

# Changing Perspectives on Corporate Payout Policy: From Cash Dividends to Share Repurchase

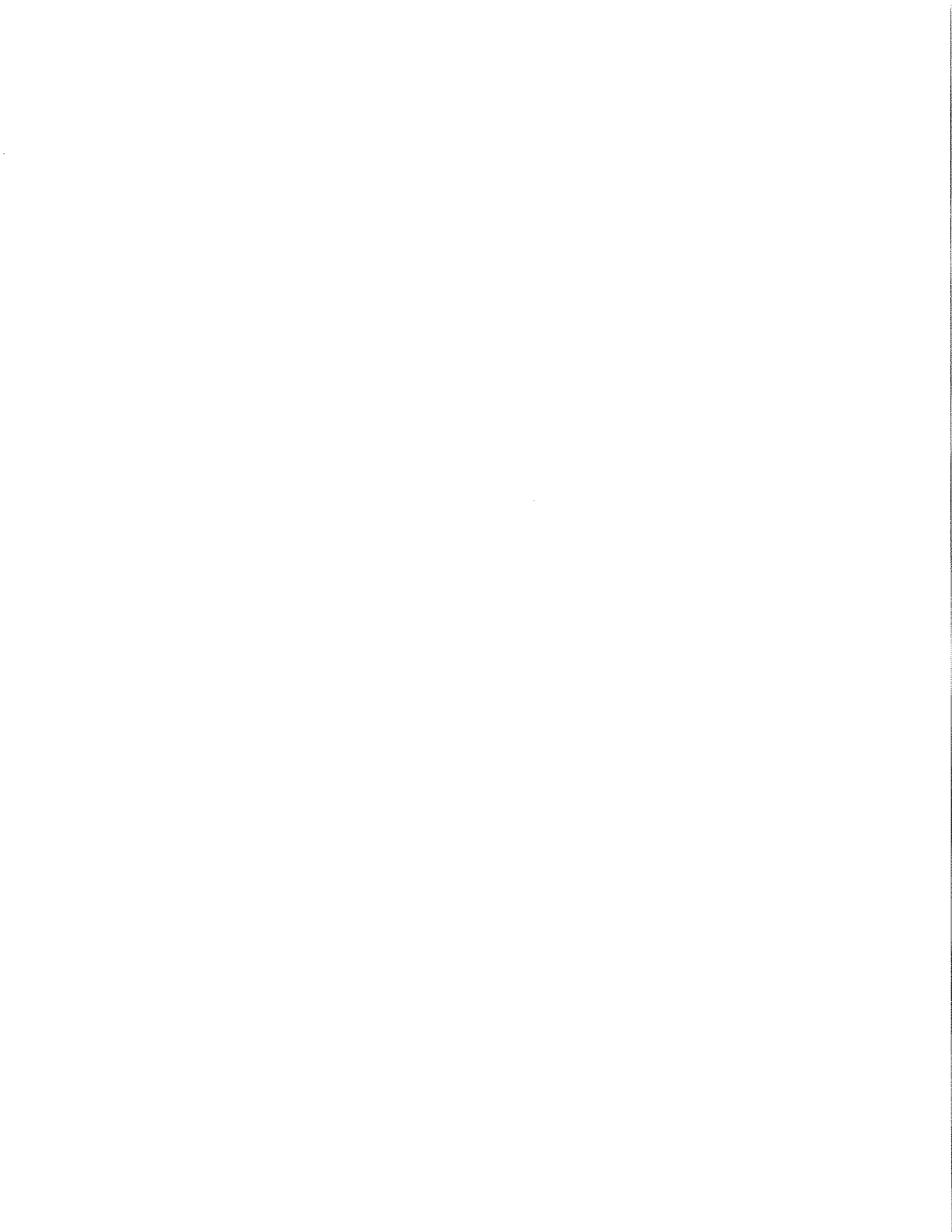
By  
Robert A. Weigand\*

WASHBURN UNIVERSITY  
SCHOOL OF BUSINESS  
WORKING PAPER SERIES  
Number 56

October 2005

Washburn University  
School of Business  
1700 SW College Ave.  
Topeka, KS 66621  
785-670-1308  
[www.washburn.edu/sobu](http://www.washburn.edu/sobu)

\* Robert Weigand is professor of Finance and Brenneman Professor of Business Strategy in the School of Business at Washburn University, Topeka, Kansas. Comments should be directed to Robert Weigand, School of Business, Washburn University, 1700 SW College Ave. Topeka, Kansas 66621, 785-670-1591, [rob.weigand@washburn.edu](mailto:rob.weigand@washburn.edu).



