Dividends, Risk And Return

Just because two giants of finance, Franco Modigliani and Merton Miller, won Nobel Memorial prizes in economics for their 1950s work demonstrating the value of a firm to investors should be, adjusted for taxes, independent of the dividend payout rate and the debt-to-equity ratio, does not mean everyone buys the idea. Far from it: Just watch what happens to a stock when it announces an unexpected increase or decrease in its dividend or, for that matter, when the firm takes on excessive debt for whatever reason. You will find out in all cases just how exciting "indifference" can be.

All of this makes various pronouncements investors should flee into dividend-paying stocks as a substitute for bonds when bond yields get too low curious, at least initially. If the firm pays a dividend instead of retaining the earnings, the stock's price should fall in proportion to the dividend payout on the ex-dividend date. In addition, the investor now has to pay taxes on the income received even though the corporation already paid taxes on that income; this "double taxation" of dividends while bond interest payouts are deductible to the corporation has been a distortion of the U.S. tax code for years, but no one is advised to hold their breath while waiting for it to change.

A Leash On Management

There are, however, several good reasons for investors to prefer dividends. One is the money is theirs, not the corporation's (stop laughing; it is true). The second is corporate managers have a demonstrated tendency to engage in empire-building whenever free cash is available and quite often when it is not. If the money is returned to the firm's owners it cannot be squandered on ill-considered mergers and acquisitions.

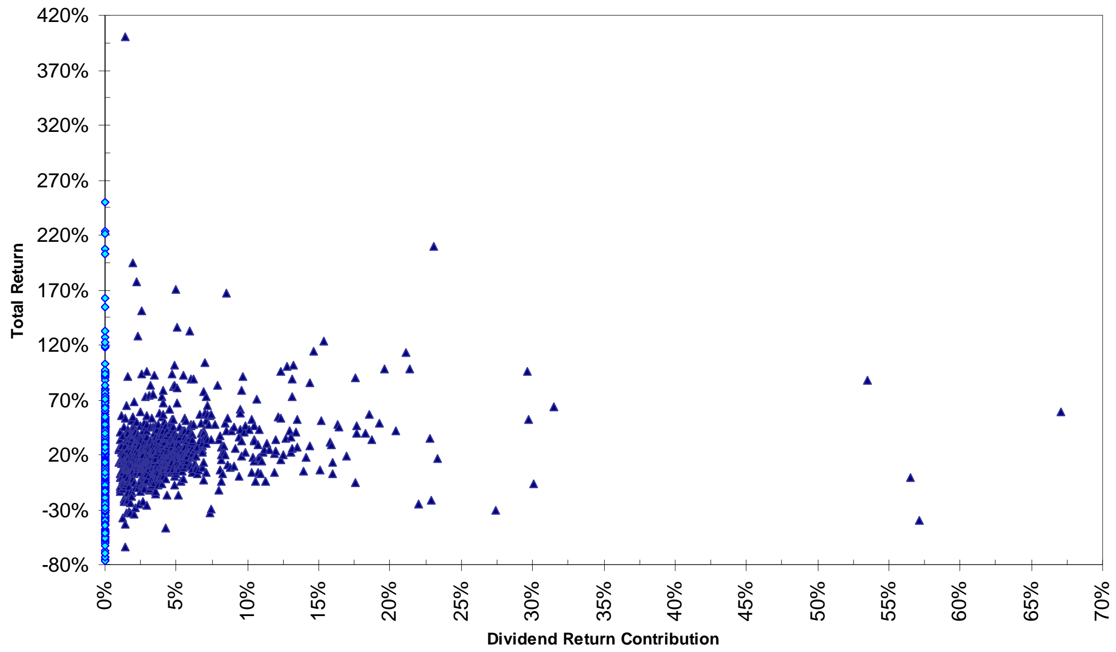
A third reason is dividends shorten the effective duration of equity. While stocks are supposed to live in perpetuity, or at least until the firm disappears for one reason or another, a low-dividend or non dividend-paying stock, like a zero-coupon bond, keeps all of the money at risk. The investor never gets to take anything off the table without selling the shares. Finally, dividends act as an economic signal: While earnings can be managed by postponing or accelerating recognition of revenues and expenditures, dividends are paid out of earnings and therefore send a powerful signal to investors the firm's "numbers" are real and are not the product of some accounting razzle-dazzle or worse.

