-payout ratio must be offset by a high earnings yield (low P/E) otherwise if both these components are low; it is left to the third component (dividend growth) to justify a high expected return.

For example, let us assume the following:

The earnings of company ABC is reported to be R5 per share, the current share price is R100, therefore the share is trading at a Price/Earnings (P/E) multiple of 20. The earnings yield (E/P) is the inverse of the Price/Earnings (P/E), therefore it is 5. The earnings-retention ratio is 80%, thus only 20% of the earnings are paid out to shareholders as dividends (R1 per share).

The dividend yield in the above example is 1% (1/100). The expected return from this share is thus basically reliant on the growth in dividends (and earnings). Say the expected return is 15% per annum, thus one will have to assume that dividends will

grow by 14% per annum in future. Thus, by retaining 80% of the earnings ABC Company will be able to continuously identify profitable investment opportunities.

The above is not impossible for a single company, yet to extrapolate that idea to the whole market is a bit rich. Yet, in general the perception exists that there is a negative relationship between the dividend-payout ratio and future earnings growth. In other words, a low payout ratio should be a good predictor of future earnings growth.

However there is one big problem using this valuation model – at the heart thereof perfect market conditions are assumed, such as that all information is public knowledge (no private information) (!), managers act in the best interest of shareholders (!), and that all investors act rationally (!). When these perfect market conditions are relaxed different results may come to the fore than otherwise predicted by the model. Some research studies have specifically investigated whether these relationships are valid and the main findings thereof are briefly summarised hereunder.

Campbell and Shiller (1998) found no evidence that future earning growth rates are related to dividend yields or P/E multiples. Their finding was that growth rates are relative stable over time, while dividend yields and P/E multiples are better in predicting the returns that investors will realise in the future. Further, they identified that P/E ratios have shown a strong tendency to revert to its long-term mean (about 15) over time. [Alan Greenspan made his famous "irrational exuberance" speech based on this work].

Another couple of researchers, Robert Arnott and Clifford Asness (2003) conclusively showed by analysing US data from 1871-2001 (amazing the kind of data that they have!) that the opposite trend, namely that higher dividend yields generally lead to higher long-term earnings growth, holds and <u>not</u> the conventional theory of low dividend yields and eventual high earnings growth. Further, they found that P/E multiples exhibit some predictive capabilities, in other words high P/E ratios (low earnings yield) forecast to a certain extent higher earnings growth in the future, but the P/E ratio as a predictive tool is totally overshadowed by the dividend-payout ratio.

Arnott & Asness (2003) proposed various explanations to this phenomenon. Firstly, dividends are "sticky" – meaning that the management of a company will unlikely drop dividend-payouts and will try to maintain the dividend policy, even if earnings drop, except perhaps in case of a severe recession.

Secondly, managers that follow a policy of generous dividend payouts are probably more conservative in pursuing new investments. Simply because less cash is at hand and additional capital will have to be acquired from the market, which in itself will bring about a re-evaluation on the viability of the proposed venture. Thus, a smaller chance for management to build corporate empires with no real value or meaning for shareholders.

Thirdly, the powerful effect of which some are considering the "gravity force" - better known as "reversion to the mean" - for example, a company might experience low earnings now, but by maintaining the dividend policy ("sticky dividends") it will offer a high dividend-payout ratio. A couple of years later by restructuring the business model or better economic conditions that same company will experience higher earnings.

Synopsis:

If one carefully thinks about these results it is perhaps not that surprising, especially if you tend to believe in the influential power of reversion to the mean. Surely if you invest in the market when dividend yields are relatively high (and P/E ratios are suppressed), you ought to make a little fortune somewhere in the future – just think back where our markets have been a year or two ago and where it is today! And so this pattern continues throughout history, all over the world. Even if one recognises these golden investment opportunities one big stumbling block remains - which is none other than you!

If you cannot get passed the psychological barriers imposed by yourself to continue investing in the hardship times of doom and gloom you are bound to miss out on the subsequent periods of strong recovery. Why? – Firstly, nobody knows when the market will recover and secondly, 80% of the gains will happen in 20% of the time.

Thus, a very strong recovery will in all probability happen in a short space of time and if you are out of the market by then you will in all likelihood miss most of the gains.

Back to our topic – these findings have some implications for corporate management and how we judged them. Where does the practice of share options fit in? – It is very unlikely that a company will like to follow a high payout ratio since the share price is likely to drop with an amount equivalent to the dividends declared, and thus making share options less attractive for management. What about share buy-back programs? – It is dividends paid in another form with the purpose of increasing the earnings per share. A share buy-back substitutes a dividend payout, thus one must effectively take these buy-backs into consideration before concluding that the dividend-payout of a firm is too low to make it a long-term buy.

For now do not be fooled by promises of great return by companies that are considered to be "growth-orientated" and therefore not keen to distribute dividends. I shall invest <u>predominantly</u> with the established "big guns" with a known dividend policy (generous dividend-payout ratios) and which exhibit good corporate governance practises. If you cannot buy these shares yourself, buy a large cap index fund which automatically gives you that exposure.

Bibliography

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