Dividends And Return

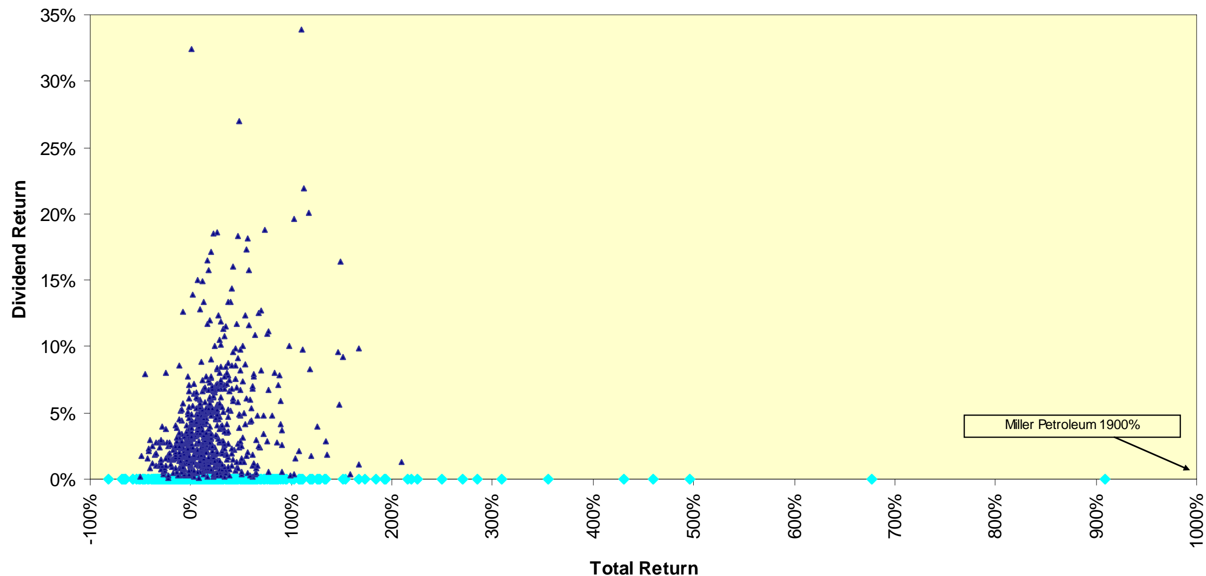
Much has been made of the huge pile of cash sitting on the balance sheets of corporate America. This cash did not get there by accident; no, it got there because corporations were saving just the way households have been saving since the trapdoor opened sometime in late 2007. It would be far better for future growth and earnings if corporations had a backlog of worthy projects in the pipeline and were increasing both their capital budgets and their leverage, but that is a story for another day.

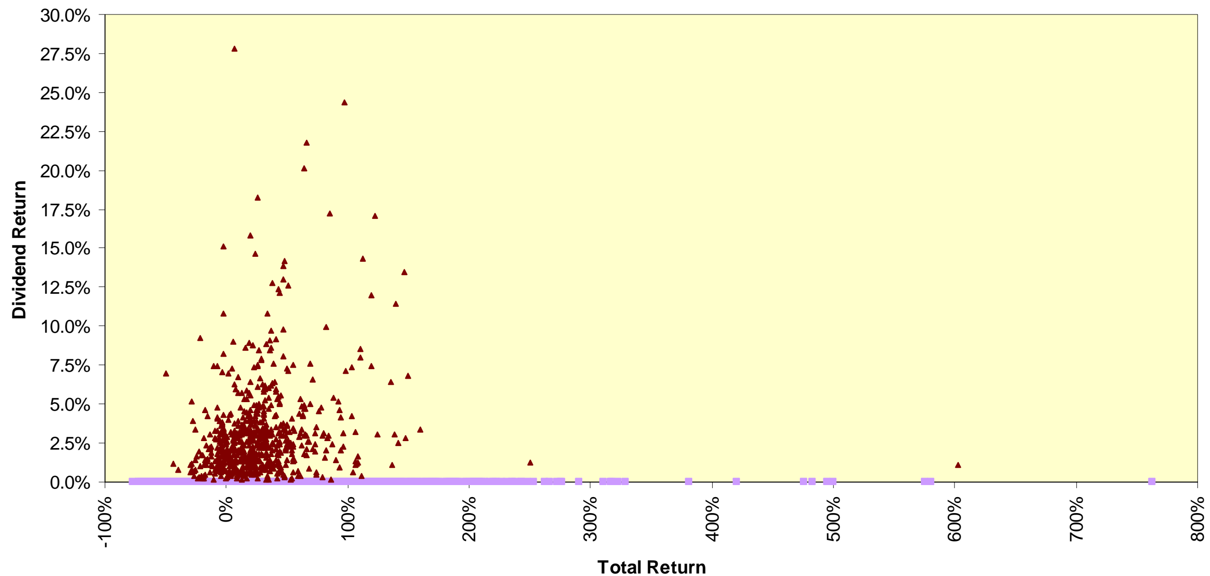
The paucity of capital investment in the face of economic slack should not be surprising; in fact, it should be welcome as it avoids future idle plant and equipment. One of the reasons the bear market of the early 1980s was prolonged was the Reagan investment incentives including tax credits and accelerated depreciation (you haven't lived if you never heard the late Gov. John Connally of Texas booming about "10-5-3" depreciation schedules as part of his campaign for the 1980 Republican presidential nomination. Candidates have not run on actual issues since that time) made new investment more attractive than the existing capital stock and its paper representations.

Should this cash be returned to shareholders, either in the form of special dividends or share-buybacks? While this question could be posed at other times, it takes on special meaning this year as the 2003 tax cuts on dividends and capital gains and the 2001tax cuts on ordinary income are set to expire barring last-minute legislation.

As dividends shorten the effective duration of equities by decreasing the percentage of total return received from price appreciation, they change the nature of stockholding. What has been the relationship over the past year between dividend returns and total returns, divided across the Russell 3000 Value and Growth indices (accessible through the IWW and IWZ exchange-traded funds, respectively)?

The answer is surprisingly small. If we exclude the 862 stocks included in both the value and growth indices and map dividend return against total return for both styles, we see a complete lack of statistical significance.





This is all the more surprising given the near-100% confidence the value and growth indices are statistically different. Two factors come into play, one practical and the other academic. The practical one is shareholders are not really craving dividends right now as their reinvestment rate is low; dividends merely transform the problem of what to do with surplus cash from corporations to shareholders. Cash held at the corporate level can be aggregated and invested in ways unavailable to most shareholders. That cash can be wasted in empire-building exercises, too, but let's pretend all mergers and acquisitions make sense.

The academic factor is one of the Modigliani-Miller theorems from the 1950s. The two Nobel Laureates posited the value of the firm was independent of its dividend policy as the shareholders were the ultimate owners of that cash, anyway. In practice, this theorem is violated quite often because of empire-building exercises, changes in the tax code and reinvestment rates.

The final answer may be for corporations to pay that cash out before 1) Uncle Sam takes it from them, 2) before Uncle Sam takes it from us in higher tax rates in 2011, and 3) before it burns a hole in executives' pockets. As Benjamin Franklin once said, "Cash is, more or less, always welcome."