Not Fooled By Randomness

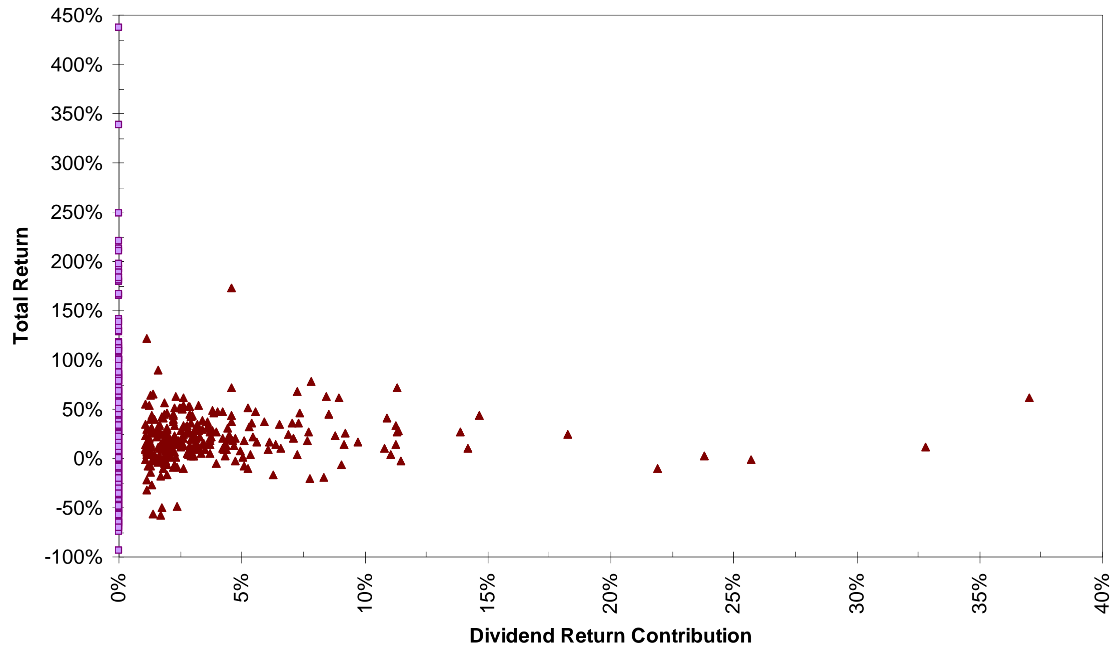
Equity returns can be split into their dividend and price appreciation components. In theory, the more skewed return is to dividends, the more likely the stock is to be a "value" stock as defined by Russell Investment Management in their taxonomy; the actual division is made on the dimensions of price-to-book and rate of earnings growth. Firms whose stocks derive their returns more from price appreciation are more likely to fall into the "growth" category, and just to make sure things do not get too simple, more than 700 members of the Russell 3000 generally straddle the two categories.

