

Dividends Do Matter*

Two great myths have sprung up from the US bull market of the late 1990s. Firstly, increased share repurchases have offset the declining dividend payments. The second myth is that granting share options to managers align their interests with those of the shareholders. In this chapter we reveal a very different truth.

- Whenever we refer to dividends in the context of the USA, we are met with questions over the role of share repurchases. The consensus seems to be that increased use of repurchases has offset the decline in the dividend yield. The truth is that they haven't even come close!
- Too many investors focus on headline repurchase numbers without checking whether the announced repurchases are actually carried out. Actual buybacks by S&P 500 companies account for only around 55% of the oft-quoted headline figures. Even worse, many fail to adjust for equity issuance. Measuring net repurchases reveals a very different picture from the headline data.
- The total yield on the S&P 500 has fallen from over 5% in the late 1980s, to 2% in 2001! Why? Because shareholders have allowed managers to get away with blue murder. Giving management share options doesn't align their interests with equity holding investors. Rather, they have an incentive to seek to reduce dividends (since options aren't dividend protected), and increase the volatility of the firms' equity. They have exploited these incentives to the full.
- If investors are to protect their returns, these practices must be reversed.

*This article appeared in *Global Equity Strategy* on 12 April 2002. The material discussed was accurate at the time of publication.

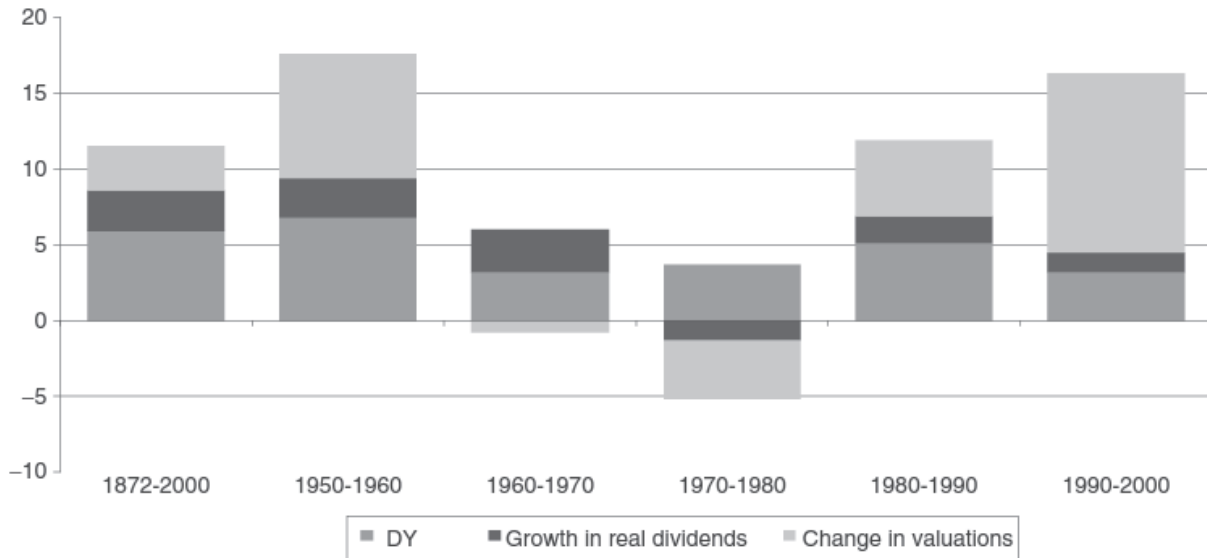


Figure 43.1 Decomposing returns (%).

Source: DKWR.

In the heady days of the bull market, dividends became a dirty word. When earnings growth was seemingly invincible, only the truly dull would concern themselves with the minuscule return embedded in the dividend yield. However, as earnings have started to disappoint, dividends started to gain more attention once more – witness the revival of value style investing.

In the past, we have opined that investors who choose to ignore dividend yield and dividend growth are making a mistake. In a world of small numbers, a far greater portion of investors' total return will stem from the dividend yield. Figure 43.1 is an example we have used before, but it bears repeating.

It shows the total nominal return to US equities (as proxied by the S&P 500) decomposed into its three components – dividend yield, real dividend growth and changes in valuation. *Over the long term, dividend yield has provided over 50% of the total return to equities!*

This bodes badly for the future. The S&P 500 dividend yield has fallen to a mere 1.6% (see Figure 43.2), and firms are paying out a paltry 32% of their earnings in dividends (see Figure 43.3). Scott McNealy, CEO of Sun Microsystems (\$8.10), opined in a recent issue of *Business Week*:

Two years ago we were selling at 10 times revenue . . . At 10 times revenue, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue rate. . . Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?

'Ahh', say the optimists, smiling knowingly, dividends don't matter any more. Repurchases have replaced dividends. At long last the world has recognized the inherent truth of the Modigliani and Miller (M&M) irrelevance theorem.¹ Furthermore, the bulls point out that in

¹ M&M showed that under conditions of perfect markets, investors should be indifferent as to whether a firm pays dividends or retains the cash, since this should just translate directly into future dividends for the investor.

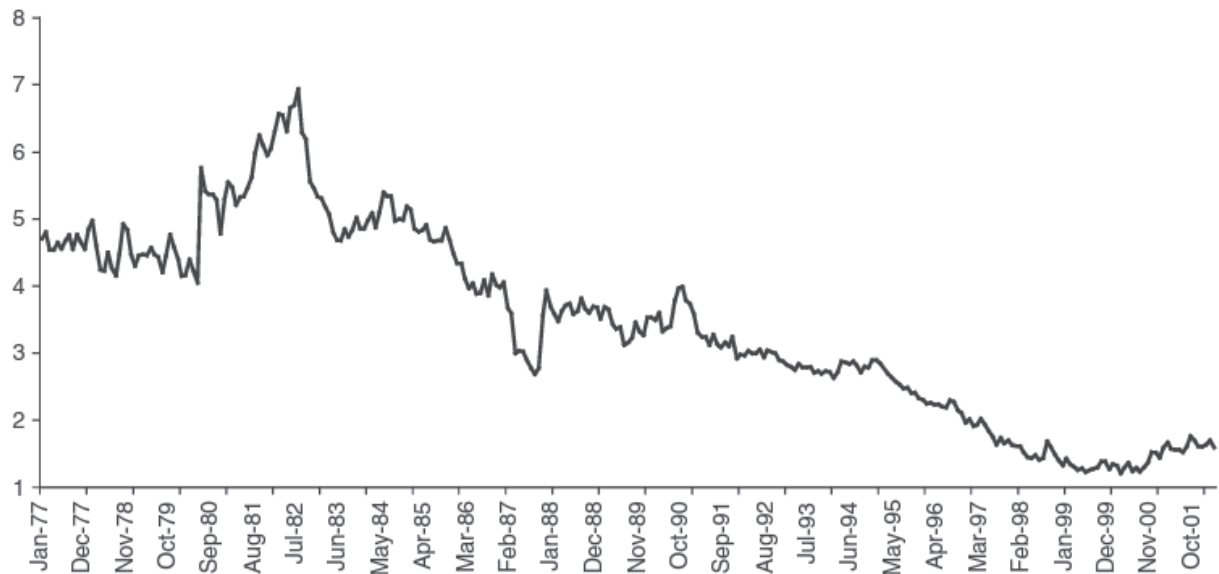


Figure 43.2 Dividend yield (%).

Source: Standard and Poor's.

a world in which income is taxed at higher rates than capital gains, people should actively prefer repurchases to dividends.

If only it were so simple! The first problem is measurement. It may seem that measuring repurchases would be a trivial exercise; however, it transpires it is far from easy. A firm can legally repurchase its own stock whenever it chooses without announcing its intention to do so.

