DIVIDEND POLICY : A FEW IDEAS TO REMEMBER

Does an optimal dividend policy exist ? A theoretical approach.

- When markets are in equilibrium, shareholders are indifferent to the level of dividends. In this case, the rate of return on equity is equal to the rate of return required by shareholders. In other words, every Euro plowed back into the business will yield exactly the kind of return shareholders are looking for. So its value will be 1 Euro. If this Euro is given back to shareholder, its value is obviously 1 Euro.

- Dividends are one of the best signals managers can give to the market. It is highly credible because cash has to be paid out. Consequently every unexpected move in the dividend level will be analyzed as a proof that the business is doing better (unanticipated dividend increase) or doing worse (unanticipated dividend decrease) than expected.

- **So the theoretical answer to the headline questions is NO.**

Some practical issues

- Managers usually have a pay-out ratio objective corresponding to the medium term growth perspectives of the business. In the short term, the pay-out rate may vary around this objective, as managers will try to avoid dramatically cutting or increasing the dividend per share.

- The higher the pay-out ratio, the lower the volatility of the share price.

- The higher the growth potential of a company, the smaller its pay-out ratio is likely to be (Microsoft and Infogrames have yet to pay a dividend).

- The lower the pay-out ratio, the more likely shareholders will be tempted to sell shares when they will need cash. In highly cash consuming industries (cognac, cement, pharmaceuticals,...) this explains why family companies tend to be sold to groups.

- A high pay-out ratio is something like a drug : shareholders tend to be accustomed to regularly receiving a high level of cash which may discourage them from selling their shares.

Conclusion

Two criteria allow us to analyze dividend policy :

- the marginal rate of return of a company versus the rate of return required by its shareholders;

- the signaling effect.