

The Dividend Myth.

A thought for those investing in wonderful companies

“...in theory, publicly traded corporations have shareholders as their kings, boards of directors as the sword-wielding knights who protect the shareholders and managers as the vassals who carry out orders. In practice, in the past decade, managers have become kings who lavish gold upon themselves, boards of directors have become fawning courtiers who take coin in return for an uncritical yes-man function and shareholders have become peasants whose property may be seized at management's whim.”

Greg Easterbrook, "Greed Isn't Good",
The New Republic www.tnr.com (1 July 2002)

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In Australia it is common for the dividend policy of a company to go unexplained by directors for many years. While the policy is often consistent and evident from a comparison of the earnings per share and the dividends per share, the directors rarely provide an adequate explanation of their logic and reasoning.

A company may state that its policy is to pay out 50% of earnings as dividends but this pronouncement will not be accompanied by any justification that the policy adopted is best for shareholders.

Conversely investors may 'punish a company' (and themselves) by selling the shares of a company that significantly changes its policy, particularly if that change involves a reduction in the dividend payout ratio.

There are several issues for investors and we list them here before expanding further

1. Not all earnings can be distributed
2. Not all companies should pay dividends
3. Some companies should pay all their earnings out as dividends
4. The rate of incremental earnings on incremental capital should determine the dividend policy.

Not all earnings are created equal.

Some investors think about a share investment opportunity by considering its fixed or tangible assets. They believe that if the company is 'supported' by lots of assets that can be seen, touched and ultimately sold, there is something 'of value' supporting the price of the shares they purchase. Given the choice of buying a company (A) at a share price of \$2.00, with earnings per share of 10 cents and Net Tangible Assets of \$2.00 per share or a company (B) with the same share price and earnings but only 20 cents of net tangible assets, these investors will choose the former.

Unfortunately a large part of the earnings of the former cannot be distributed to the shareholders. For companies with a high ratio of assets to profits, a large part of the earnings will be 'inhibited' or required to maintain those assets and preserve the company's economic position.

For example suppose company A intends to double earnings over the next ten years from ten cents to twenty cents while maintaining its current rate of return on assets. Its assets will therefore also be required to double. Company A will generate total earnings over ten years of \$1.49 per share but require \$2.00 in assets over the same period. The total earnings generated over the period are therefore 'inhibited' earnings. They will be required or restricted to purchase assets, if earnings are to grow. The shortfall between the earnings generated and the assets required will need to be met by a capital injection - either equity or debt. And this simple example has not taken into account the fact that the old assets are valued on a historical cost basis and new assets will be purchased at higher prices due to inflation. The example also assumes that no dividends were paid out.

If company A elected to pay dividends from its inhibited earnings to its shareholders, it would most certainly lose ground. The company either would not be able to maintain its unit sales volumes or its competitive position and its financial position may weaken. By distributing inhibited earnings the company is destined to collapse unless additional funds are injected.

Should Company B share the same intentions as company A with regards to earnings growth over ten years, it would be required to add only an additional 20 cents per share of assets, while its business generated \$1.49 per share in earnings. Therefore \$1.29 of 'uninhibited' earnings per share (assuming no inflation) can be distributed to shareholders by way of dividends or share buybacks at appropriate times. Company B is producing uninhibited earnings that can be taken to the grocery store by the owners, while company A is not – all of its earnings are needed.

There are many examples of capital-intensive businesses in Australia that demonstrate similar economics to company A above. Perversely, these companies pay dividends! That's right. From inhibited earnings, they distribute dividends to shareholders. Such actions only serve to weaken the company's financial strength and by implication that of it's owners - the shareholder's.

While inhibited earnings have some value for most companies, they generally cannot be distributed to the owners. Only uninhibited earnings should be distributed. While clearly silly and worthy of closer examination, the payment of inhibited earnings as dividends is not the topic of this note. This note is concerned with the equally illogical practice of some companies retaining uninhibited earnings.

We are concerned about the motives and intelligence of management that elects to retain a portion of uninhibited earnings at below attractive rates of return simply because it is the 'policy' of the company. As one famous investor once quipped "**traditional wisdom is often long on tradition and short on wisdom.**" It is this practice that is not in the best interest of the shareholders and the topic for discussion.