However, by *announcing* a repurchase programme a firm can protect itself from the accusation of stock price manipulation (under rule 10b-18, SEC). Since *announcing* a repurchase

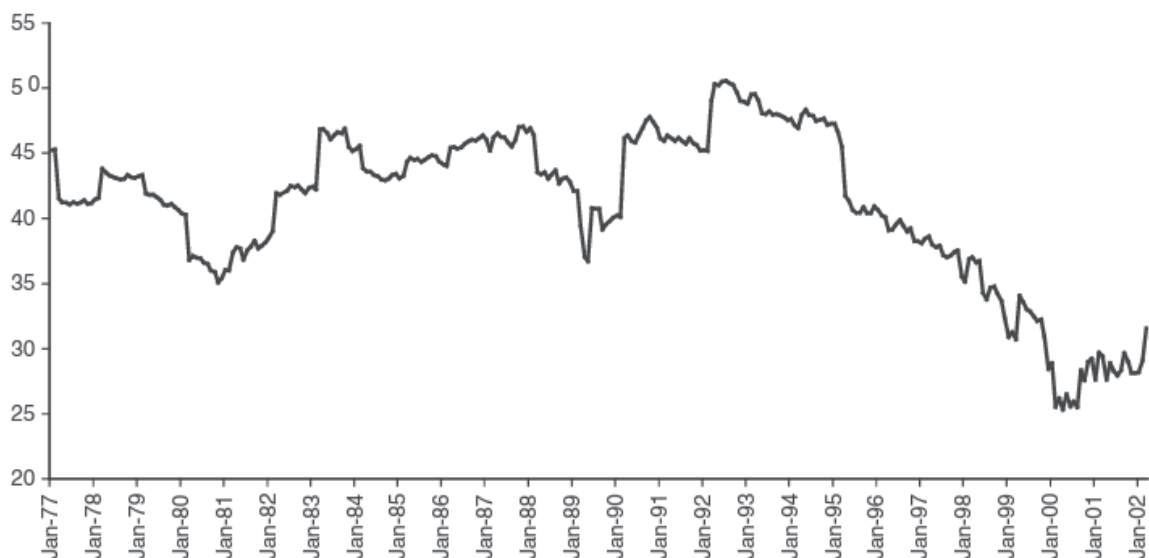


Figure 43.3 Dividend payout (%).

Source: Standard and Poor's.

Table 43.1 Repurchases: Announced vs Completed (\$mn)

	Announced buybacks	Completed buybacks by top 100 firms	Estimated total completed buybacks	%
Q4 2000	58,185	27,498	45,647	78
Q1 2001	54,621	24,577	40,798	75
Q2 2001	44,195	23,360	38,778	87
Q3 2001	77,589	27,484	45,623	35

Source: TrimTabs, DKWR.

programme is essentially costless to the firm, we can assume that virtually all firms *do* announce their repurchases.

These announcements are usually made over wire services, and collected by bodies such as Securities Data Company (now part of Thomson Financial). However, data from sources such as SDC may seriously overstate the true level of buybacks.

Firstly, an announcement of a repurchase is simply a statement of the firm's intention to buy back stock, the firm is not obligated to do so. The estimates in Table 43.1 suggest that around 80% of announced buybacks are actually completed (an opinion supported by academic work – (see Sniezek, Stephens and Weisbach, 1998).

Secondly, the aggregate dollar value of announced repurchase programmes reported by firms such as SDC overstates the total value of repurchases due to the methodology employed. For instance, firms may announce their repurchase programmes to multiple sources, i.e. on the wires and the press. SDC tends to count both announcements. Also, any programmes that are withdrawn do not get removed from the data, and privately negotiated also get counted as a repurchase under the SDC approach.

Thankfully, we can gain a better insight into the *true* level of repurchases via the statement of cash flows issued by US listed companies once a quarter. *In their cash flow statements, firms are required to report the actual dollar amount of repurchases carried out.*

Thus by aggregating across firms we can see just how much corporates are really spending in returning cash to investors. Figure 43.4 shows three series, the Dealogic announced buybacks series for the total market, the *actual* S&P 500 repurchases, and a line we have labelled net repurchases. The differences between the three are marked. Actual buybacks by firms in the S&P 500 fall well short of those reported by Dealogic – on average, actual S&P 500 buybacks are only around 55% of those reported by Dealogic.

The most interesting line from our perspective, however, is the bottom line, which we have labelled Net S&P 500 buybacks. Looking purely at repurchases is a dangerous game. It is the sort of game played by people who want you to believe that firms have been switching dividends into repurchases.

However, this ignores the *issuance* of equity that firms carry out. The relevant measure (in terms of assessing the returns to equity holders) is net buybacks – that is repurchases minus issuance. Figure 43.4 presents a very different picture from the gross repurchase series. Net repurchases are far more cyclical, indeed in the early 1990s, net repurchases were negative!

This fits well with the idea that net repurchases are used to disburse excess cash of a *temporary nature*. It has long been known that dividend changes are relatively infrequent, and managers will not raise dividends only to cut them a year or two later. For economists, think of

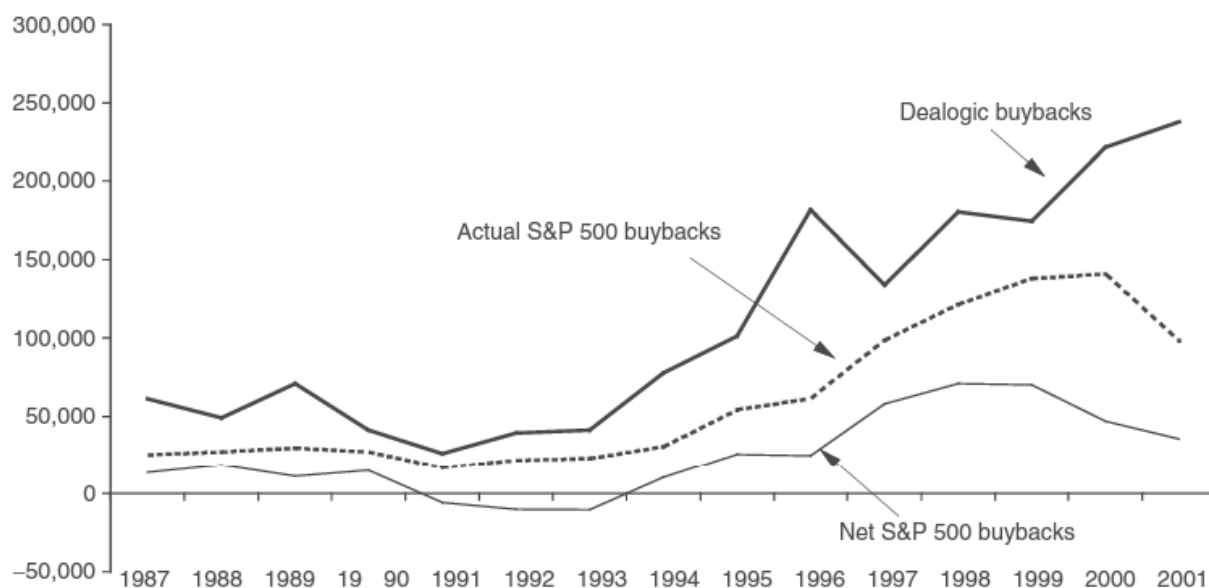


Figure 43.4 US buybacks – various measures.
Source: DKWR.

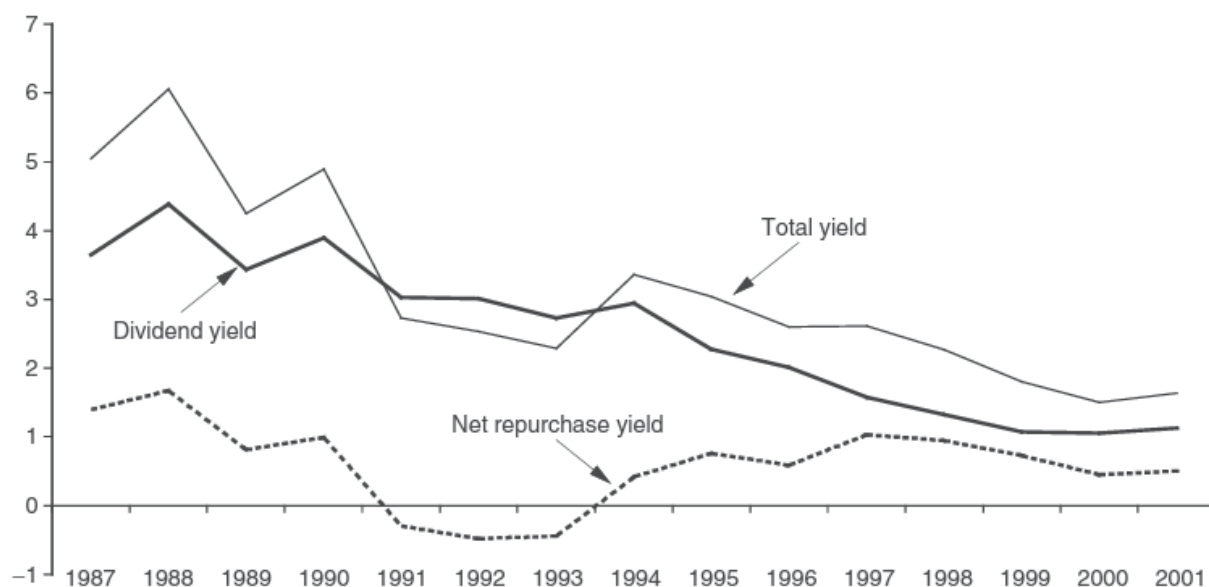


Figure 43.5 Total yield on the S&P 500.
Source: DKWR.

it as a corporate version of the permanent income hypothesis, permanent changes in cash flows are distributed via dividends, and temporary gyrations are dispersed via net repurchases.²

Figure 43.5 shows the very minor effect that net repurchases have had on the total yield return to investors in the S&P 500 – adding a mere 50 bps to the dividend yield in 2001. This is hardly massive recompense for the relentless decline in dividend yield over the last decade. Nor does it alter the downward trend.