# **Changing Perspectives on Corporate Payout Policy: From Cash Dividends to Share Repurchase**

**Robert A. Weigand**  
Professor of Finance and  
Brenneman Professor of Business Strategy  
Washburn University School of Business  
Topeka, Kansas USA 66621

---

## **Abstract**

Considerable evidence exists that investors' high regard for regular dividend payments is well-founded. Dividends are tangible cash flow streams that give stocks their intrinsic value, in addition to lowering risk and communicating managers' good long-term intentions. Despite these benefits, however, the changing nature of firms dominating the U.S. economy and managers' desire for increased flexibility make it likely investors will continue receiving more payouts in the form of share repurchase for the foreseeable future.

*JEL Classification:* G35

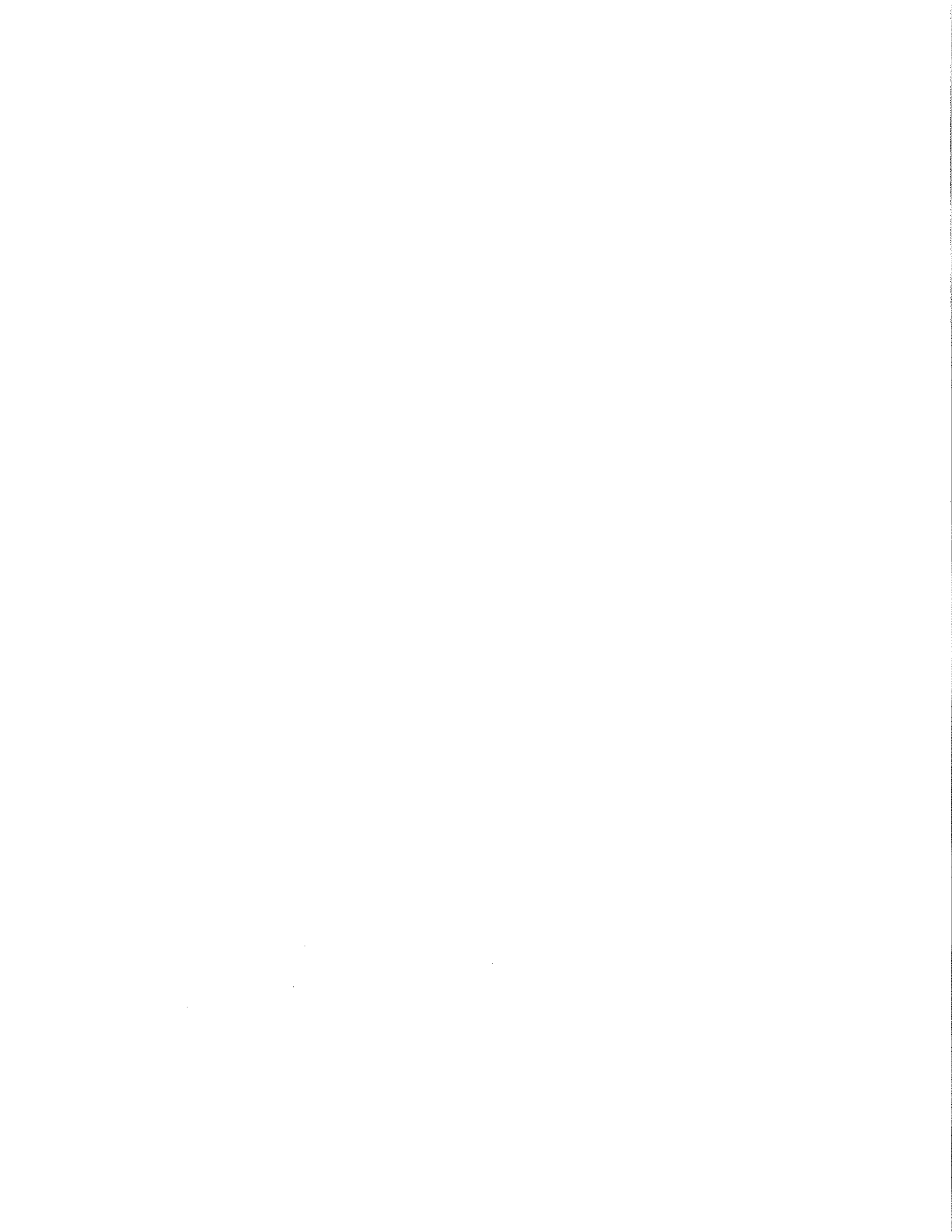
*Keywords:* Payout Policy, Dividends, Share Repurchase

