



**THE
PURPOSEFUL
COMPANY**

Dividend policy in purposeful companies

The Purposeful Company Steering Group

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About The Purposeful Company

The Purposeful Company was established in 2015 with the support of the Bank of England to identify changes to policy and practice to help transform British business with purposeful companies committed to creating long-term value through serving the needs of society. The Purposeful Company has published extensively on Executive Pay, Corporate Governance, and Investor Stewardship, liaising closely with all main policy-making bodies during the governance reforms of recent years.

The Steering Committee comprises:



- Clare Chapman: Co-Chair of The Purposeful Company; Non-executive Director of the Weir Group, G4S plc and Heidrick & Struggles Inc; Chair of Acas
- Will Hutton: London School of Economics and Co-Chair of The Purposeful Company; former Principal of Hertford College, Oxford
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Should companies be paying dividends right now?

[Management Today article](#) by Alex Edmans – 7 May 2020

In the midst of a global pandemic, many companies are correctly focusing on society, by paying furloughed employees, donating products, and prioritising the most vulnerable customers.

But investors are reminding companies of their responsibilities to them. The Investment Association wrote to all FTSE chairs stressing that “dividends are an important income stream for pension funds and charities, as well as ordinary savers and pensioners ... shareholders would be concerned if companies unnecessarily reduced or rebased the dividend level.” The FT’s Lex column cautioned that “if all UK businesses stop paying dividends, the impact would be dreadful.”

So companies seem to be caught between Scylla and Charybdis. If they focus too much on employees and customers, they risk seriously harming their investors. It seems that they might have to let some workers go, to protect the dividend.

But this thinking violates a fundamental principle of Finance 101, known as the “free dividends fallacy”. Paying dividends does not increase shareholder wealth, because a dividend of £1 simply reduces the stock price by £1 – just as withdrawing from your bank account gives you more money in your pocket, but less in the account. Pension funds absolutely must satisfy their obligations to pensioners. But they can do so by selling their shares – and they can sell them at a higher price if the company cut its dividend.

Take a pension fund that needs to raise £1,000, and owns 1,000 shares worth £10. If the company pays a £1 dividend per share, the fund’s needs are met. But the share price falls to £9, so its holdings are now worth £9,000. If the company scrapped the dividend, the stock price remains £10. The fund could sell 100 shares for £10 to raise the £1,000. It’s left with 900 shares worth £10 each – so its holdings are again £9,000. Investors can always meet their liquidity needs by selling shares. They don’t need the company to meet it for them by paying dividends.

“Ah”, an investor might respond, “I remember that Miller-Modigliani principle from my finance textbook. But real life isn’t a finance textbook. The Miller-Modigliani assumptions don’t hold in the real world.”

That’s true. The assumptions are normally violated, so dividends are normally good for shareholders. But – critically – these assumptions may actually ring true in the crisis, meaning we’re back to dividends not affecting shareholder value.

One key assumption is that CEOs maximise value. In the real world, some pursue self-interest. If they didn’t pay out spare cash as dividends, they’d waste it on corporate jets. That’s a legitimate concern in normal times, where firms have enough cash to take all profitable projects, and so further investments may be wasteful. But, right now, companies are cash-strapped. They can’t even pay their workers, let alone make value-creating investments. They’re highly unlikely to waste the cash savings from dividend cuts.

Another key assumption is that CEOs have the same information about their company as investors. In the real world, they’re better informed, and a CEO who knows that his or her

firm's outlook is good will want to communicate this. Raising the dividend is a credible signal, because only if the firm's future is truly rosy will it be able to sustain the new dividend. Otherwise, the CEO would have to cut it later and see the stock price torpedoed.

But a CEO only has superior information about a firm's internal factors. In a crisis, most of a company's value is driven by external factors – government policy responses and whether the curve is flattening out – where the CEO has no special insight. Internal factors – how hard his or her firm has actually been hit – still matter but are less important. No company will be able to credibly signal that it's resilient by paying a high dividend. The only thing it will signal is how out of touch the CEO is.

That's where investors have a part to play. They need to communicate to boards that they realise that the world is now different. The reasons why, in normal times, they justifiably favour dividends, no longer hold true. Investors claim not to use box-ticking approaches to evaluate companies. Now is the time to step up and show this, by not greeting a dividend cut with the usual – and usually-warranted – negative reaction.