So why have we seen such a massive surge in repurchases, and then an offsetting increase in issuance?

² A view confirmed by Lie (2001).

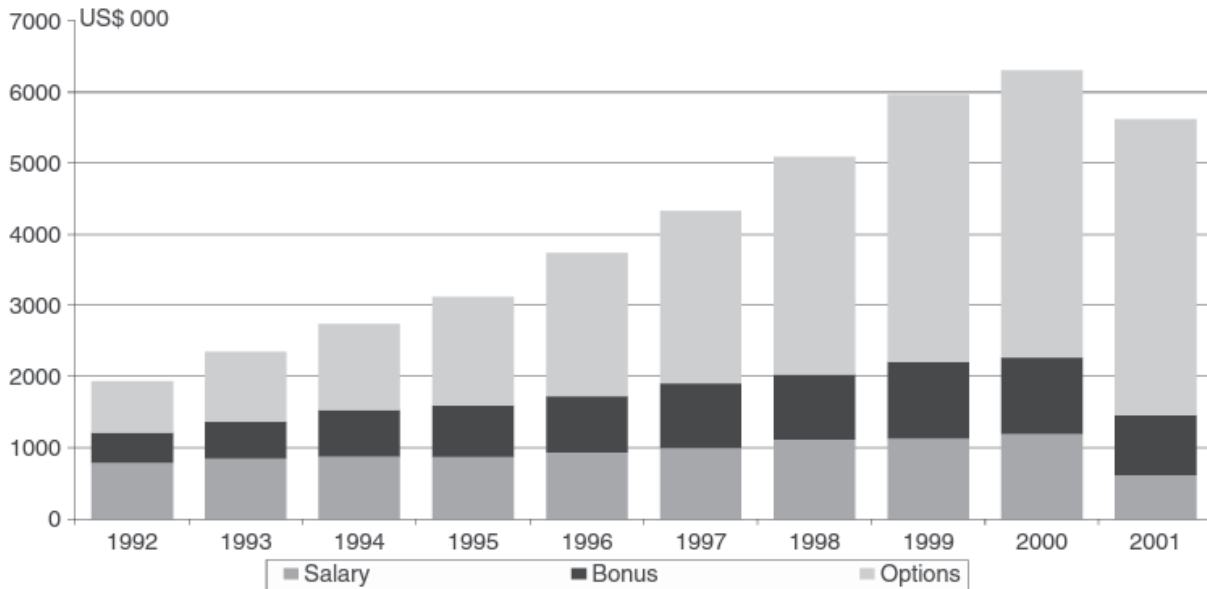


Figure 43.6 Median CEO compensation.
Source: DKWR.

The reason is not hard to find. The increased use of options must surely have a *prima facie* case to answer in this respect. One of the greatest myths of the bull market of the late 1990s was that options align the interests of shareholders and management. The idea that managers should have a financial stake in the business they are running is fine, otherwise we end up paying management like bureaucrats (to borrow an expression from Michael Jensen). However, this doesn't translate into loading them up with stock options (see Figure 43.6).

The value of an option depends upon six inputs (Capital budgeting and Finance 101): the riskless rate of interest, the price of the underlying security, the exercise price of the option, the time remaining until the option expires, the rate of dividend payment on the underlying security, and the volatility of the underlying equity.

Since executive options are call options, their value will increase with the underlying share price, and so having options supposedly ensures that managers will try to run the firm to increase the company's stock price.

However, managers also have some control over two other determinants of option values – dividend payments and the volatility of the underlying equity. Call option values are decreasing in the dividend level (dividend payments lower the stock price – share prices drop immediately after dividends are paid), and executive options are rarely dividend protected, hence the management's clear incentive is to reduce dividends as much as possible.

We don't believe in coincidence – the decline in dividends occurring simultaneously with the gearing up of management via stock options. Indeed, Jolls (1998) finds that the managers with the most stock options are much more likely to use repurchases rather than dividends.

Interestingly, she also finds that if managers are rewarded with restricted stock (which gives managers a share in the dividend distributions), the problem doesn't arise.

Secondly, managers can affect the volatility of a firm's equity. Remember that call option value increases in the level of underlying equity valuation. So managers loaded with options will seek to increase the volatility of the underlying equity. Two potential avenues for increasing volatility are to take on riskier projects (effectively increasing the left-hand side of the firm's



Figure 43.7 S&P 500 measures of leverage (%).

Source: DKWR.

balance sheet), and, secondly, to increase the leverage of the firm (increase the risk on the right-hand side of the balance sheet).

Let's deal with the second of these issues. If managers are seeking to increase the volatility of the firm's equity, we would expect to see evidence of increasing leverage. Figure 43.7 shows two regularly used measures of leverage – debt to equity, and debt to total capital employed. Of the two we prefer the latter measure simply because it removes the vagaries of equity market ups and downs (and not just that it fits our case – honest!). It clearly shows a trend towards higher leverage over the course of the option compensation explosion during the 1990s.

Option Impact on Earnings

Later, we will return to the issue of managers seeking to take on riskier investments, but first, indulge us in a little detour on the options impact on earnings. In the early 1990s, the FASB tried to force firms to expense their option grants, i.e. count them as a cost in the compensation figures. However, in the wake of protest from USA Inc. and a supportive legislature which threatened to remove the FASB's right to set accounting policy, the FASB's moves were relegated to footnotes in the annual reports.

However, for anyone desperate enough, the impact of option expensing can be uncovered by reading the small print – and believe me, having spent three days doing exactly that, it really is small print! Not everyone has filed their 10-ks for 2001 just yet, but with 62% of firms disclosed, we know that if options were fully expensed as per the FASB's recommendation, then GAAP reported earnings would be 17% lower than they are currently. Remember, that is GAAP reported, *not* pro forma! (See Figure 43.7).

Let us return to the issue of managers taking on “excessively” risky investments as a method of creating volatility. Certainly, the late 1990s can offer plenty of anecdotal examples of over

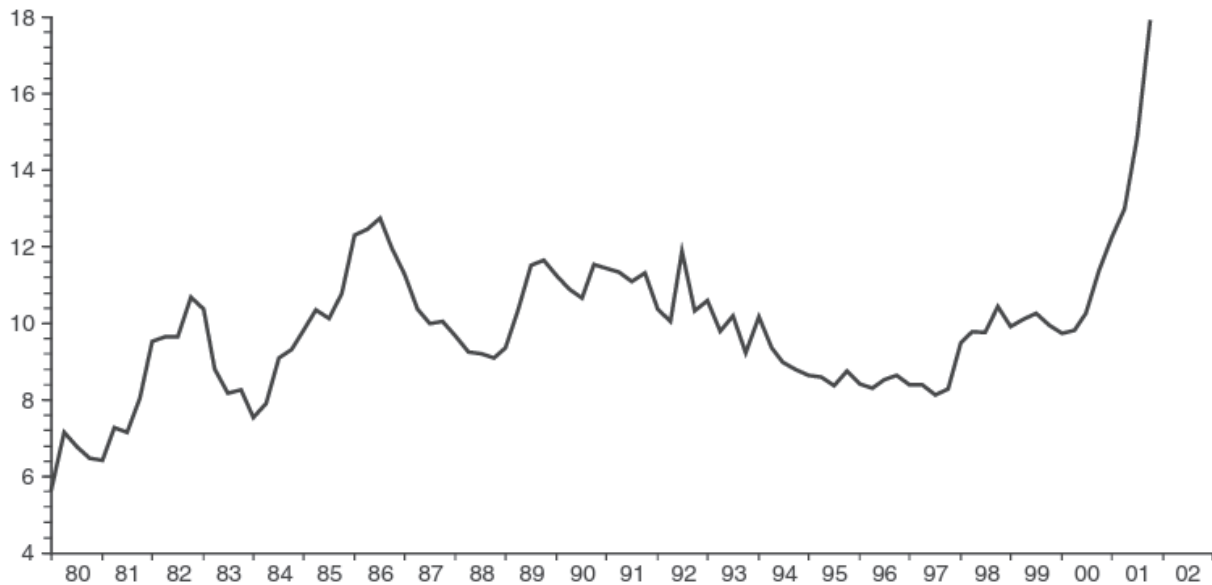


Figure 43.8 Whole economy – non-financial debt to profits ratio (x).

