Dividend policy and shareholder value: relevance versus irrelevance

Even as conflicting theories abound around whether a firm's dividend policy does indeed exercise any influence on its value, we look at the literature surrounding both the relevance and irrelevance aspects of the dividend decision to understand what effect the declaration of a dividend, and the quantum thereof, has on the firm's share value, if at all.

The overriding assumption underlying much of the academic finance literature is that business decisions are made in view of maximising shareholder value which is reflected in common stock share prices. Dividend decisions, as determined by a firm's dividend policy, are a type of financing decision that affect the amount of earnings that a firm distributes to shareholders as opposed to the amount it retains for future investments. Dividend policy refers to the payout policy that a firm follows in determining the size and pattern of cash distributions to shareholders over time.

Under real-world conditions, determining an appropriate payout policy is more often a difficult choice because of the necessity to balance many potentially conflicting forces. According to conventional thinking, paying dividends affects both shareholder wealth and the firm's ability to retain earnings to exploit growth opportunities. Because investment, financing, and dividend decisions are interrelated (Pruitt and Gitman, 1991), management cannot consider dividend policy in isolation from these other decisions. The general rule is that managers typically act as though their firm's dividend policy is relevant despite the controversial arguments set forth by Miller and Modigliani (1961) (MM) that dividends are irrelevant in determining the value of the firm.

Theory of Irrelevance

In their pioneering study, MM provide an elegant analysis of the relationships between dividend policy, growth, and the valuation of shares. On the basis of a well-defined but simplified set of perfect capital market assumptions (for instance, no taxes, transaction and agency costs, and information freely available to everyone), MM propounded a dividend irrelevance theorem where investment policy is the sole determinant of firm value. The theorem relies on prudent investment choices being made while payout policy and capital structure would take care of themselves. MM's irrelevance theory suggests that payout policy is an economically trivial issue which may be ignored provided sensible investment decisions are made. Early studies by Black and Scholes (1974), Miller (1986), and Miller and Scholes (1978, 1982) support the dividend irrelevance argument.

MM's unconventional and controversial conclusion about dividend policy irrelevance stirred a heated debate that has reverberated throughout the finance community for decades. In Modigliani and Miller (1958), perhaps their most influential paper, they showed that under certain assumptions the mixture of debt and equity that a firm holds does not affect overall firm value. A few years later, MM (1961) reported a similar result for dividend payout policy. The conclusion arrived at is that in perfect capital markets value results from investment decisions while financing decisions are irrelevant. Given a choice between financing new projects with retained earnings or with new equity, firm managers should normally be indifferent. The prevailing opinion just before MM's breakthrough research was that dividends were highly relevant to shareholder wealth and high-dividend paying firms sold at a premium over low-dividend-paying firms. Early criticism focused on MM's unduly restrictive assumptions which were considered to be unrealistic.

Testing out the theory in real world markets

When comparing MM's abstract world of economic theory with the real world, the issue of dividend irrelevance seems to raise a host of questions. For instance, researchers responded to MM's conclusion of dividend policy irrelevance by offering competing hypotheses about why corporations pay dividends and why investors want them—the dividend puzzle, as Black (1976) coined.

Some early theories that explain the potential relevance of dividends involve taxes, agency costs, and asymmetric information, thus leading to the conclusion that dividend policy can have an impact on shareholder wealth because of various market imperfections. Because these imperfections affect firms differently, one would expect dividend policies to vary substantially among firms.

> Dividend policy refers to the payout policy that a firm follows

Among the recommendations of agency theory is the residual dividend policy specifying that managers pay shareholders the free cash flows remaining after funding all profitable investments. While empirical evidence suggests that firms generally do not follow this type of policy, firms would generally maintain a smooth dividend pattern that is as strongly related to past dividends as it is to current earnings. Firms normally build up cash balances to fund future investments and whenever a funding shortage occurs, those firms would often use short-term borrowing rather than cut dividends.

The basis of signalling theory is the premise of asymmetric information, where managers have access to information that the market does not.

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Corporate financial decisions can be viewed as signalling devices that a company's managers send to investors to communicate information, which reduces asymmetries. Changes in dividend policy are one such device at the managers' disposal to communicate information to the market about the future prospects of the firm.

Asymmetric information can also affect the internal versus external financing decision. If firms are undervalued, external equity is more costly than internal equity. Firms paying dividends reduce internal equity, resulting in a considerable commitment to use external financing. A major issue with signalling arguments is figuring out exactly what the signal is. Most signalling-related studies assume that dividend increases or initiations serve as harbingers of future earnings increases.

How these earlier theories are refuted by subsequent arguments

Predecessors and contemporaries of MM (1961) often cite what MM call bird in hand fallacies to explain investor preference for dividends. These fallacies claim that investors prefer dividends because they represent guaranteed cash receipts, which are more valuable given that they are not affected by uncertainty, including possible poor future firm performance.

> Asymmetric information can also affect the internal versus external financing decision

MM, however, rebut the value of receiving dividends in hand by arguing that cash-strapped investors can simply sell a proportion of shares to mimic dividend receipts. If investors reinvest these dividends, their total return, whether from capital gains or dividends, would be the same.

Of the lesser imperfections, the clientele effects are perhaps the most notable where certain investors demand dividends and firms adjusting their dividend policy accordingly to cater for certain types of investors. MM (1961), while recognising the possibility of clientele effects, state that each corporation would tend to attract to itself a 'clientele' consisting of those preferring its payout ratio. MM discount the importance of the latter effects by claiming that the value of a firm would not change despite different clienteles.

> Firms normally build up cash balances to fund future investments

How can firms balance out all factors to arrive at a sound dividend policy?

Irrelevance theory is clearly the benchmark to beat in the dividend policy realm, similar to the null hypothesis in Mathematics (Statistics). Despite the flaws in their irrelevance theorem, the influence of MM on financial theory cannot be understated. This, in turn, has made researchers respond by identifying several areas that may generate dividend relevance.

While dividends and dividend policy will always be a continuing cause of debate, theory dictates that, provided retained earnings are reinvested at the cost of equity, or higher, shareholder wealth will be increased by cutting dividends.

However, in the real world, where not necessarily all investors are logical and where transaction costs and other market imperfections intervene, determining a successful and popular dividend policy is quite a challenge in many instances.