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The Pros, Cons and Paradoxes of Dividends [3 comments](#)

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Entrepreneurial investors have a low tolerance for broad generalizations and so-called "conventional wisdom." The frequent and sometimes fanatical debate over the pros and cons of dividends perfectly illustrates the reasons for our disgust with the passionately argued nonsense that so often passes for investment advice.

Dividends have been in the news a lot this year. Companies like General Motors ([GM](#)) and Citibank ([C](#)) have been attacked in the press and blogosphere for continuing to pay dividends even as they rush to raise capital elsewhere. Other companies take heat for lowering or eliminating dividends (or for not paying them in the first place). We think it's appropriate for shareholders to question these decisions, but one should fully understand the role of dividends and the company's cash flow before jumping to conclusions.

Generally speaking, dividend-paying companies do not need to reinvest all of their cash flow to maintain operations, and cannot reinvest all of their excess cash flow at a high rate of return. But generally speaking, speaking generally misleads investors. Let's discuss some of the typically reported pros and cons of dividends to see if they help or hinder one's understanding of the topic.

Benefits of Dividends

Supporters of dividend payments often refer to the practice as "bird in the hand" cash. Every dividend received reduces the risk of the investment and contributes to the long-term return. Some consider this analogous to owning a rental property, which presumably provides both cash flow and long-term equity growth. Certainly, companies paying regular dividends often appear in lists of overall return leaders.

Wire services publish a rash of dividend announcements every quarter, because the distribution of cash to shareholders holds great public relations value for the paying company. Such payments lend the appearance of stability and ample resources. When Tiffany & Co. ([TIF](#)) raised its quarterly dividend this year, some believe it was responding to Merrill Lynch's downgraded "sell" rating for the company.

Sometimes a stock gets a bump when announcing a dividend increase or a special dividend, but a broader effect is the "frequent flyer miles" syndrome. Dividends contribute to shareholder loyalty, which can make companies less susceptible to market volatility. For example, Tiffany's dividend announcement may have reassured shareholders that despite the downgrade, all was still well. It may have also lured new investors.

Long-term investors also like dividends because they make it easier to fund and automate "dollar cost averaging." In simplest terms, dollar cost averaging is the process of investing a specific amount of money on a regular basis, usually per month or quarter. When the stock price is high, the amount buys fewer shares, but when the price drops, it buys more shares. Over time, one accumulates stock at an average price well below its periodic highs. Direct reinvestment plans, or DRIPS, automatically reinvest dividends, which may improve compound returns.

Another argument one commonly hears is that the requirement to pay dividends tempers management's spending elsewhere, "saving corporations from themselves," as one columnist put it "Wasteful, egomaniacal corporate spending is rampant. It's not that executives aren't trying. But lacking a strong incentive to return the cash to shareholders, optimistic CEOs waste *your* money chasing projects that don't work out." Often, executives are compensated based on pre-tax earnings goals instead of per-share goals, and this situation can misalign executive and shareholder interests. Not all executives make bad capital allocations, but this illustrates the importance of studying management's historical capital allocation.

A 2003 study by Rob Arnott and Cliff Asness showed that despite their reputation as slow and stodgy companies, the highest dividend yielders actually had the highest earnings growth over the next decade. Obviously, dividends provide many benefits to shareholders. Except when they don't. Every benefit listed above also has a downside to be considered.

Detriments of Dividends

Dividends have been a better than usual deal for the past few years, because the 2003 Jobs and Growth Tax Relief Reconciliation Act lowered the tax rate on dividends. While this in fact spurred many companies to declare or increase dividends, one must remember that the shareholder pays taxes twice on dividends. First the company pays corporate taxes; then when they distribute some of what is left to shareholders, those shareholders are taxed again. Moreover, the tax reduction act only lasts until 2010, when dividend tax rates could very well skyrocket again. There is also a risk that the government could change this sooner. With double taxation and unsure rates, the bird in the hand starts to feel more like a sparrow than a plump pheasant.

Whoever said there is no such thing as bad PR did not own a public company in the age of the Internet. PR is always a double-edged sword, and sure enough, just as companies benefit by announcing dividends, they suffer horribly when they suspend or reduce dividends. The *Los Angeles Times Money & Co.* blog headline, "More shareholders getting stiffed on dividends" is a good example. The story cites statistics on the number of companies that didn't raise dividends, as well as the number that suspended dividends. But the story did not detail the specific companies' cash flow situations.