Source: Thomson Financial Datastream.

ambitious investment by corporate managers – witness the scale of the goodwill write downs that companies are now announcing.

Alternative evidence of inefficient investment can be found by looking at the relationship between earnings, dividends and retained earnings. It is often said that the earnings yield serves as a proxy for total returns from equities. The logic behind this statement is that the earnings yield implicitly consists of two elements – the dividend yield, and a “retained earnings yield”. If investment is efficient then the future dividend growth should be equal to the retained earnings yield.

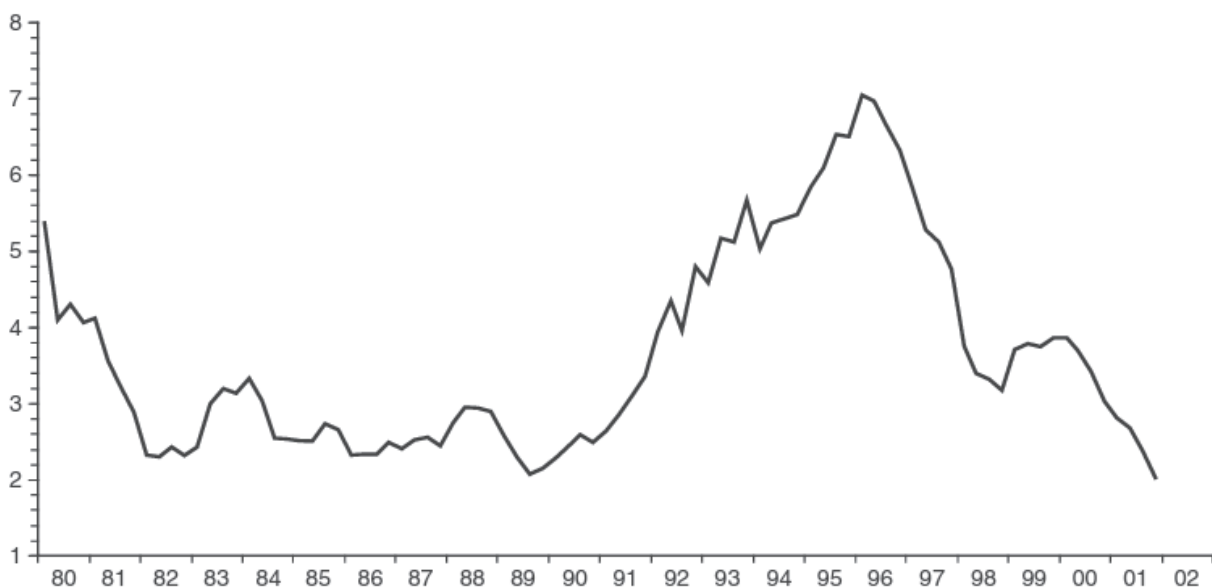


Figure 43.9 Whole economy – non-financial net interest cover (x).

Source: Thomson Financial Datastream.

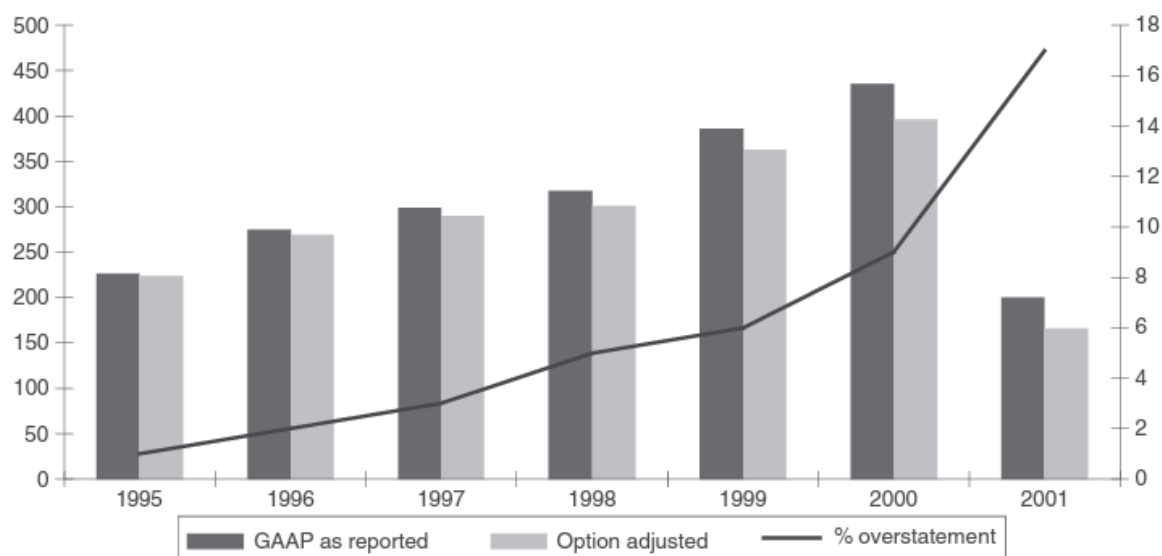


Figure 43.10 Option expensing impact on S&P 500 earnings.

Source: DKWR.

Table 43.2 Percentage earnings overstatement due to option non-expensing – S&P 500

Sector	2001	2000
Basic	14	7
Consumer cyclicals	72	6
Consumer non-cyclicals	6	7
Communications	32	31
Energy	7	3
Financials	9	7
Industrials	8	6
Technology	96	16
Utilities	3	2

Source: DKWR.

Table 43.3 Efficient investment – sadly not

Decade	Earnings yield (%)	Dividend yield (%)	Retained earnings yield (%)	Delivered real dividend growth rate (%)
1950–60	13.8	6.8	7.0	2.6
1960–70	5.8	3.2	2.6	2.8
1970–80	6.3	3.5	2.8	–1.3
1980–90	13.5	5.1	8.4	1.8
1990–00	6.6	4.2*	2.4	1.3

Source: DKWR.

*Adjusted for net repurchases.

If, on the other hand, investment is inefficient then future dividend growth will be below the retained earnings yield. Table 43.3 shows the decomposition of the earnings yield into the dividend yield and the retained yield. We have also shown the growth in real dividends achieved over the subsequent 10 years.

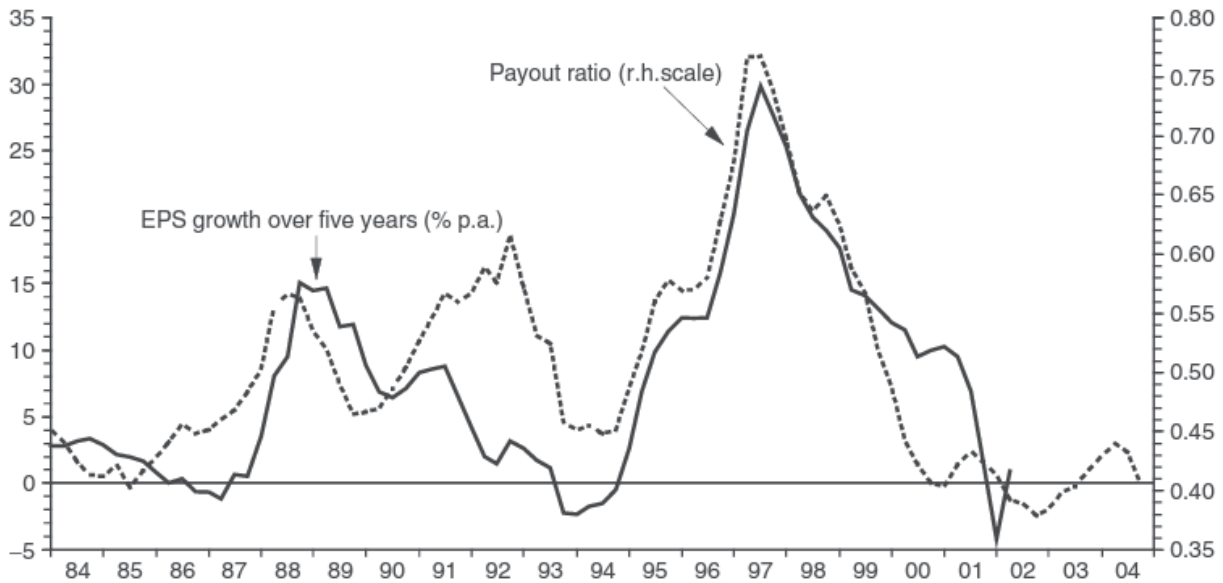


Figure 43.11 Inefficient investment?
 Source: Thomson Financial Datastream.