---

October 2005

Forthcoming in *Financiële Studievereniging Rotterdam Forum*, Erasmus University

Author contact information: Washburn University School of Business, 1700 SW College Ave., Topeka, Kansas, USA 66621. Phone: 785.670.1591. Email: [rob.weigand@washburn.edu](mailto:rob.weigand@washburn.edu).



## **Changing Perspectives on Corporate Payout Policy: From Cash Dividends to Share Repurchase**

Two distinctly different branches of thought emanate from the early literature on corporate payout policy and its primary historical manifestation, cash dividends. The first line of thought emerges from the classic works of Williams (1938), Gordon (1959), and Lintner (1956), asserting that dividends are an important determinant of firm value and a first-order concern for value-maximizing managers. The second perspective, attributable to Miller and Modigliani (1961) and echoed in Black (1976), suggests cash dividends are irrelevant for firm value, a trivial detail to be dealt with only after the firm's investment policy is established. In this article I will present a review of research in the area of dividends evolving from these seminal papers and summarize the current state of knowledge on corporate payout policy, which, in brief, I interpret as follows: Payout policy (in general) and dividends (specifically) have always influenced firm value, and they remain an important determinant of firm value. Due to the types of firms dominating the U.S. economy and managers' preferences for greater flexibility in payout policy, however, many firms now prefer to repurchase shares rather than commit to conventional cash dividends. This trend is likely to persist for the foreseeable future.

### **Dividends Past and Present**

The earliest data available on U.S. markets indicates that dividend payouts in the 19<sup>th</sup> and early 20<sup>th</sup> centuries were larger and comprised a much higher percentage of investors' total returns than those offered by corporations today. As summarized in Table 1, Siegel (2002a) reports that the dividend yield (annual dividend ÷ current price) on U.S. stocks averaged 6.4% from 1802-1870. Dividends accounted for 90% of the total returns earned by investors during this period.

From 1871-1925 the average dividend yield of 5.2% represented over 70% of investors' total returns, and from 1926-2001 the average yield of 4.1% made up 40% of total returns. The magnitude of dividend payouts over such an extended period and the degree to which these payouts dominate investor returns suggest that, at least historically, dividends were an important component of stock valuation.

**Table 1**

Years	Dividend Yield	Capital Gains	Total Returns
1802-1870	6.4%	0.7%	7.1%
1871-1925	5.2%	2.2%	7.4%
1926-2001	4.1%	6.2%	10.3%
1982-2001	2.9%	11.6%	14.5%

Historical dividend payouts also provide a striking contrast with the payouts of today. The Federal Reserve Bank of New York reported that the September 2005 dividend yield on the S&P 500 index stood at about 2%, almost double its all-time low of 1.2% from June of 2000, but still far below its long-term historical average. Scholars have marveled over the paucity of modern dividend payouts, suggesting that in addition to serving as a primary determinant of firm value, dividends serve other important functions as well. Siegel (2002b) observes that with no Securities and Exchange Commission or Financial Accounting Standards Board providing oversight in the 19<sup>th</sup> century, investors demanded that firms provide "concrete evidence of real earnings" via regular cash dividends. Bernstein (2005) points out that investments in securities or assets with no expected payout cannot have an "intrinsic value," and suggests investors' tolerance of low dividends is analogous to people who settle for frozen orange juice when fresh is so easy to obtain: "Never having tasted the real thing, they have no concept of what they are missing."