A responsible business absolutely needs to serve shareholders, in addition to wider society, because shareholders are a critical part of society. But a landmark theory shows that serving investors need not mean paying dividends. And this is a time when the theory actually rings true.

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Dividend policy in purposeful companies

A purposeful company needs to serve both shareholders and stakeholders. Evidence gathered in The Purposeful Company's Interim Report suggests that, in the long-run, there are far fewer trade-offs than commonly believed – companies that create value for society generate higher returns to investors.

But in the short-run, trade-offs do exist. These trade-offs are especially stark in the pandemic as cash is limited. It may seem heroic to retain all staff and maintain all environmental initiatives despite plummeting revenues; indeed, commentators argue that commitment to stakeholders in a pandemic is a true sign that a company is purpose-led. However, doing so may force it to cut dividends, and a purposeful company must also recognise its responsibility to investors.

Despite this responsibility, maintaining dividends need not be beneficial to shareholders. Shareholders care about total returns, and higher dividends reduce capital gains, leaving total returns unchanged. Alex Edmans, a member of TPC's Steering Group, wrote the preceding article in *Management Today* in May 2020 and a related article in the *Wall Street Journal*, "Why Many People Misunderstand Dividends and the Damage This Does", in June 2020 (the *WSJ* does not allow reprints, hence being unable to include this article). These articles advocate that companies adopt flexible dividend policies, where companies first take all profitable investments and then pay out excess cash as dividends (or retain it as a buffer), rather than the current practice of first maintaining the dividend and then investing only out of any cash that happens to be left over. Indeed, repurchases have this flexibility, and it provides a vital lifeline to companies. In Q2 2020, as the pandemic hit, S&P 500 firms were able to cut buybacks by 55%, but dividends by only 6%.

However, investors and executives may have concerns with moving to a flexible dividend policy. This paper discusses these concerns. It's based on a follow-up article in the *Wall Street Journal* that Alex wrote in July 2020 addressing reader questions on the original article, but expands on some in more detail. We group the potential concerns into categories, and address them in a Q&A format.

Dividends Are Important for Investors

1. Dividends are a safe income stream for investors. Stock prices move around all the time, but if a company is paying a £1 dividend, I'm guaranteed a £1 income.

Rigid dividends need not mean higher dividends. Under a rigid dividend policy, dividends will be higher for some firms in a given year – they have good investment opportunities, but rigidity means they will forgo them to maintain the dividend. However, other firms will have surplus cash. They may not increase the dividend, because they will be "committed" to the new dividend level – if they subsequently cut it (e.g., because the economy weakens), their stock price will plummet. Thus, they inefficiently hold onto the cash, but would pay it out under a flexible dividend policy. Overall, at a portfolio level, an investor may receive similar dividends under flexibility than under rigidity.

Moreover, thinking about income and capital gains separately is misleading. It's the total return that determines how much the investor's wealth has changed, and thus how much she can "afford" to consume. How the return is divided between dividends and capital gains doesn't matter in the absence of taxes; with taxes, dividends are less attractive since they're tax-

disadvantaged. That the dividend is guaranteed is irrelevant – it doesn't guarantee the investor a return. If the stock price falls from £10 to £6, a £1 dividend doesn't mitigate her loss, as it would cause the stock price to fall further to £5. The total return is independent of the dividend.

There are indeed many income-seeking investors – a pension fund needs to pay pensions to its beneficiaries, or a university endowment needs to pay staff salaries. However, such investors don't seek income as much as liquidity. It doesn't matter whether this liquidity is provided through dividends or capital gains – investors can always obtain liquidity by selling shares, even if a company doesn't pay a dividend. It may seem more prudent to consume out of dividends, as it doesn't require the investor to sell shares – hence rules such as “consume only from dividends, don't erode capital gains”. However, such a rule isn't logical, since a dividend is a withdrawal of capital from the company – just like selling shares. Consuming from dividends does erode capital gains, as the capital gain would have been even higher had the dividend not been paid.

Indeed, the emphasis on dividends is inconsistent with how many investors operate. Investors evaluate the performance of their investments based on total return, and vote for incentive packages that reward executives based on total return.

Thus, to address investor concerns with a flexible dividend policy, a starting point is to ask investors whether they agree or disagree with the proposition that total returns are what matter. In other words, are there any circumstances in which an investor would prefer a stock to pay a 9% dividend with zero capital gain than to return a 10% capital gain with no dividend? If not, then they should support a flexible dividend policy, as this allows a company to take the investments that maximise total returns. If so, it's useful to understand the reason for the preference for dividends. There may indeed be valid reasons; a potential one is below.