The results don't make comfortable reading for those who believe that corporate managers know best. In general, corporate managers have consistently failed to deliver real dividend growth even close to the retained earnings yield. That is to say, investors would have been substantially better off if managers had returned the cash to the shareholders rather than investing for them!

Only the 1960s stand out as years where corporate managers' investments seem to have been efficient. We have adjusted the 1990s for the increased use of net repurchases, and still managers have failed to deliver reasonable real dividend growth to investors. Over the 1990s,

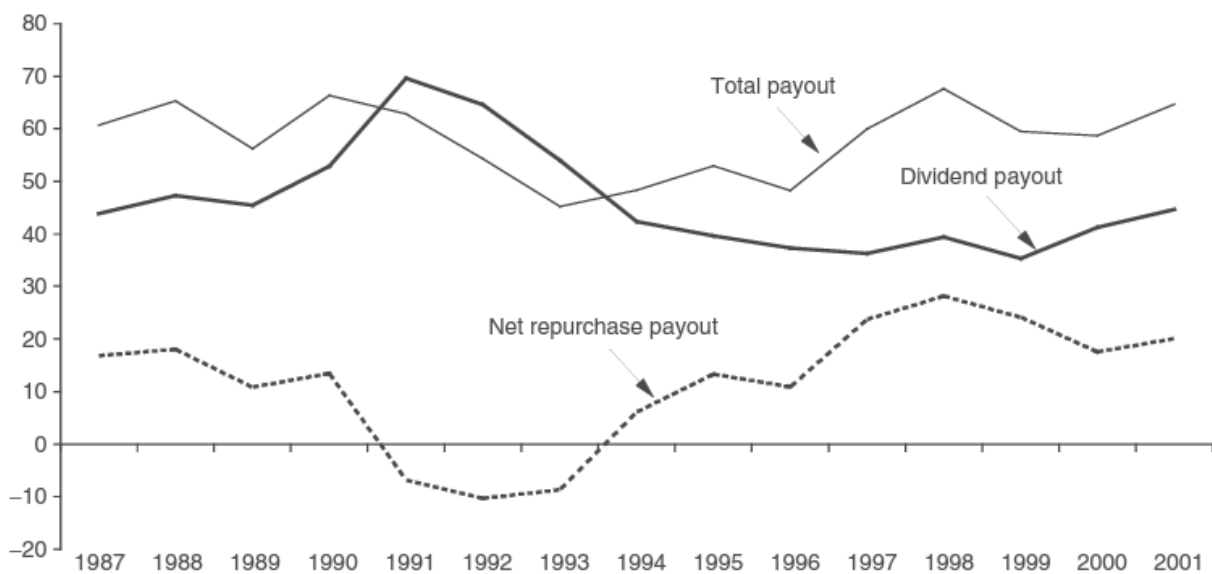


Figure 43.12 Total payout policy – using all firms (% of earnings).
 Source: DKWR.

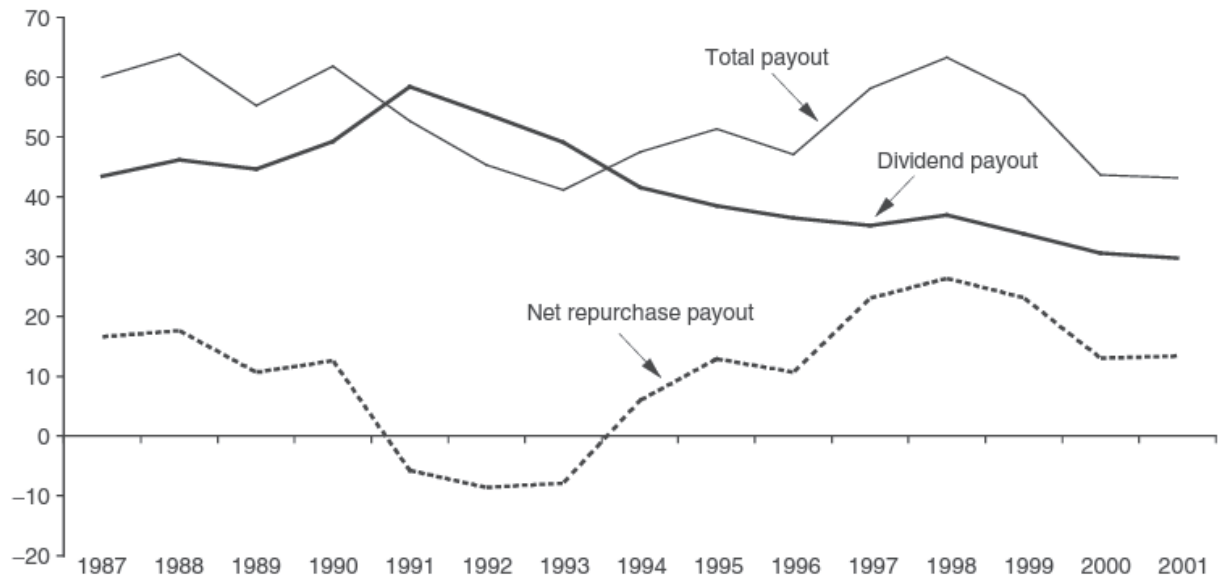


Figure 43.13 Total payout policy – positive earnings only (% of earnings).

Source: DKRW.

real dividends grew at a rate of just 1.3% CAGR, while the retained earnings yield required them to grow at 2.4%! This was still better than the 1980s, however!

So just how much money are firms returning to shareholders? Figure 43.12 shows the payout policy for the S&P 500, based on all firms, and using net repurchases. This figure makes the situation look good from a corporate point of view. The total payout ratio appears to be somewhere between 50% and 70%. So why am I criticising USA Inc. for its lack of cash distributions?

The answer is shown in Figure 43.13. This restates the payout policy using positive earnings only. Figure 43.12 uses *total* earnings, and hence lowers the denominator by including firms with negative earnings. If we strip out firms with negative earnings then the payout level is very different. Instead of paying out 64% of their earnings as Figure 43.12 shows, the rebased series shows corporates who created profits paid out a mere 43% of those earnings to investors in 2001. Given our comments above about the inefficient nature of investment by USA Inc., this doesn't bode well.

CONCLUSIONS

Investors should not be blindsided by two of the great myths stemming from the bull market of the late 1990s – firstly, repurchases *don't* offset reduced dividends, and, secondly, stock options *don't* give managers the same incentives as equity holders. Corporates should focus on returning cash to the owners and, failing that, they should concentrate on growing dividends – both have been sadly lacking from investors' experience in the US equity market over the 1990s.

Dividends, Repurchases, Earnings and the Coming Slowdown*

What is the US market yielding? That might sound like a simple question, but repurchases complicate the picture. If buybacks keep running at their current pace they will add 3 percentage points to the dividend yield in 2006! However, they appear to be used to distribute cyclical earnings. So high levels of buybacks could be an omen as to the extended nature of earnings and the risks ahead.

- In the past I have often noted that buybacks had not replaced dividends as a method of cash distribution. However, the latest data show an incredible pick-up in repurchases – even in net terms. If buybacks continue at the current pace, they could add 300 bps to the dividend yield of the US market. This would take the yield to just short of 5%, or approximately to its long-run average!
- Now, before you get all excited that I have written something vaguely bullish on the US, it is worth considering another point I have made in the past. That is, buybacks are used to distribute temporary (cyclical) earnings. Firms tend to only change their dividend policy when they believe it is sustainable. So buybacks are used to distribute earnings that deviate from trend. The trend rate of buybacks is probably closer to 50–100 bps in terms of dividend yield.
- As such, a very high repurchase level suggests that firms believe their earnings are at a cyclical peak. Our model shows that earnings are around 40% above their trend. This degree of extension usually marks peaks.
- Additionally, the payout ratio is soaring. According to our numbers, nearly 80% of earnings are being distributed to shareholders. The dividend payout ratio is only 30%, the rest comes from repurchases. It seems unlikely that firms will maintain this level of payout (much as I might approve of it).
- It is also worth considering whether repurchases are the best use of funds. For instance, 30% of firms in the S&P 500 have an earnings yield below the 10-year bond yield. Arguably, such firms could increase EPS more by investing in bonds than by buying back shares.
- Several indicators point to earnings peaking out. For instance, William Hester of Hussman Funds has pointed out that the Conference Boards CEO Confidence measure is a good lead indicator of profits growth. When CEO confidence is greater than 55, profits growth over the following 12 months averages 12%. When CEO confidence is below 45, profits growth averages 1%. CEO Confidence is rapidly heading towards 45.

