The manager’s dilemma

Dividends or Growth

The advent of dividend imputation has changed the way investors view the sharemarket—but not always in the expected directions. In this article, Ray H. Anderson focuses on the effect of dividend payouts on share prices and whether institutional investors prefer dividends to capital gains. He also gathers evidence on a range of theoretical and practical questions of dividend policy.

The volume of literature on dividend policy in the US and Australia testifies to its importance to investors and ultimately to valuation (Lowenstein 1991). In the Australian context, Partington (1984, 1989) has examined the use of target payout ratios, motives for paying dividends, how dividend policy is determined and variables that influence the decision.

Institutional investors play a central role in these issues. Insurance companies, superannuation funds and other financial institutions dominate the ownership of financial assets. Institutional ownership of shares in companies listed on the Australian Stock Exchange is close to 90 per cent by value. The trading activity of these institutions is a significant influence on the companies’ share prices.

This study examines two hypotheses. The first is that institutional investors believe that an increased dividend has a short-term positive effect on a company’s share price. This view is consistent with the results of behavioural research in the US by Baker (1988) and Baker and Farrelly (1988) into policy-makers’ perceptions of the effects of dividend payouts on the pricing of ordinary shares. It is contrary, however, to the argument of Miller and Modigliani (1961) that dividend policy does not affect the value of a firm. They arrived at their view by assuming a world without transaction costs and taxes, a given investment policy and fully informed, rational investors. Institutional investors clearly do not conduct their operations in such perfect markets.

The second hypothesis is that institutional investors prefer dividend income to capital gains. Since the introduction of dividend imputation in Australia, dividends may provide taxation benefits not available with capital gains (although any such benefits would depend on the institutional investors’ own taxation position).

The study was also designed to obtain opinions on 17 closed-end statements on theoretical questions involving the market’s reaction to and preference for dividends. These questions covered issues such as the riskiness of dividends compared with future capital gains, and share buybacks versus dividend payouts.

Survey design

The survey document was a questionnaire mailed to 37 investment managers who were members of the Australian Investment Managers Group (AIMG). This group was formed at the end of 1990 with the objectives of:

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advancing the integrity of the Australian capital markets;
- protecting the rights of investors;
- promoting the interests of investors;
- providing assistance to the various regulatory and government agencies in matters relating to investors’ interests; and
- assisting companies to understand the requirements of investors.

For reasons of confidentiality, the questionnaires were distributed by the AIMG secretariat on behalf of the writer. Twenty-six completed questionnaires were returned, representing a response rate of 70 per cent. All respondents had undertaken formal studies in accounting, with one-fifth of them holding a higher degree (see Table 1). Periods of involvement in investment varied, with the largest group having more than 20 years’ experience. Their positions varied; the most common titles given were general manager, investment manager or fund manager. The managers in the group sampled held total assets of $203 million.

**Dividends and share prices**

The traditional view is that increases in dividend payout may convey positive information to investors and that this may lead to an increase in share price. