Introduction to Dividends

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WHAT'S COVERED

In this lesson, you will learn about key terms associated with shareholder dividends. Specifically, this lesson will cover:

1. Defining Dividends

Dividends are payments disbursed to shareholder members of a corporation on a regular basis, typically quarterly. These payments represent the shareholder's part of a company's profits. A dividend is designated as a fixed or set amount per share, which means that each shareholder receives a dividend proportional to their shareholding; owning more shares results in greater dividends for the shareholder.

When it is time to make dividend payments, corporations always pay preferred stock owners first, and then common stock dividends are allocated after all preferred dividends are paid in full. In the United States, dividends are usually declared quarterly by the corporation's board of directors.

Dividends per share (DPS) refers to the dollar amount shareholders earn for each share, calculated by dividing the total dividend amount by the total number of shares outstanding. **Dividend yield** refers to the ratio between dividends per share and the market price of each share, and it is expressed in terms of percentage.

Payout ratio is calculated by dividing the company's dividend by the earnings per share. A payout ratio greater than 1 means the company is paying out more in dividends for the year than it earned, while a low payout ratio indicates that the company is retaining a greater proportion of their earnings instead of paying out dividends. These ratios have historically been used as indicators of a stock's investment strength and the company's overall performance.

TERMS TO KNOW

Dividend
A pro rata payment of money by a company to its shareholders, usually made periodically (e.g., quarterly or annually).

Dividends Per Share (DPS)
The amount shareholders earn per share.

Dividend Yield
A company's total annual dividend payment per share, divided by its price per share.

1a. Types

Dividends may be assigned in various forms of payment.

Types of Dividends	Description
Cash dividends	This type of dividend is the most common and is disbursed as currency, by way of an electronic funds transfer or physical check. For each share owned, a specific determined amount of money is distributed. For instance, if an individual owns 1000 shares with a cash dividend value of $0.90 per share, the shareholder will receive a total amount of $900.
Stock dividends	Also known as scrips, this type of dividend is a payment in the form of additional stock shares of the company itself or one of its subsidiaries, as the name suggests. This may be a more palatable option for companies who would prefer to use their earnings towards the growth of the company, rather than diverting them into cash dividends for shareholders.
Property dividends	Also known as dividends in specie (Latin for "in kind"), this type of dividend is disbursed in the form of assets from the distributing corporation or one of its subsidiary corporations. This type of dividend is somewhat rare and can also be expressed as securities of other companies owned by the distributor, or products and services.

HINT

Companies may also offer reinvestment plans where shareholders can automatically reinvest dividends into more stock.

1b. Important Dates

There are six important dates to keep in mind regarding dividends for public companies:

- *Declaration date:* This is the day a company's board of directors announces that they intend to pay a dividend, thereby creating a liability which is recorded on the company's books. This means that they now owe money to the stockholders. They also declare a date of record and payment date (see below).
- *In-dividend date:* This date is the last day when the stock is considered "cum dividend," which means "with, or including, dividend." This means that those who already own the stock, and any others who buy it on this particular day, will receive the dividend, while any stockholders who choose to sell their stock forego their right to the dividend. After this date, which is one trading day before the ex-dividend date, the stock becomes ex-dividend, which will be covered next.
- *Ex-dividend date:* On this date, all shares that are purchased and sold are no longer guaranteed to be paid the most recently declared dividend. This date, which is generally two trading days prior to the record date for U.S. securities, has a pivotal importance for companies with a lot of stockholders, including those that trade on exchanges, because it streamlines the process of who is to be paid the dividend. Those who already own the stock will get the dividend, even if they opt to sell the stock now. On the other hand, anyone who buys the stock now will not. It is quite common for the price of a stock to fall on the ex-dividend date by the approximate amount of the dividend paid, reflecting the reduction in the company's assets due to the announcement of the impending dividend. Note, the company does not take overt action to alter its stock price; in the context of an efficient market, purchasers and sellers will automatically account for this.
- *Book closure date:* This is the date when a company, in an ideal scenario, temporarily closes its books for new stock transfers.
- *Record date:* By this date, shareholders must be registered on record in order to get the dividend; if they

are not, they will not get the dividend.

- *Payment date:* This represents the date on which dividends are actually either distributed to a company's shareholders or credited to brokerage accounts.

2. The Nature of Dividends

The nature of dividends may appeal to investors because they offer consistent returns on relatively low risk investments. While companies experiencing rapid growth are unlikely to offer dividends, established companies with stable business and less room to grow do pay dividends to shareholders. Despite the low earnings growth of these stocks, shareholders get the benefit of knowing that the value of their initial investment is likely to remain stable. They can still profit off a steady stream of dividend payments.