2. Time and effort are required to obtain liquidity by selling shares. It's much more convenient to receive dividends.

There may indeed be investors with a unique preference for dividends, not total returns. Even if so, an individual company can't create value by satisfying this clientele.

By analogy, some drivers like red cars; others like blue cars. Despite there being “red” and “blue” clienteles, a car company can't profit by changing its colour ratio, because the car industry is already producing the correct proportion to satisfy demand. Similarly, if dividend clienteles exist, some stocks could provide rigid dividends—perhaps mature companies that invest little—and dividend-seeking investors would hold them. Other companies can't gain by offering rigid dividends to satisfy these investors, as their needs have already been satisfied. They may lose, since rigid dividends hinder investment. Purposeful companies in particular would be hindered by rigid dividends, since investment in stakeholders is particularly important to them.

3. The stock price does fall when a company pays a dividend, but only in the short-term. The long-term stock price is affected by so many other factors, so the initial fall is irrelevant.

The dividend reduces the “baseline” level of the stock price; future changes are now off a lower base so the dividend has a permanent effect. Assume the current stock price is £10. Depending on interest rates, market irrationality etc., it has a 50% probability of rising by 50% (to £15) by year end, and a 50% probability of falling by 40% (to £6). If the company pays a dividend of £1, it falls to £9. The year-end stock price will still be affected by interest rates and irrationality. It could rise by 50% to £13.50, or fall by 40% to £5.40. In both cases, the stock

price is lower than without the dividend.

Revisiting the analogy in the original article: Paying a dividend is like withdrawing cash from an ATM. It gives you cash in hand but reduces your bank balance. It's true that your year-end balance will be affected by your bonus at work and household expenditure. But, irrespective of these factors, your year-end balance will be lower with the withdrawal than without it.

4. Dividends are safe. Keeping the money in the company is risky – the stock price is affected by many other factors.

This is the “bird-in-the-hand” fallacy, disproved in a [1979 article](#). The intuition is as follows. Reinvesting the £1 is indeed risky, but you get a return for that risk. In the above example, the expected year-end value is $50\% \times £13.50 + 50\% \times £5.40 = £9.45$. Without the dividend, it was £10.50, which is £1.05 higher. The reinvested pound earns a 5% return.

What if the company has no good reinvestment opportunities? It should indeed pay out the cash, but through flexible dividends or buybacks. Under rigidity, companies may hoard cash, because they're worried about creating a commitment.

5. You can reinvest dividends in other stocks, increasing your portfolio's return.

A company that doesn't pay dividends reinvests the cash within the firm, which grows the company's stock price as above. Doing so creates value for shareholders if the return on reinvested capital exceeds the return that shareholders can get elsewhere. Flexible dividends allow the company to take all investment opportunities that provide a return greater than the cost of capital.

Many non-dividend paying stocks have provided substantial total returns such as Alphabet, Amazon, Facebook and Tesla. It's curious that some investors accept either rigid dividends, or no dividends at all, but not a flexible dividend policy between the two extremes.

6. Flexible dividends – making dividends a lower priority than investment – means that shareholders will have a lower priority than stakeholders.

This isn't the case. It's shareholders who are the ultimate beneficiaries of investment – they receive the returns to both tangible investments in factories and intangible investments in human capital. Instead, flexible dividends allows a company to choose the investment policy that benefits both shareholders and stakeholders in the long-term.

Moreover, flexible dividends don't mean that companies should maintain all investments in stakeholders. Some companies (e.g. in the energy and travel industries) should permanently downsize, since demand will be permanently lower in a post-COVID world; paying dividends will allow capital to be reallocated to faster-growing sectors (e.g. biotech or cyber security). Flexible dividends allow companies to tailor their investment decisions to current commercial realities and societal needs, rather than being constrained by past history.

7. Encouraging investors to sell shares to finance consumption encourages short-term trading not long-term investing. This, in turn, induces short-termism among companies.