## **One View: Dividends are Directly Related to Intrinsic Value**

It is highly likely that the dominance of dividends in the 19<sup>th</sup> and early 20<sup>th</sup> centuries as the primary source of shareholder returns influenced Williams' (1938) development of the discounted cash flow model, which expresses the intrinsic value of a firm's stock as the present value of a growing stream of dividends. This model gained significant popularity when Myron Gordon (1959) published an updated version of the same idea. Variants of this model remain in vogue today, as security analysts are rigorously trained how to estimate the value of a firm and its securities as the present value of a stream of dividends and/or particular definitions of free cash flow. Williams' model is also consistent with the prevailing conventional wisdom of the early 20<sup>th</sup> century, as related by Graham and Dodd:

The considered and continuous verdict of the stock market is overwhelmingly in favor of liberal dividends as opposed to niggardly ones. The common stock investor must take this judgment into account in the valuation of common stock for purchase (*Security Analysis*, 1951).

John Lintner, arguably the most influential finance scholar of the period, published a study in 1956 that includes a model of how managers set their firm's dividend policy. Lintner's model proposes that managers conservatively smooth past and current earnings changes into the level of the firm's dividend. Survey evidence also reported in Lintner's study confirms that managers believe dividends should be related to permanent (rather than temporary) increases in profits, consistent with the idea that dividends are fundamentally related to firm value. Managers' responses also indicate dividend payments should be uninterrupted, and increased only when the level and stability of earnings make it likely dividends will not have to be reduced in the future. Corporate surveys conducted over subsequent decades by researchers such as Fama and Blahnik (1968), Baker, Farrelly, and Edelman (1985), and Baker, Veit, and Powell

(2001) support Lintner's conclusions. Attitudes regarding dividends have remained remarkably similar to those observed by Lintner in the 1950s.

It is also important to note that none of the above studies are vague regarding dividend policy and its relation with past, present, and future profitability. Lintner's early model and subsequent survey evidence indicate that dividend policy reflects information regarding past and current earnings, and whether recent earnings changes are permanent. Research proposing a link between dividends and future earnings occurs later, and emerges from a different line of thinking in the literature (elaborated upon in the following section). Lintner's views on this topic are also reminiscent of those of Graham and Dodd, who urge analysts to value firms based on demonstrated earnings power, rather than speculative notions of future earnings:

The analyst's philosophy must still compel him to base his investment valuation on an assumed earning power no larger than the company has already achieved in some year of normal business (*Security Analysis*, 1951).

The view that dividends are related to firm value is firmly rooted in the conventional wisdom of the early 20<sup>th</sup> century. This view is reflected in classic texts and research papers, valuation models still used by analysts today, and the magnitude of dividend payout investors were accustomed to receiving.

### **Another View: Dividends Signal Information and Reduce Agency Costs and Risk**

Miller and Modigliani (M&M 1961) disagree with the idea that dividends directly affect firm value. Posing the following question early in their paper: "Do companies with generous distribution policies consistently sell at a premium above those with niggardly payouts?", is an obvious reference to the well-established Graham and Dodd wisdom they intend to challenge. M&M present a model that shows the value of a company is determined by the firm's assets and the cash flows generated by those assets, not how the cash flows are distributed to shareholders.



They contend that different payout policies constitute nothing more than slicing a fixed pie of cash flows into different pieces, and that in perfect, frictionless markets the value of these pieces will always sum up to the value generated by the underlying investment policy that produced the cash flows. Changing the form of the distribution does not affect value.

Black (1976) takes M&M's ideas even further and asserts that when taxes are considered, paying dividends actually destroys value. He coins an enduring phrase when he declares the convention of dividends to be a "puzzle," and leaves the reader to wonder why the corporate world has not adopted his vision of zero (or near zero) dividend payouts.