The company that generates high incremental earnings on incremental capital (better than is available elsewhere) should retain its earnings. A company that generates a low return on incremental earnings should pay all of those earnings out as a dividend or if the shares are below estimated intrinsic value, buy back shares.

Table 1 is a company that generates a normalized rate of return on equity of 5% - a retailer for example and retains all its earnings, paying no dividends.

Table 1

INPUTS			Year 1	Year 2	Year 3	Year 4	Year 5
Equity per Share	<input type="text" value="\$1.00"/>	Beginning Equity	\$1.00	\$1.05	\$1.10	\$1.16	\$1.22
Return on Equity	<input type="text" value="5.00%"/>	Earnings	\$0.05	\$0.05	\$0.06	\$0.06	\$0.06
Payout ratio	<input type="text" value="0.00%"/>	Dividends	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
P/E	<input type="text" value="10"/>	Equity at End	\$1.05	\$1.10	\$1.16	\$1.22	\$1.28
OUTPUT							
IRR	<input type="text" value="5.00%"/>	P/E	10	10	10	10	10
		Price	\$0.50	\$0.53	\$0.55	\$0.58	\$0.61
		IRR	-\$0.50	\$0.00	\$0.00	\$0.00	\$0.61

As a result of retaining its earnings, the equity of the company grows by the earnings retained and those retained earnings go on to earn another 5% - the rate of return on equity. By allowing management to continue this practice, the shareholders are forsaking a higher return elsewhere. Often the hope that higher returns are possible is used as justification for the retention of earnings at sub par rates. A simple glance at

management's long-term track record however should be enough to dispel any romantic notions the shareholder harbors.

Assuming the shares are purchased and sold at the same price earnings ratio, the internal rate of return (IRR) to the shareholder will be equal to the company's rate of return on equity. Given this rate of return on equity is lower than can be obtained elsewhere it appears rational that the company should not retain its earnings but pay them out.

In Table 2 the company now pays all its earnings out as a dividend – as it should. As a result there is **no** growth in the company but (note that even though earnings have risen slightly, this is not how we measure growth) such a company should not grow unless it can materially enhance its return on equity. Regardless of the fact that the company has no growth, the shareholder now achieves a higher return (an IRR of 10%), buying and then selling five years later at the same price earnings ratio.

Table 2

INPUTS			Year 1	Year 2	Year 3	Year 4	Year 5
Equity per Share	\$1.00	Beginning Equity	\$1.00	\$1.00	\$1.00	\$1.00	\$1.00
Return on Equity	5.00%	Earnings	\$0.05	\$0.05	\$0.05	\$0.05	\$0.05
Payout ratio	100.00%	Dividends	\$0.05	\$0.05	\$0.05	\$0.05	\$0.05
P/E	10	Equity at End	\$1.00	\$1.00	\$1.00	\$1.00	\$1.00
OUTPUT							
IRR	10.00%	P/E	10	10	10	10	10
		Price	\$0.50	\$0.50	\$0.50	\$0.50	\$0.50
		IRR	-\$0.50	\$0.05	\$0.05	\$0.05	\$0.55

You will notice that the investor's rate of return (IRR) is higher when a company with a low ROE pays all its earnings out as a dividend. This is rational behaviour on the part of management who 'think like owners'. They wouldn't invest their bonus payments and other incentives at 5%, so they shouldn't invest the funds of the owners at the same rate.

Uninhibited earnings should only be retained when there is a good possibility (use history as a guide) that capital retained will produce incremental earnings at a rate that is equal to or higher than returns produced by alternative investment options.

Capital Gains and Dividends Retained

While it is entirely possible and indeed frequent for management to have no rational explanation for their dividend policies, it is also extremely popular for investors to be romantically attached to their dividends at the expense of better financial returns.

Take the example of a company that has two certainties, a sustainable return on its equity of 20% and a share price that is always 20 times higher than the company's earnings. That is the P/E ratio is 20.

In year one, assuming the company had \$10.00 of equity per share, it would earn \$2.00 and the shares would trade at \$40 per share (p/e 20 X eps \$2.00). Now suppose the shareholders demanded a dividend of 50% of the earnings, which a policy the company agrees to adopt. The company would therefore pay its

shareholders a dividend of \$1.00 and retain the remaining \$1.00 - adding it to the beginning equity. The shareholders have gratefully received their \$1.00 in dividends but they have lost a great deal more.