*This article appeared in *Global Equity Strategy* on 31 August 2006. The material discussed was accurate at the time of publication.

- Of course, analysts are still expecting around 12% earnings growth over the next 12 months (and indeed 12% p.a. over the next 5 years). If they are right, then repurchases are likely to continue apace. However, personally I don't have much faith in their ability to forecast their way out of a paper bag, let alone earnings over the next 5 years!

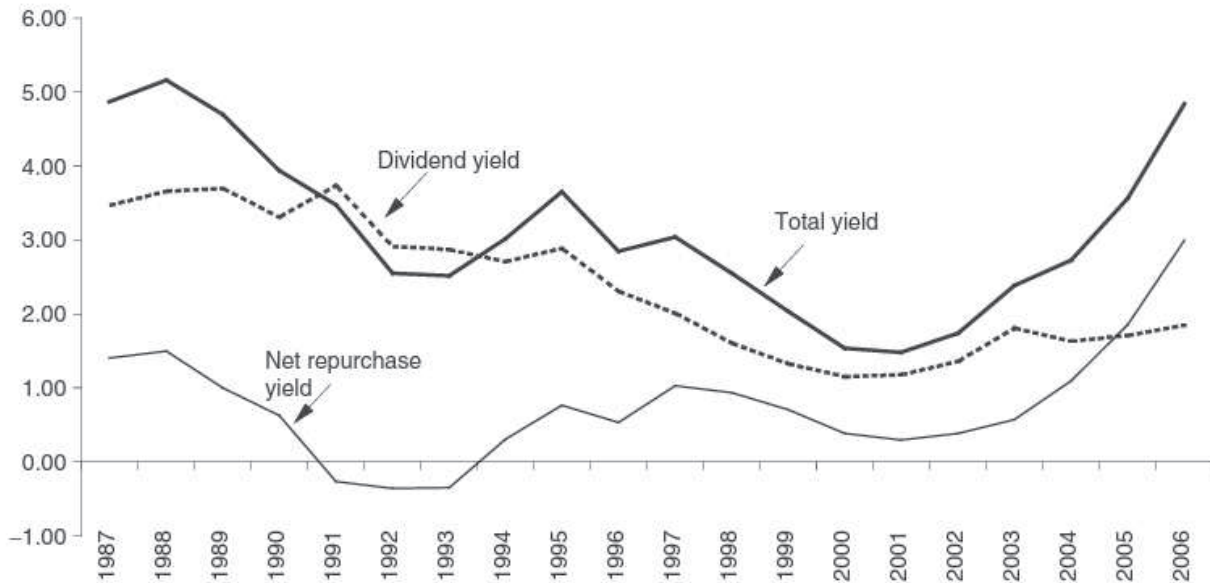


Figure 44.1 Dividends and repurchases in yield space (S&P 500, %).

Source: DrKW Macro research.

In the past I have often pointed out that, contrary to popular belief, buybacks have not exceeded dividends in terms of cash distribution mechanisms. However, the latest data show that I can no longer make this claim. In fact, if (net) repurchases continue at the rate seen in the first half of this year, they will add 3 percentage points to the dividend yield of the US market, leaving the market yielding just short of 5% (Figure 44.1).

To put this in perspective, Figure 44.2 shows the long run dividend yield with the buyback adjustment. In contrast to almost all our other valuation indicators, this suggests that the US market has repaired the damage done by the bubble years, and offers long-run fair value!

Figures 44.1 and 44.2 use the net repurchase yield which is the level of repurchases after all the issuance for share options has been deducted. However, US corporates continue to

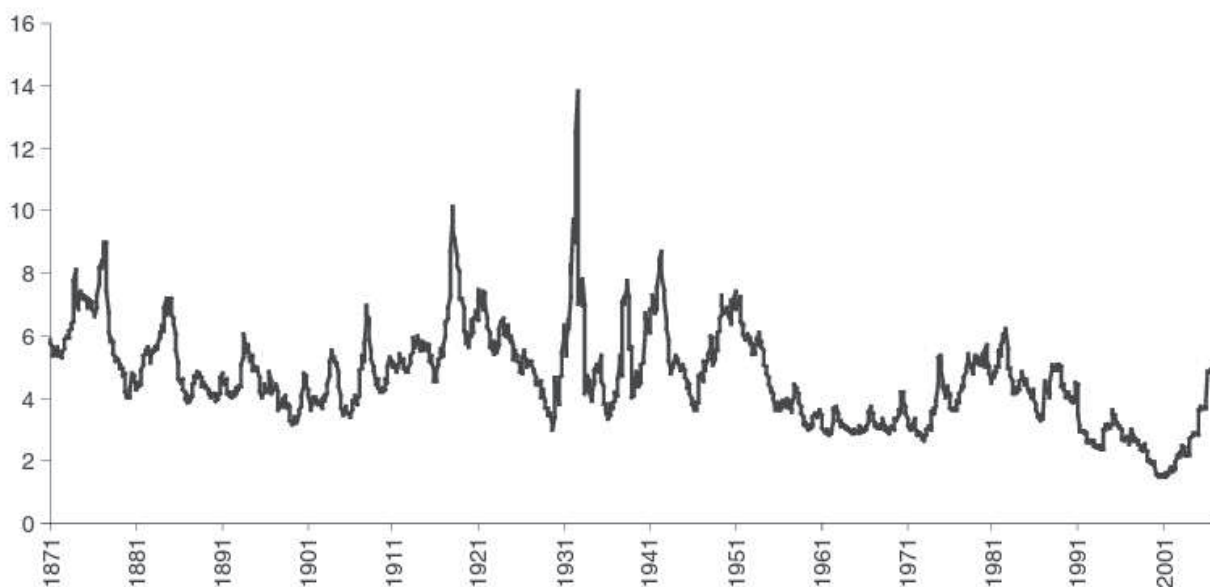


Figure 44.2 Buyback-adjusted dividend yield.

Source: DrKW Macro research.

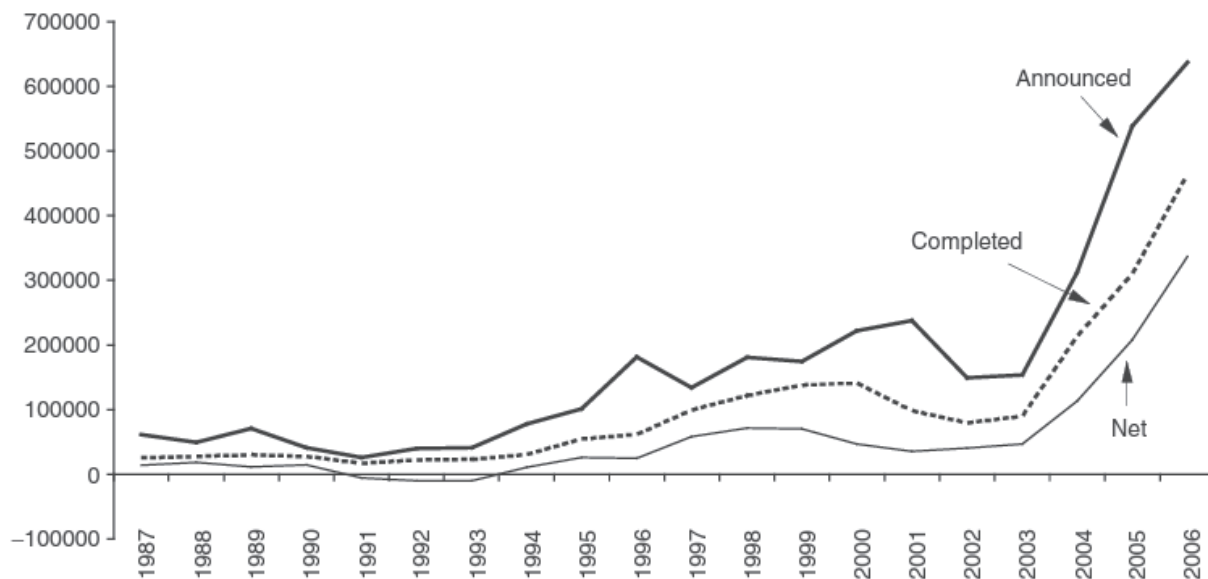


Figure 44.3 Announced, completed and net repurchases (US\$ mn).
 Source: DrKW Macro research.

announce far more buybacks than they actually manage to complete (let alone turn into net repurchases). On average since 1987, 57% of the announced level of repurchases are actually completed, and only 22% of announced buybacks actually translate into net repurchases.