The conclusions of M&M (1961) and Black (1976), for years considered virtually unassailable, have recently come under harsh criticism themselves. DeAngelo and DeAngelo (2005) present a voluminous and convincing critique of M&M's analysis, demonstrating that the finding of dividend irrelevance obtains because M&M's framework mandates 100% payouts — the effect of "niggardly" payouts cannot be considered in their model. The irrelevance result is therefore hardwired into their assumptions, which means their argument is little more than an elegant tautology. DeAngelo and DeAngelo assert that M&M and Black have

limited our vision about the importance of payout policy and sent researchers off searching for frictions that would make payout policy matter, while it has mattered all along ...

In the remainder of this section I discuss the research findings spawned by this search.

One of the first attempts to explain why firms would want to pay dividends suggests corporate dividend policy reflects managers' expectations of *future* firm earnings, a specific application of an economic concept known as signaling, pioneered by Akerloff (1970) and Spence (1973). This idea is incorporated into the finance literature on dividends and information by Bhattacharya (1979), Miller and Rock (1985), and John and Williams (1985). In these and

other studies managers are portrayed as intentionally communicating their expectations of future firm earnings via dividend increases and decreases.

Empirical support for the signaling explanation of dividends has been limited. Studies that find a positive relation between dividend changes and future earnings include Watts (1973), who presents weak statistical evidence that changes in current dividends forecast future earnings. Gonedes (1978) reports similar results, as do Nissim and Ziv (2001). Studies of dividend initiation report some evidence of short-term earnings growth following first-time dividend payments. Among these are Healy and Palepu (1988) and Benartzi, Michaely and Thaler (1997, p. 1022), who find increases in earnings during years  $-1$  to  $+2$  relative to an initial dividend.

A significant body of research fails to find a relation between dividend changes and future earnings, however. Miller (1987) concludes that "...dividends are better described as lagging earnings [rather] than leading earnings." Benartzi, Michaely and Thaler (1997) find that dividend changes following firms' initial dividend convey no information about future earnings. Dyl and Weigand (1998) show that profits increase prior to dividend initiation but then level off for the next several years once the long-term drift in EPS is taken into account. Grullon, Michaely and Swaminathan (2002) report that firm profitability grows leading up to dividend increases, but gradually declines over the next several years, and eventually falls below its pre-increase levels. Koch and Sun (2004) find that investors use dividend changes as signals to corroborate the persistence of past, rather than future, earnings changes. The general consensus among more recent studies of dividends and earnings is that the decision to initiate or raise the firm's dividend is based on past and current earnings growth, not expected growth in future earnings.

Easterbrook (1984) offers another explanation for why firms would pay dividends, arguing that dividends provide investors with a way to monitor managerial behavior. Companies paying out cash that could be used to fund new investment must access capital markets more frequently than firms that do not. This increased scrutiny by markets adds value as investors monitor managers' investment and operating decisions, which are the real drivers of value in an M&M world. Jensen (1986) builds on Easterbrook's arguments by asserting that dividends increase the value of mature firms that generate large cash flows because they limit managers' tendency to waste excess capital on low-return investments. Jensen believes in this "free cash flow theory" so strongly that he recommends mature firms should maximize their value by paying out all the free cash flow they cannot profitably reinvest.

There is mixed empirical evidence as to whether dividends are successful in reducing agency costs. Lang and Litzenberger (1989) report that overinvesting firms have more positive stock price reactions to announcements of dividend increases than firms engaging in less overinvestment. Borokhovich, Brunarski, Harman and Kehr (2005) find that firms with fewer outside board members have higher average stock returns around the announcement of large dividend increases. This finding is consistent with the idea that the market views dividends as a mechanism for controlling agency costs, as firms with fewer strict outsiders on their boards are thought to be more prone to corporate governance problems than firms with greater outside representation. Other studies fail to find a link between dividends and agency costs, however; among these are Denis, Denis and Sarin (1994) and Yoon and Starks (1995).