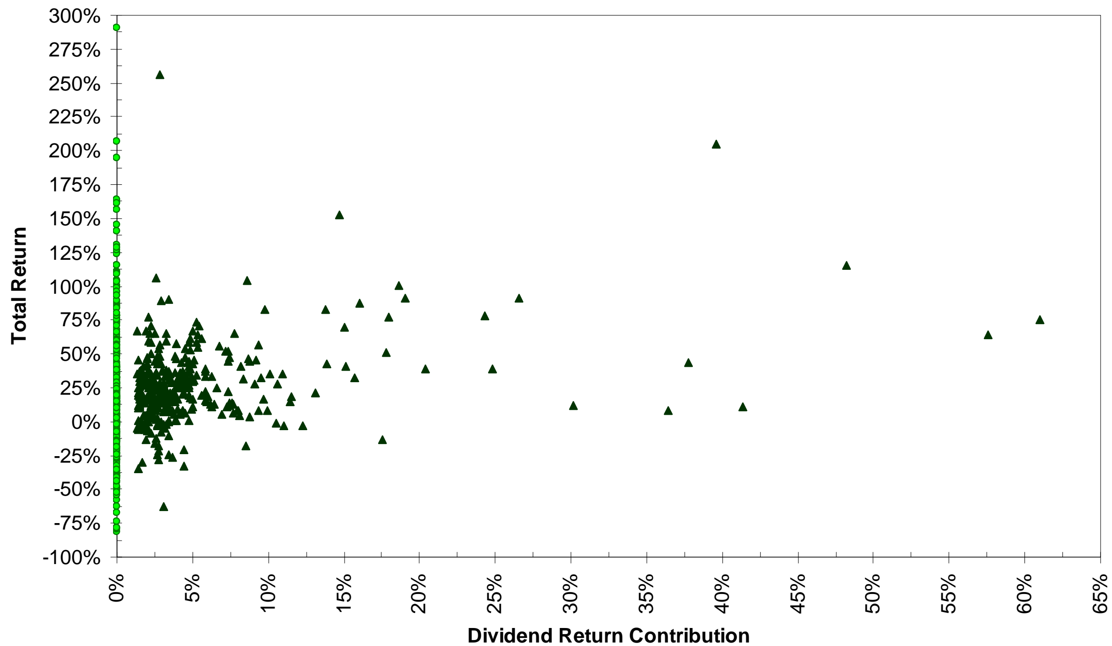
If Modigliani and Miller were correct, the total returns for stocks in any of these industries should not be a function of the percentage of their total return produced by dividends. Let's see whether this is the case over the one-year period ending in May 2013. The total return of value, growth and dual stocks as a function of the contribution dividends make to their total return are presented below; in all cases, zero-dividend stocks are displayed with a different marker.

Total Return As A Function Of Dividend Return Contribution, April 2012 - May 2013
Russell 3000 Value Index



Total Return As A Function Of Dividend Return Contribution, April 2012 - May 2013
Russell 3000 Growth Index





None of the three classifications produce a relationship where total return is a statistically significant function of dividends' contribution to return.