In line with the surge in net repurchases shown in Figure 44.2, these numbers are significantly higher for H1 2006 (Figure 44.3): 73% of the announced repurchases have been completed, and 53% of announced buybacks have become net repurchases!

Before you all dash out and get very excited about the ‘fair value’ of the US market, it might be worth considering a point I have argued before – that is, repurchases are used to distribute temporary earnings.

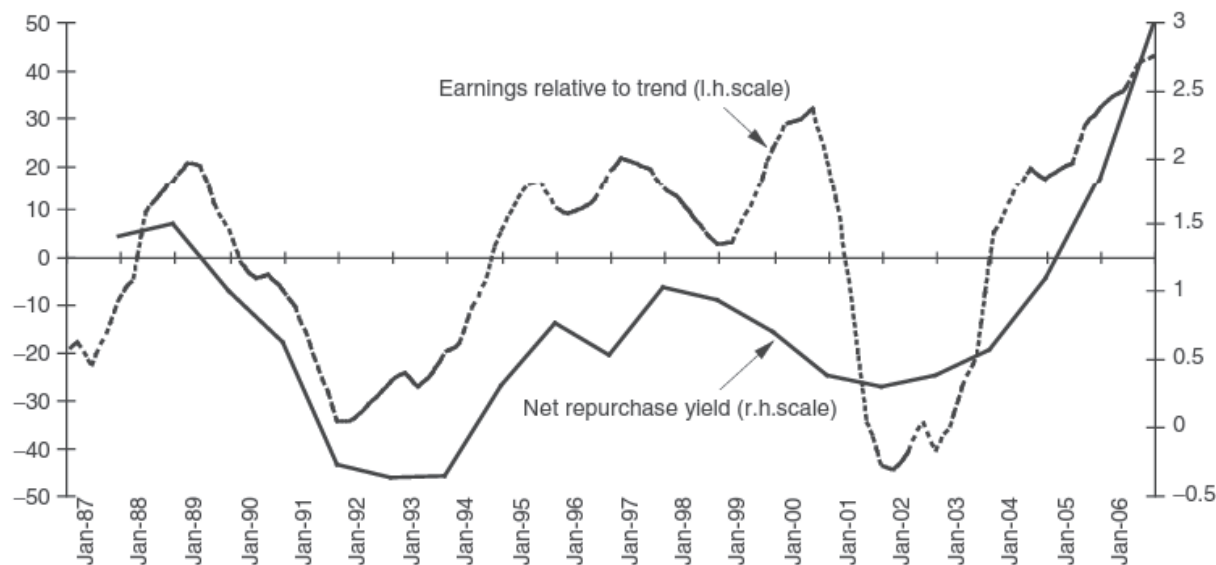


Figure 44.4 Deviation of US earnings from trend, and net repurchases (%).
 Source: DrKW Macro research.

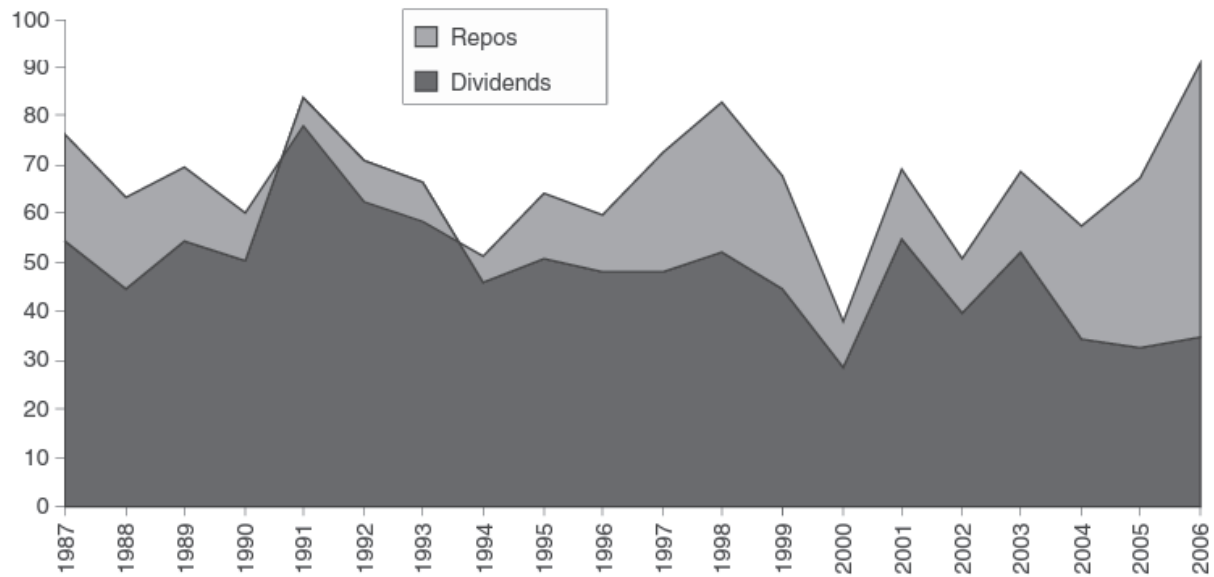


Figure 44.5 Buyback corrected payout ratio (%).

Source: DrKW Macro research.

If a firm increases its dividend, they are generally reluctant to then later cut the dividend as it sends a poor signal to investors. Hence dividend changes are not taken lightly by firms, resulting in a high degree of dividend stickiness.

However, repurchases are altogether more transitory in nature. Figure 44.4 shows the deviation of US earnings from their trend and the net repurchase series. The two are reasonably correlated. As earnings surge above their trend, so firms distribute cash via share buybacks. When earnings take a tumble, firms scale back on the level of the repurchases.

The willingness of firms to distribute cash has certainly surprised us. However there are limits on their ability to continue to do this. Firstly, firms' payouts are incredibly high. With

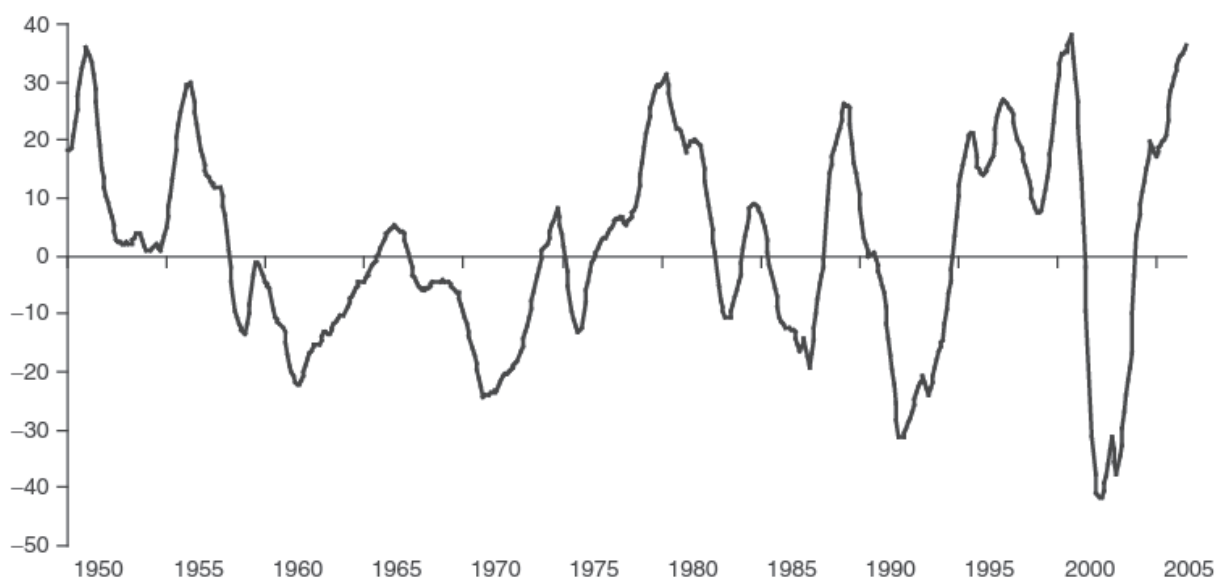


Figure 44.6 Deviation of US earnings from trend (%).