Researchers have also proposed that dividend payments are associated with lower firm risk. Venkatesh (1989) argues that stock return volatility should decrease after firms begin paying dividends because investors will focus more on the information content of dividend

announcements and less on other news events, such as earnings announcements. Dyl and Weigand (1998) maintain that dividends convey information about lower risk more directly to markets, as managers decide to initiate or increase dividends when they believe the firm's earnings stream is not only permanently higher, but more stable and predictable as well.

Empirically, Venkatesh (1989) finds that unsystematic risk is lower after firms begin paying dividends. Dyl and Weigand (1998) report a significant decrease in the volatility of both stock returns and earnings that coincides with the announcement of dividend initiation. Boehme and Sorescu (2002) document a decline in the Fama-French factor loadings following dividend initiations. Bajaj and Vijh (1990) report similar results following dividend increases; systematic risk is lower after firms raise dividends. Grullon, Michaely and Swaminathan (2002) also document significant declines in beta and other risk factor loadings following dividend increases. The empirical evidence indicates that risk is lower following both dividend initiations and increases, although the results are mixed as to whether the risk change is confined to systematic risk or also involves total stock return volatility.

Summarizing several decades of research reveals that in addition to the longstanding idea that dividends are a direct source of firm value, dividends serve other important functions as well. Markets view changes in the level of the firm's dividend as corroboration that recent changes in earnings are permanent rather than temporary. Paying regular cash dividends may also indicate managers of slower-growth firms are aware of the dangers of overinvestment, and willing to submit the firm to greater scrutiny by markets. Another benefit derives when dividend-paying firms experience decreases in risk, both when they first initiate dividends and again when dividends are increased. Even if DeAngelo and DeAngelo's (2005) critique of M&M and Black withstands the test of time, and ideas regarding the irrelevance and value-destroying

nature of dividends lose their validity, the research streams spawned by their scholarship have produced a substantial body of evidence which shows dividends have many characteristics that are viewed favorably by investors and markets.

### **Dividends and Payout Policy in the 21<sup>st</sup> Century**

The benefits of dividends reviewed in the previous section make it all the more difficult to justify recent trends in both the market demand for dividends and firms' propensity to pay. Table 1 shows the average dividend yield on U.S. stocks from 1982-2001 was a paltry 2.9%. The precipitous decline in dividends is further underscored by the fact that yields averaged 3.9% from 1982-1991, but only 2.0% from 1992-2001.<sup>1</sup> Fama and French (2001) confirm that the convention of cash dividend payments has been in a long-term downtrend. While 67% of publicly-traded firms in the U.S. paid dividends in 1978, only 21% of firms were dividend-payers in 1999.<sup>2</sup> Fama and French find markets have become increasingly tilted toward firms that are less likely to pay dividends — small firms with low profitability and high growth opportunities. They also report all types of firms have become less likely to pay dividends, however, including larger firms with slower growth opportunities.

Julio and Ikenberry (2004) present evidence of a mild revival in the tendency to pay dividends. From 2002-2004 the percentage of firms paying dividends in the U.S. has increased steadily. They attribute renewed interest in dividends to firms needing to reassure investors about the quality of their earnings in a post-Enron/Global Crossing/Tyco world. Another reason firms may be more willing to pay dividends is that tax rates in the U.S. on dividend income and capital gains are now equal (15%). Julio and Ikenberry also suggest technology firms that went

---

<sup>1</sup> Data courtesy of Robert Shiller, Yale University.

<sup>2</sup> Julio and Ikenberry (2004) show the all-time low was reached in 2001, when 15% of firms paid regular dividends.

public in the 1980s and 1990s are now maturing and facing slower growth opportunities (think Microsoft), so paying dividends makes more sense for these firms than it would have earlier in their life cycle.

Recent survey evidence by Brav, Graham, Harvey and Michaely (2005) provides us with the latest word on managers' attitudes regarding dividends and other forms of payouts to shareholders. The evidence indicates that share repurchase is now more highly-favored than dividends, although respondents believe both forms of payout communicate important information to markets (85% for repurchases and 80% for dividends). Attitudes toward the relative importance of repurchases and dividends have apparently changed, however. Thirty-six percent of managers believe repurchases are as important as they were 15-20 years ago (implying the relative importance of repurchases has increased), while only 40% believe dividends are as important (implying the relative importance of dividends has decreased).