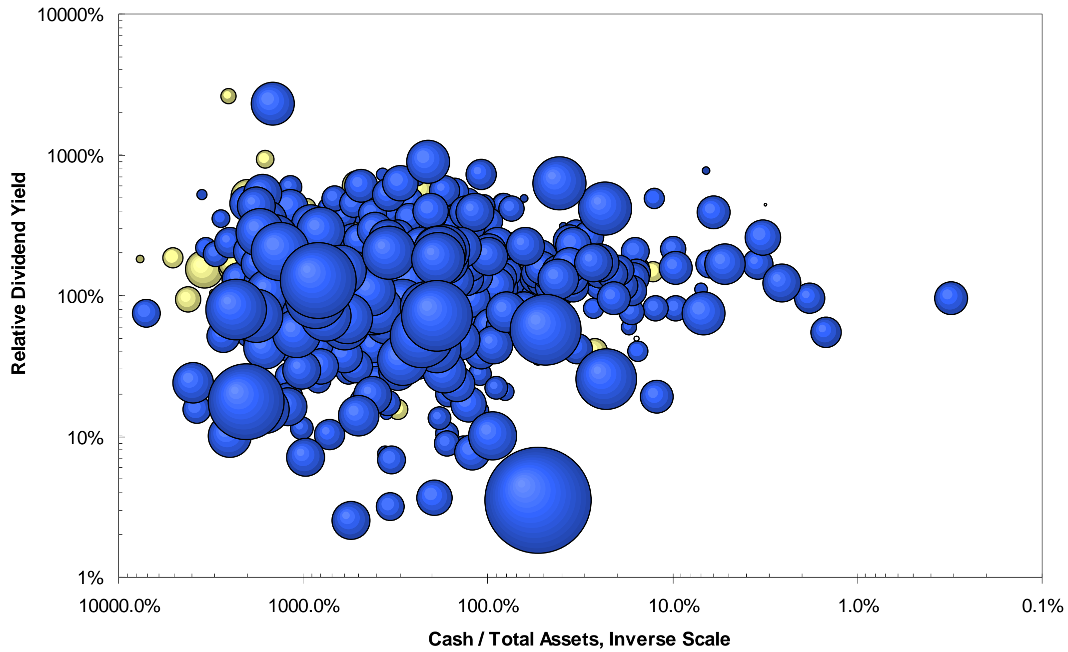
Cash On The Sidelines

What about the role of corporate cash? Corporations pile up cash on their balance sheets for any one of several reasons. The first, and least happy reason, is they have a shortage of attractive investment opportunities. This should be particularly alarming for high-tech firms, pharmaceutical firms or resource-extraction firms; in all cases they should have more investment opportunities than cash available to fund them. The second is they are fearful of being shut out of the credit markets either because of their own condition or, as was increasingly the case in the aftermath of the financial crisis, because credit conditions are tight. A third reason is corporate hoarding; certain firms like certain people just get a warm and fuzzy feeling from a huge stash of cash.

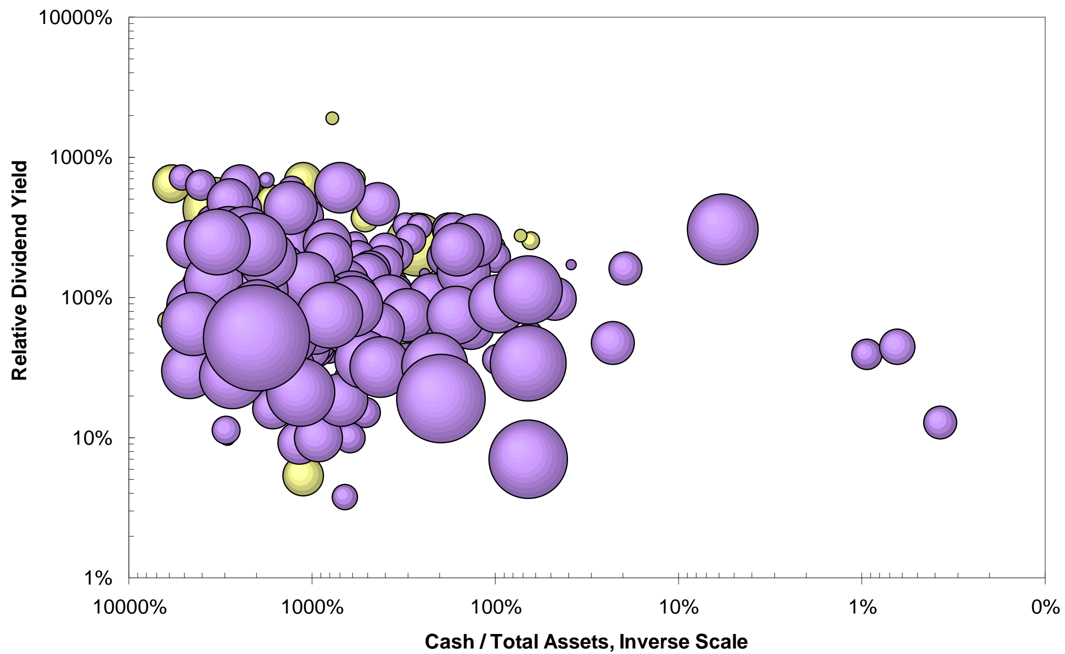
Just as cash can burn a hole in managements' pockets and can be squandered, many investors see cash as a source of buybacks, increased dividends or other value-enhancing moves. Corporate gadflies also have an opinion on cash: They see it as something to be deployed in job-creation exercises as if anyone went into business with the objective of increasing payrolls for their own sake.