Throughout the press and blogosphere, critics have attacked Citigroup (C) for paying dividends while raising capital elsewhere and diluting shareholders, but Holman Jenkins posits another point of view in the *Wall Street Journal* (Dividend Dummies? May 28, 2008): the company made a smart decision based on the cost of capital. Jenkins maintains that Citigroup got a big influx of capital with long-term commitments, at a lower cost, and without offending loyal investors (and inciting bad PR) by slashing dividends.

Citigroup's financial difficulties make the cost of funds argument seem like a necessary rationalization for a company in dire straits, and critics are right to raise the problematic issue of "strategic" dividends: can one tell when a company is merely using dividends as "lipstick on a pig?"

We mentioned as a benefit that dividends temper management spending elsewhere, but some consider this the biggest problem with dividends. Some people believe companies pay dividends because they lack the ambition or ingenuity to find better paying investments. In this context, shareholder loyalty looks more like imprudent complacency. A growing company, it is believed, aggressively reinvests in itself by taking on new projects, share repurchases (when the equity is undervalued), acquiring new companies or other profitable assets, and even by investing in other financial assets. Investment decisions rely on an understanding of a company's intrinsic value, and the sources and uses of cash flow play a significant role in the equation.

Frankly, we see merit in all of the positions for and against dividends. In fact, we note that the lists of benefits and detriments are pretty much identical. When a subject's pros are the same as its cons, you have found a subject about which generalizations are pointless. And that is our point. There is no formula; each situation must be evaluated on a case-by-case basis, because every detail of cash flow is relevant and inter-related. Let's make a quick comparison of dividends and share buybacks to illustrate the case-by-case nature of such decisions.

Dividends versus Buybacks

Our position is that dividends are merely one optional use of "extra" cash flow. Share buybacks are another. Neither is a perfect or permanent solution to the disposition of cash.

Right off the bat, share repurchases eliminate the double-tax consequences of dividends, while increasing ownership percentage of shareholders. One could benefit from the buyback by selling shares, paying a tax rate based on length of ownership (income versus capital gains), but if one chooses not to take the cash, one benefits from a less diluted stock pool. Naturally, the current tax rates for income, capital gains, and dividends influence this decision.

The shareholder loyalty issue gets murky in this decision as well. Share buybacks provide immediate cash rewards for those who sell, whereas dividends provide incentives to hold the stock.

Some companies buy back stock *and* distribute dividends as a simple cost-of-funds decision. As Phil Weiss explained on The Motley Fool.com:

In some cases, companies will buy back stock by borrowing money. This can be done to change the relative allocation of debt and equity on the company's balance sheet. Since interest expense is tax deductible, there are companies that favor carrying some debt on their balance sheet due to the fact that it's cheaper to finance via debt than equity.

In other words, the costs of using shareholder money are too high.

But one way or another, it's all shareholder money, and that's key to the understanding dividends.

Long Live the King

The *Wall Street Journal* opened a May 12, 2008, story by advising:

When sizing up stocks in uncertain times, it's best to follow the cash." What an absurd comment. They might as well have said, "When water is wet, it's best to carry an umbrella in the rain.

Times are always uncertain in the stock market, so one should ALWAYS follow the cash.

As we wrote in *The Entrepreneurial Investor* (J.Wiley & Sons, 2007):

Most Wall Street analysts use earnings as a primary measure of valuation. This is no surprise, since these same analysts recommended Enron, WorldCom, and other famous disasters. The smart money pays attention to cash flow and how it is being managed...Some managers maximize cash flow and distribute it efficiently through new projects, share repurchases, and dividend payments, while others waste cash on terrible acquisitions and careless extravagance.

High levels of inside ownership often coincide with greater attention to the details of cash management. Managers with a big stake in the company may be less likely to squander resources through ego-driven acquisitions or PR influenced dividend distributions.

Cash is king, and the truth about dividends is that they are merely one optional use of cash flow. Share buybacks make great sense when the stock is cheap, but a regimented recurring distribution of dividends reduces a company's ability to invest opportunistically. Instead of making blanket statements about the superiority of dividends or share buybacks, investors should understand the context of each decision, and companies should consider eliminating recurring dividends in favor of situational, opportunistic cash flow decisions. A dividend is an investment, and like any other investor, the company and its shareholders must ask, "Is this the best use of our money right now?"

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