Short-term selling is [critically different](#) from short-termism – short-term sales can be driven by long-term information, and [evidence](#) suggests that that they are. For example, Ford Motor hit record profits in 2015 and 2016, but investors sold because Ford wasn't investing enough

in self-driving and electric cars. Indeed, the ideal shares to sell are ones with high stock prices but poor long-term prospects. Such selling is desirable *ex post*, as it reduces the stock prices of overvalued companies. Moreover, it's also desirable *ex ante* – knowing that it will have to sell some shares forces an investor to monitor its companies deeply, so that it won't sell ones with good long-term prospects. In turn, knowing that its investors will understand its long-term value, a company will focus on long-term value rather than short-term stock prices.

On the other hand, dividends are inherently “short-term” in that they withdraw funds from the company. Dividends also allow an investor to finance its liquidity needs without actively monitoring the companies that it owns.

8. If I sell shares to finance consumption, I might sell in a down market. E.g., I might have sold at the start of the pandemic for a low price, and the market has since rebounded.

It's important not to over-extrapolate from one example. The systematic evidence shows that stocks exhibit [time-series momentum](#): after they've fallen recently, they tend to continue to fall. The need to sell disciplines investors who are reluctant to take losses and thus would throw good money after bad.

There will certainly be some exceptions to the rule – cases in which the stock has fallen but management knows that it's undervalued and will rebound. If so, rather than paying dividends, it should use its spare cash to buy back stock.

Dividends vs. Buybacks

9. The article advocates returning capital through buybacks rather than dividends. But CEOs use buybacks to artificially hit earnings per share bonus targets.

This concern is frequently raised, but not supported by the evidence. A [study](#) that Alex, fellow TPC Steering Group Member Tom Gosling, and PwC did for the U.K. government found that not a single U.K. FTSE 350 used share buybacks to hit a bonus target between 2007 and 2016. U.S. [research](#) discovered that CEOs do take actions to hit bonus targets, such as cutting R&D, but buybacks aren't one of them.

10. CEOs buy back stock at inflated prices, destroying shareholder value.

A seminal 1995 [paper](#) found that U.S. companies that buy back stock outperform their peers by 12% over the next four years—they do so at depressed, not inflated prices. An updated and expanded 2019 [study](#) showed that the original results continue to hold, not only in the U.S., but globally (including in the U.K.).

Dividends Would Otherwise Be Wasted

11. The article assumes that, if dividends were not paid, the company would reinvest the cash profitably—but it may waste it. Dividends provide discipline and prevent overinvestment. They can only do this because they're rigid—they commit the firm to pay out dividends in the future.

Debt is a superior way to prevent overinvestment. First, it provides more discipline as it's a stronger commitment—a contractual one rather than a market expectation. Second, debt is tax-advantaged, as interest is tax-deductible. Third, debt [concentrates the CEO's equity](#), giving him a larger stake in the firm and thus stronger incentives not to waste cash. Indeed, there is an industry that makes use of these benefits—private equity. Contrary to popular claims of asset stripping, [research](#) finds that it creates long-term value.

If the firm wishes not to take on debt, there may be a role for rigid dividends to provide discipline, which must be traded off against the cost of preventing valuable investment. These

are the correct considerations to discuss when determining whether dividends should be flexible or rigid—not arguments that dividends are safe, or needed to provide a return to investors.

Dividends Are Positive Signals

12. Dividends are a positive signal of a firm's prospects. Since dividends are rigid, a company will only pay dividends if it's sufficiently positive about future prospects that it thinks it can sustain the dividend.

Repurchases are also a positive signal as they're an investment in your own company. Debt would be the strongest signal as it offers a stronger commitment.

Moreover, the value of signalling through dividends is much lower today. A CEO only has superior information about a firm's internal factors. In a crisis, most of a company's value is driven by external factors – government policy responses and the projected R rate – where the CEO has no special insight. Internal factors – how hard his firm has actually been hit – still matter but are less important. Few companies will be able to credibly signal that it's resilient by maintaining the dividend; in contrast, such actions may send a negative signal about the company's commitment to purpose.

An influential survey of CFOs found that “many of those firms that pay dividends wish they did not, saying that if they could start all over again, they would not pay as much in dividends as they currently do.” The current crisis provides companies with the opportunity to reset their dividend policy, particularly if other companies do so. Investors can play their part by encouraging such flexibility, *if* there is a good alternative use for the cash, just as many investors have highlighted to companies that they're not concerned if they miss short-term earnings targets in the pandemic. Indeed, just as the investment community – even before the pandemic – played a major role in encouraging companies to stop quarterly reporting to allow them to focus on the long-term, it can play a similar role in enabling companies to be flexible with their dividend policy.

The Purposeful Company

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