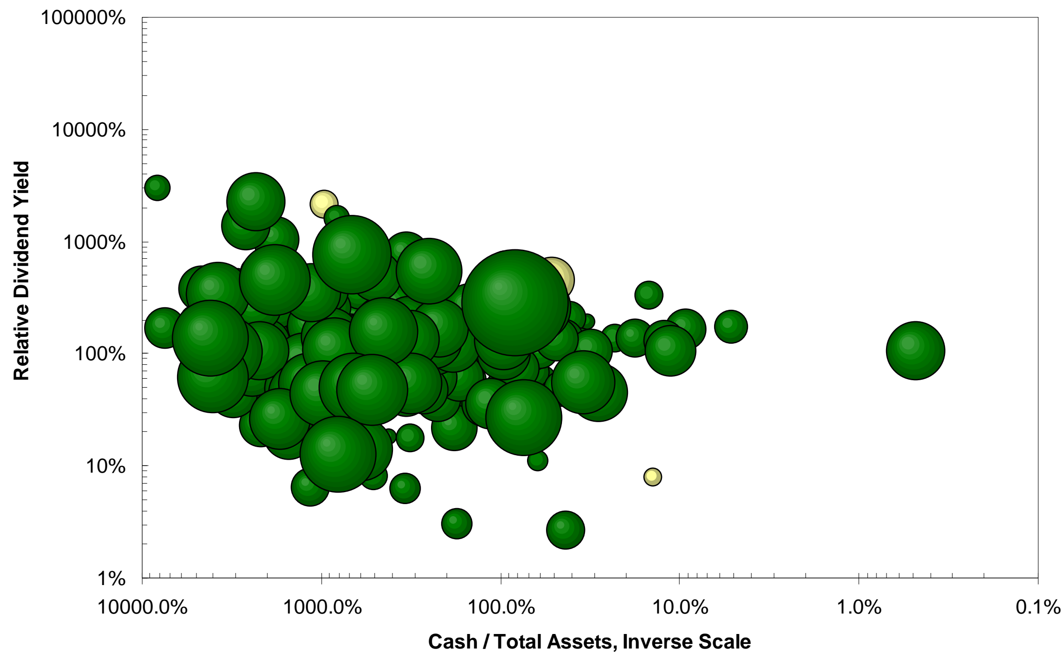
What is the relationship between cash as a percentage of assets, dividend yield and returns? Let's map total returns for the year ending in May 2013 as a function of these two variables. Positive returns are in colored bubbles; negative in light yellow, with the diameter of the bubble corresponding to the absolute magnitude of the return. As before, these will be mapped separately for the Russell 3000 Value, Growth and dual-membership indices.

Total Return As A Function Of Cash And Relative Dividend Payout:
Russell 3000 Value Index, April 2012 - May 2013



Total Return As A Function Of Cash And Relative Dividend Payout:
Russell 3000 Growth Index, April 2012 - May 2013





The conclusions here are clear. If total returns were a function of higher dividend yields and of lower cash holdings, we would see clusters of colored bubbles in the upper right-hand corners of these charts. We do not. In addition, if investors in value stocks actually rewarded firms with high dividend payouts, we should expect to see a preponderance of colored bubbles in the top halves of the chart for value stocks and in the bottom half of the chart for growth stocks. Once again this is not the case.

The net result of all the above is the entire value of dividend payment may lie in the signal management is sending to the world that their earnings are not bogus, and here is a check to prove it. If this is the case, one has to marvel at the amount of time and attention devoted at the board level to dividend payouts. Modigliani and Miller were correct; dividends do not lie but then again, they really should not matter as much as they do.