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CASE STUDIES

"Case Studies" presents a case pertinent to contemporary issues and events in investment management. Insightful and provocative questions are posed at the end of each case to challenge the reader. Each case is an invitation to the critical thinking and pragmatic problem solving that are so fundamental to the practice of investment management.

Jack L. Treynor, Senior Editor

THE DIVIDEND DECISION

The basic problem for the directors is the conflict between the needs of the retired shareholders and the needs of the company's banker. The banker needs a certain aggregate amount of equity for his margin of safety. Any dividend that threatens that margin is unacceptable to the bank.

Many retired households are restricting their consumption to their dividend income. It's painful to be poor. But it's even more painful to have to reduce consumption. If dividends fluctuated as much as share price, such households would experience a lot of pain.

These two groups have needs for predictability. When boards of public companies decide on the size of their dividend, how do they resolve the conflict? Here is one way to structure the dividend decision; it is probably not the only way or even the right way. The author hopes that it stimulates some constructive discussion.

The company in our example has two kinds of investors:

(1) retired households that limit their consumption to their dividends; and
(2) unretired households that consume a fixed portion of their wage and invest the rest in the company's stock.

Because it equals the difference between their wage and their consumption, the saving of the unretireds is predictable. In particular it doesn't depend on the share price.[1] Because the savings of the unretireds don't depend on share prices, any dividend they receive gets reinvested.

If the company cuts the dividend, retired households can sell shares to the unretired in order to maintain their consumption. But then the unretired will buy fewer new shares from the company. If the latter simply offsets the former, the net effect on the market value of its equity will be the same as if the company hadn't cut the dividend.

Not for Distribution

This could be disappointing to the company's banker.

The company in the following example is in a convenient kind of steady state: because the company isn't growing or shrinking, the number of employees entering the work force at age 25 equals the number of retireds at age 65 which equals the number dying at age 77. Salary, consumption, and savings rates are constant over the relevant time periods,

Assume:
Unretireds save 20% of their wage.
Retireds consume five-sixths of the unretireds' consumption.
Unretireds work from age 25 to age 65.
Retireds live from age 65 to age 77.

Then, because the company isn't growing, the aggregate savings of the unretired is

$$40 \text{ times } 0.20 = 8,$$

and the aggregate consumption of the retired is

$$12 \text{ times } 0.666 = 8.$$

We see that the dividend to the latter equals the savings of the former.

Questions

1. What if retired and unretired investors own different companies, with different dividend policies?
2. Do retireds tend to own more bonds?
3. How would it change our example if the public company were growing? Shrinking?
4. Wouldn't increasing the retirement age improve the numbers in our example?
5. Even if the author's approach is not the answer, isn't it time to take the problem more seriously?
6. Shouldn't corporate finance textbooks provide more guidance?
7. Isn't the dividend decision an appropriate problem for finance scholars?

Note

[1] To be sure, the latter probably stop saving when they lose their jobs.

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