Interestingly, "old-school" Linter perspectives regarding dividends continue to influence modern managers. Among firms that pay dividends, 94% of respondents said they try to avoid reducing dividends, while 90% strive for a smooth dividend. Managers are also reluctant to make dividend decisions that might have to be reversed in the future (78%), they strive for consistency with historic dividend policy (84%), and consider the expected stability of future earnings before increasing dividends (72%).

Managers increasingly favor the increased flexibility offered by share repurchase, however. Only 22% believe there are negative consequences to reducing repurchases, but 88% believe there are negative consequences to reducing dividends. Other reasons for repurchasing shares include the market price of the firm's stock relative to its "true value" (86%), the availability of good investment opportunities (80%), and the attractiveness of the firm's stock

relative to other investments (79%). Managers also like repurchases because they increase earnings per share (78%) and offset the dilutionary effects of stock option and other stock plans (68%).

Julio and Ikenberry (2004) show that, despite the substitution of share repurchase for dividends, total payouts to shareholders as a percentage of earnings have remained stable from 1984-2004. These authors also point out that while both dividends and share repurchase signal managers' optimism about the permanence and expected stability of earnings, repurchases offer the additional benefit of explicitly communicating managers' belief that their shares are undervalued. Dividends have signaling benefits of their own, however; share repurchase indicates short-term optimism while dividends represent a more reliable, long-term commitment to pay out excess capital.

### **Summary and Implications for the Future of Payouts**

There is considerable evidence that investors have historically held dividends in high regard. Early research quantifies dividends as the tangible cash flow stream that gives stocks intrinsic value, while subsequent studies find that dividend-paying firms are less risky and exposed to greater market scrutiny, which leads to healthier corporate governance. Despite these benefits, however, modern managers prefer the flexibility afforded by share repurchase, and have increasingly substituted this form of payout for the convention of regular cash dividends. Although there is evidence that some firms may be reconsidering the dividend decision, it is likely that U.S. firms will maintain their preference for share repurchase for a substantial period of time.

## References

- Akerloff, G., (1970). The Market for Lemons: Quality Uncertainty and the Market Mechanism. *Quarterly Journal of Economics* 84, 488-500.
- Bajaj, M. and A. Vijh, (1990). Dividend Clienteles and the Information Content of Dividend Changes. *Journal of Financial Economics* 26, 193-219.
- Baker, H., G. Farrelly, and R. Edelman, (1985). A Survey of Management Views on Dividend Policy. *Financial Management* 14, 78-84.
- Baker, H., E. Veit, and G. Powell, (2001). Factors Influencing Dividend Policy Decisions of NASDAQ Firms. *The Financial Review* 38, 19-38.
- Bhattacharya, S., (1979). Imperfect Information, Dividend Policy, and 'The Bird in the Hand Fallacy'. *Bell Journal of Economics* 10, 259-270.
- Benartzi, S., R. Michaely, and R. Thaler, (1997). Do Changes in Dividends Signal the Future or the Past? *Journal of Finance* 52, 1007-1034.
- Bernstein, P., (2005). Dividends and the Frozen Orange Juice Syndrome. *Financial Analysts Journal* 61, 25-30.
- Black, F., (1976). The Dividend Puzzle. *Journal of Portfolio Management* 10, 7-9.
- Boehme, R. and S. Sorescu, (2002). The Long-Run Performance Following Dividend Initiations and Resumptions: Underreaction or Product of Chance? *Journal of Finance* 57, 871-900.
- Borokhovich, K., K. Brunarski, Y. Harman, and J. Kehr, (2005). Dividends, Corporate Monitors and Agency Costs. *The Financial Review* 40, 37-65.
- Brav, A., J. Graham, C. Harvey, and R. Michaely, (2005). Payout Policy in the 21<sup>st</sup> Century. *Journal of Financial Economics* 77, 483-527.
- DeAngelo, H. and L. DeAngelo, (2005). The Irrelevance of the MM Dividend Irrelevance Theorem, Working Paper, University of Southern California.
- Denis D. J., D. Denis, and A. Sarin, (1994). The Information Content of Dividend Changes: Cash Flow Signaling, Overinvestment and Dividend Clienteles. *Journal of Financial and Quantitative Analysis* 29, 567-587.
- Dyl, E., and R. Weigand, (1998). The Information Content of Dividend Initiations: Additional Evidence. *Financial Management* 27, 27-35.
- Easterbrook, F., (1984). Two Agency-Cost Explanations of Dividends. *American Economic Review* 74, 650-659.
- Fama, E. and H. Babiak, (1968). Dividend Policy: An Empirical Analysis. *Journal of the American Statistical Association* 63, 1132-1161.
- Fama, E. and K. French, (2001). Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay? *Journal of Financial Economics* 60, 3-43.
- Gonedes, N, (1978). Corporate Signaling, External Accounting, and Capital Market Equilibrium: Evidence on Dividends, Income, and Extraordinary Items. *Journal of Accounting Research* 16, 26-79.
- Gordon, M. (1959). Earnings and Stock Prices. *Review of Economics and Statistics* 41, 99-105.