At the beginning of the second year the company has \$11.00 of equity per share on which it earns 20% or \$2.20. The share price should therefore rise to $\$2.20 \times 20$ or \$44.00.

Suppose however that company management, confident that it will continue to generate 20% return on equity, ignored the wishes of its shareholders in this regard and did not pay a dividend. Instead of beginning the second year with \$11.00 of equity per share, the company begins the year with \$12.00 on which it can generate 20% returns. In the second year the company would earn \$2.40 and with the shares trading at 20 times the earnings, the shares should trade at \$48.00.

By foregoing the \$1.00 in dividends the shareholders have gained an additional \$4.00 in capital growth. By paying a \$1.00 dividend the shares may rise to \$44.00 but by not paying a dividend the shares should rise to \$48.00. Of course there is some risk that the shares fall in price. While this may be a concern in the short term (1-3 years), over long periods of time the market cannot but help recognise the true earnings power of such a business.

As we are fond of comparing shares to bonds, a bond example will further help cement our point. Suppose you own an Australian Government bond (risk free) that generates a return of 7.5% forever, with a feature that allows you to choose between taking the coupon as cash or reinvesting the cash at the same rate of 7.5% forever by buying another bond with exactly the same features. If the interest rate at the date of receipt of the coupon were 4.75%, it would be irrational to take the payment as cash. The investor can reinvest at 7.5% and would be able to buy a bond for \$100 that would be trading at $(\$100 \times 7.5\% / 4.75\%)$ \$157.89. If the investor needed the cash, they could simply buy the bond at \$100 and resell it at 57% premium and realise more cash than simply taking the coupon as a cash payment. But if interest rates were higher than 7.5% - say 10%, it would be best to take the payment in cash directly. Reinvesting would mean buying a bond at \$100 that is trading at \$75.00. It would be best to take the cash and buy the bonds at \$75.00 in the market, producing a higher 10% return.

Deciding whether a company should retain or pay out its uninhibited earnings is not as simple as the above example. The decision is complicated at least by the uncertainty over future rates of return on equity for long-term investors and for those with shorter-term cash needs, by changing price earnings ratios.

Suppose a company consistently generates a return on its equity of 20% beginning with equity per share of \$10.00. In the first year the company elects to pay a dividend of 50% of its \$2.00 in earnings. Shareholders receive \$1.00 and the company retains \$1.00, increasing the equity per share to \$11.00. Now suppose the shares always trade at a price earnings ratio of 15 times earnings. The company's shares will trade at \$30.00 each ($15 \times \2.00).

In contrast suppose the company paid no dividends. The shareholders would seemingly 'miss out' on the \$1.00 dividend. Fortunately all is not lost. The company's equity has increased from \$10.00 to \$12.00 and by earning 20% on this new equity, the company will be able to earn \$2.40. With the shares trading at 15 times the earnings, the shares will trade at \$36.00 ($15 \times \2.40). Even after paying capital gains tax, the shareholder is better off reinvesting the cash in the company.

For management teams the task is a simple one. First establish a reasonable estimate for long-term future returns. Second, reinvest earnings if the expected return is high or pay the earnings out, if returns are expected to be low. Warren Buffett once quipped; **"If earnings have been unwisely retained, it is likely that managers, too, have been unwisely retained"**.

Unfortunately, some management teams, driven by ego seek to preside over a vast empire and in order to 'grow' the business they retain uninhibited earnings at low rates of return. In the examples above, no amount of growth can change the fortunes for the shareholder. Only an improvement in the rate of return on equity and/or a cheaper purchase price can boost the returns.

At Clime we seek to avoid companies whose prospective returns on equity are relatively low while seeking to also avoid companies whose management act irrationally with the funds entrusted to them by their shareholders. In *The New Republic*, a July 2001 article by **Greg Easterbrook** entitled "*Greed Isn't Good*" <http://www.tnr.com/doc.mhtml?i=express&s=easterbrook070102> stated: "University of San Francisco business professor Richard Puntillo has noted that under US securities law, in theory, publicly traded corporations have shareholders as their kings, boards of directors as the sword-wielding knights who protect the shareholders and managers as the vassals who carry out orders. In practice, in the past decade, managers have become kings who lavish gold upon themselves, boards of directors have become fawning courtiers who take coin in return for an uncritical yes-man function **and shareholders have become peasants whose property may be seized at management's whim.**" Emphasis added

Roger Montgomery

February 2002