Source: DrKW Macro research.

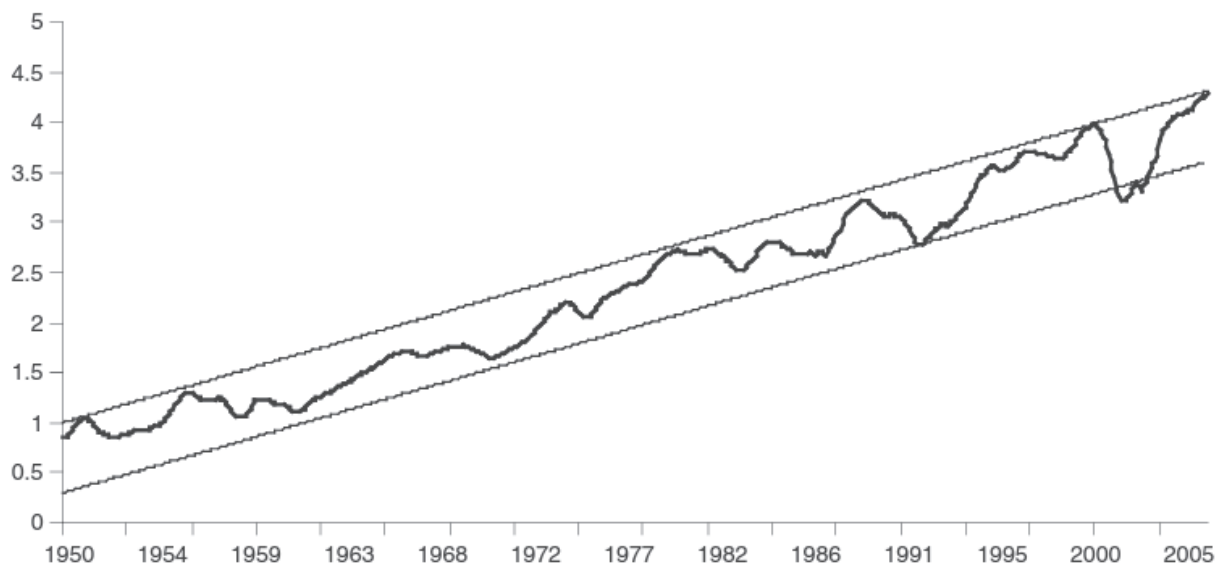


Figure 44.7 Log S&P 500 earnings and 6% channels.

Source: DrKW Macro research.



Figure 44.8 US earnings growth and the payout ratio (%).

Source: DrKW Macro research.

net repurchases included, firms are paying out nearly 80% of their earnings! (See Figure 44.5). It seems unlikely that firms will continue to pay out at this rate (much as I would like them to!).

Secondly, earnings are quite extended at the current juncture. Figure 44.6 shows the deviation from trend for US as reported earnings since 1950. At nearly 40%, this represents the peak levels seen in the post-war period.

A similar picture is revealed if one uses the approach suggested by John Hussman.¹ He uses Figure 44.7. Which uses log earnings that, when measured peak to peak (or equivalently

¹ See www.hussmanfunds.net

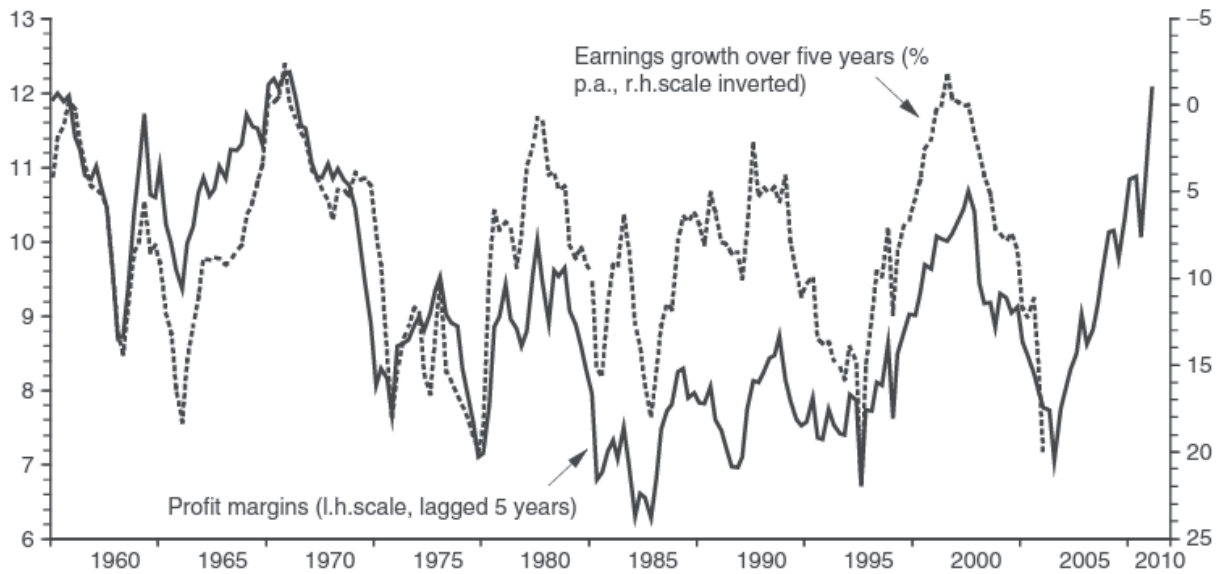


Figure 44.9 Profit margins and corporate earnings growth (%).

Source: DrKW Macro research.

trough to trough), show that US earnings have never ever grown by more than 6% p.a. Where are we right now? Right at the top of the channel – firmly in peak earnings territory.

There is also plenty of evidence to suggest that US earnings are likely to face cyclical pressure in the not too distant future. Much as I wish I could take credit for Figures 44.9 and 44.10, I can't. They come from John Hussman and William Hester. Both argue for a slowdown in US earnings.

Of course, you might prefer to believe the bottom-up analysts who are still predicting 12% earnings growth for both next year and over the next five years. In which case expect those repurchases to keep on rolling. Personally, somehow I doubt it.

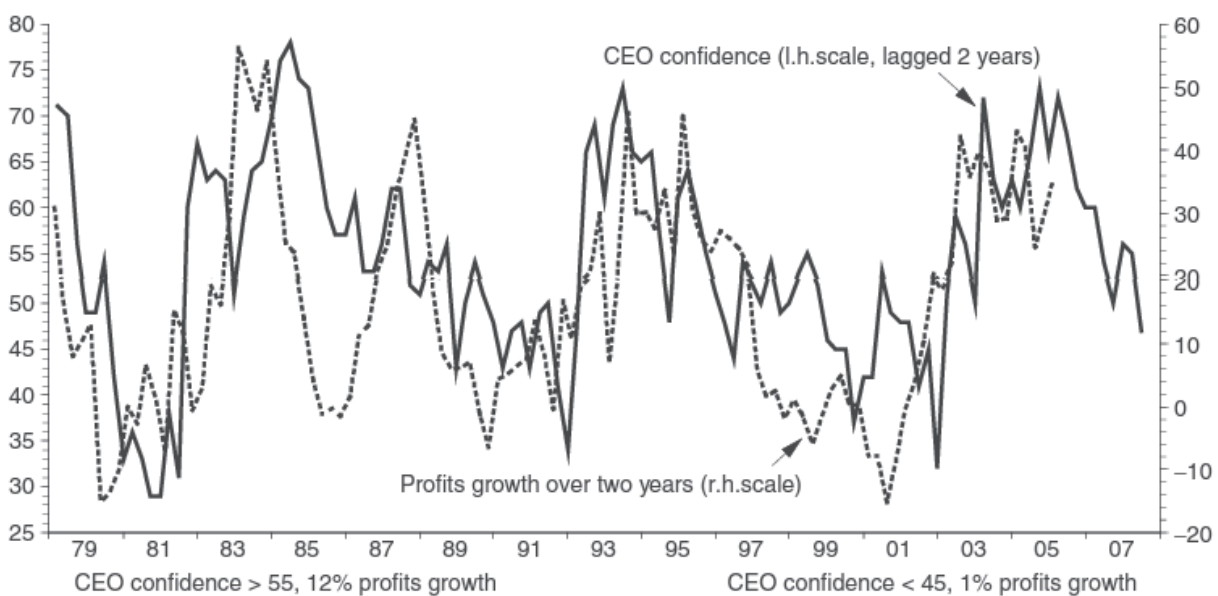


Figure 44.10 CEO confidence survey and corporate earnings growth.

Source: DrKW Macro research.