A firm's dividend decision may also serve as a signaling device which gives clues about a firm's future prospects. Due to **information asymmetry** between investors and the firm managers, investors will look to indicators like dividend decisions. Studies have shown that stock prices tend to increase when an increase in dividends is announced and tend to decrease when a decrease or omission is announced. Managers have more information than investors about the firm, and such information may inform their dividend decisions. When managers lack confidence in the firm's ability to generate cash flows in the future, they may keep dividends constant or possibly even reduce the amount of dividends paid out. Conversely, managers that have access to information that indicates very good future prospects for the firm are more likely to increase dividends.

Investors can use this knowledge about managers' behavior to determine their decision to buy or sell the firm's stock, bidding the price up in the case of a positive dividend surprise or selling it down when dividends do not meet expectations. This, in turn, may influence the dividend decision, as managers know that stockholders closely watch dividend announcements looking for good or bad news. Managers tend to avoid sending a negative signal to the market about the future prospects of their firm. This also tends to lead to a dividend policy of a steady, gradually increasing payment.

On the other hand, critics of dividends contend that company profits are best reinvested back into the company for research and development, capital expansion, and so forth. Their view is that an eagerness to return profits to shareholders may signal to investors that the management does not have ideas for the firm's future prospects.

TERM TO KNOW

Information Asymmetry

The study of decisions in transactions where one party has more or better information than the other.

3. Dividend Irrelevance Theory

Economists Modigliani and Miller put forth a theory that only the firm's ability to earn money and the riskiness of its activity can have an impact on the value of the company; the value of a firm is unaffected by how that firm is financed. It does not matter if the firm's capital is raised by issuing stock or selling debt, nor does it matter what the firm's dividend policy is. Dividend irrelevance follows from this capital structure irrelevance.

Modigliani-Miller grounded their theory on a set of assumptions:

- No time lag and transaction costs exist.
- Securities can be split into any parts (i.e., they are divisible).
- No taxes and flotation costs.
- Financial leverage does not affect the cost of capital.
- Both managers and investors have access to the same information.
- Firm's cost of equity is not affected in any way by distribution of income between dividend and retained earnings.
- Dividend policy has no impact on firm's capital budget

Under these frictionless perfect capital market assumptions, **dividend irrelevance** follows from the Modigliani-Miller theorem. Essentially, firms that pay more dividends offer less stock price appreciation that would benefit stock owners who could choose to profit from selling the stock. However, the total return from both dividends and **capital gains** to stockholders should be the same. If dividends are too small, a stockholder can simply choose to sell some portion of his stock. Therefore, if there are no tax advantages or disadvantages involved with these two options, stockholders would ultimately be indifferent between returns from dividends or returns from capital gains.

BIG IDEA

Since the publication of the papers by Modigliani and Miller, numerous studies have shown that it does not make any difference to the wealth of shareholders whether a company has a high dividend yield or if a company uses its earnings to reinvest in the company and achieves higher growth. However, the importance of a firm's dividend decision is still contested, with a number of theories arguing for dividend relevance.

TERMS TO KNOW

Dividend Irrelevance

Theory that a firm's dividend policy is not relevant because stockholders are ultimately indifferent between receiving returns from dividends or capital gain.

Capital Gains

Profit that results from a disposition of a capital asset, such as stock, bond, or real estate due to arbitrage.

4. Value of a Low Dividend

The value of a dividend is expressed as some percentage proportion of the number of shares held. A relatively low payout could mean that the company is retaining more earnings toward developing the firm instead of paying stockholders. Some investors would prefer this low payout because it hints at future growth. Furthermore, retained earnings lead to long-term capital gains, which have taxation advantages over high dividend payouts, according to the Taxation Preference Theory. Taxes on capital gains are deferred into the future when the stock is actually sold, as opposed to immediately like cash dividends. Furthermore, capital gains are taxed at lower rates than dividends. Therefore, taxation benefit is another point in favor of low dividend payouts.

However, under dividend irrelevance theory, the actual value of a dividend is inconsequential to investors. If the dividend is too low, they can simply sell off part of their portfolio to generate more income for themselves. The conflicting theories on dividend policy complicate interpretations of low dividends in real life.

Dividend value must also be considered in relation to other measures of the firm, such as their earnings and stock price. If a stock has a low dividend yield, this implies that the stock's market price is considerably higher than the dividend payments a shareholder gets from owning the stock. There are a number of ways to interpret this ratio. A history of low or falling yields may indicate that the firm's cash situation is not stable. They cannot afford to give higher dividends because they do lack cash on hand. This instability can be seen in calculating the dividend cover, which is calculated as DC = EPS/DPS.