- Graham, B., D. Dodd, and C. Tatham (1951). *Security Analysis*. New York: McGraw-Hill.
- Grullon, G., R. Michaely, and B. Swaminathan, (2002). Are Dividend Changes a Sign of Firm Maturity? *Journal of Business* 75, 387-424.
- Healy, P. and K. Palepu, (1988). Earnings Information Conveyed by Dividend Initiations and Omissions. *Journal of Financial Economics* 22, 149-175.
- Jensen, M., (1986). Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers. *American Economic Review* 76, 323-329.
- John, K. and J. Williams, (1985). Dividends, Dilution, and Taxes: A Signaling Equilibrium. *Journal of Finance* 40, 1053-1070.
- Julio, B. and D. Ikenberry, (2004). Reappearing Dividends. *Journal of Applied Corporate Finance* 16, 89-100.
- Koch, A. and Amy Sun, (2004). Dividend Changes and the Persistence of Past Earnings Changes. *Journal of Finance* 59, 2093-2116.
- Lang, L. and R. Litzenberger, (1989). Dividend Announcements: Cash Flow Signaling vs. Free Cash Flow Hypothesis. *Journal of Financial Economics* 24, 181-192.
- Lintner, J., (1956). Distribution of Income of Corporations Among Dividends, Retained Earnings and Taxes. *American Economic Review* 46, 97-113.
- Miller, M. and F. Modigliani, (1961). Dividend Policy, Growth, and the Valuation of Shares. *Journal of Business* 34, 411-433.
- Miller, M., (1987). The Information Content of Dividends. In *Macroeconomics: Essays in Honor of Franco Modigliani* (MIT press: Cambridge, Mass.), edited by J. Bossons, R. Dornbusch, and S. Fischer, 37-61.
- Miller, M. and K. Rock, (1985). Dividend Policy Under Asymmetric Information. *Journal of Finance* 40, 1031-1052.
- Nissim, D., and A. Ziv, (2001). Dividend Changes and Future Profitability. *Journal of Finance* 56, 2111-2133.
- Pettit, R., (1972). Dividend Announcements, Security Performance, and Capital Market Efficiency. *Journal of Finance* 27, 993-1008.
- Siegel, J., (2002a). *Stocks for the Long Run*, 3<sup>rd</sup> ed. New York: McGraw-Hill.
- Siegel, J., (2002b). The Dividend Deficit, *The Wall Street Journal*, February 13 2002, p. A20.
- Spence, M., (1973). Job Market Signaling. *Quarterly Journal of Economics* 87, 296-332.
- Venkatesh, P., (1989). The Impact of Dividend Initiation on the Information Content of Earnings Announcements and Returns Volatility. *Journal of Business* 62, 175-197.
- Watts, R., (1973). The Information Content of Dividends. *Journal of Business* 46, 191-211.
- Williams, J., (1938). *The Theory of Investment Value*, Cambridge: Harvard University Press.
- Yoon, P. and L. Starks, (1995). Signaling, Investment Opportunities, and Dividend Announcements. *The Review of Financial Studies* 8, 995-1018.