BIG IDEA

A ratio of 2 or higher is considered safe – in the sense that the company can well afford the dividend – but anything below 1.5 is risky. If the ratio is under 1, the company is using its retained earnings from a previous year to pay this year's dividend, which signals the risk of instability and poor performance of the firm. Signs of risk will deter investors, particularly if they are looking for cash dividends as a steady source of income.

Conversely, a low dividend yield can be considered evidence that the firm is experiencing rapid growth or that future dividends might be higher. Investors who prefer a "growth investment" strategy may prefer a stock with low to no dividend yields, as that is one of several indicators for a firm experiencing quick growth.

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5. Value of a High Dividend

Generally speaking, a high yield stock is one with a dividend yield greater than the yield of any benchmark average like the 10-year U.S. Treasury note. However, since there is no set standard for determining if a dividend's yield is high or low, a high yield stock's classification is contingent upon the particular benchmarks used by any given analyst.

EXAMPLE Some may deem a 2% yield to be high for a dividend, while others regard this as low.

A high dividend yield hints at undervaluation of the stock, because the dividend is high compared to the price of the stock, making this one that tends to be pursued by income and value investors. These high yield stocks are apt to perform better than low yield or no yield stocks in bear markets, as a lot of investors believe stocks that pay dividends pose less risk.

Generally speaking, most firms that pay out high dividends are quite mature, profitable, and stable. They pay out high dividends simply because they have too much cash flow and few positive net present value investment possibilities.

But not all firms offering high dividend yields are steady, reliable investments. Perhaps the greatest risk in high dividend securities is a falling stock price, which means that the high yield is due to the decline of the firm. If a company is not earning enough profit to cover their dividend payments, the current dividend is unsustainable. In this case, a falling stock price indicates investor fears of a dividend cut. Therefore, if an investor buys these risky high dividend stocks and the dividend is decreased because the company is suffering losses, the investor will have the problem of both less dividend income and a portfolio of stocks with declining values. There may be investors, such as retirees, who prefer current income from high dividends to low dividends and growth in stock value. Theories may say this should not matter since investors could sell a portion of the low dividend paying stocks to supplement cash flow, but in the real world, markets are not frictionless. The sale of securities involves transaction costs that may outweigh any benefits of the sale.

Therefore, some individuals are better off holding high dividend stock.

IN CONTEXT

The Dogs of the Dow strategy is a well known and rather extreme strategy that incorporates high dividend yields. The strategy dictates that the investor compile a list of the 10 highest dividend yielding stocks from the Dow Jones Industrial Average and buy an equal position in all 10 at the beginning of each year. At the end of each year, the investor finds the 10 highest dividend yield stocks again, and reallocates their positions so as to have an equal position in all 10 Dogs of the Dow. The Dogs of the Dow made a compounded annual return of 18% from 1975 to 1999, outperforming the market by 3%. This would make $10,000 turn into $625,000 in 25 years.

Advocates of the Dogs of the Dow strategy contend that blue chip companies do not adjust their dividend based upon trading conditions. Thus, the dividend is a barometer of the company's average worth. Conversely, the stock price vacillates throughout the business cycle. This should translate to a scenario whereby corporations with a high yield, meaning high dividend relative to stock price, are close to the bottom of their business cycles and are expected to witness an increase in their stock price that occurs more rapidly than low yield companies.

Utilizing this model, an investor who reinvests in high yield companies every year should exceed the overall market. The logical assumptions behind this theory are that a high dividend yield implies the stock is oversold and that management feels confident about the company's prospects - enough to back it up by an outlay of relatively high dividends. In this case, investors expect to profit from above average stock gains and comparably high quarterly dividends.

Of course, several assumptions are made in this argument. The first assumption is that the dividend price reflects the company size rather than the company business model. The second is that companies have a natural, repeating cycle in which good performances are predicted by bad ones.

SUMMARY

In this lesson, you learned about when and how companies issue dividends to their shareholders and what dividends may signal to investors. **Dividends are defined** as disbursements made to shareholders on a regular basis. You learned that there are several **types** of dividends, including cash, stock, and property dividends, and you learned about **important dates** in the process of declaring, recording, and paying dividends.

The **nature of dividends** is such that they help to bridge the information gap between investors and managers; therefore, decisions about whether to issue dividends or reinvest earnings can affect stock price and demand. Conversely, some theorists argue for the **dividend irrelevance theory**, which argues that stockholders are ultimately indifferent between receiving returns from dividends or capital gain. Finally, you learned about the **value of a low dividend** and the **value of a high dividend**, information that investors can use to pursue different investment strategies and goals.

Best of luck in your learning!

TERMS TO KNOW

Capital Gains
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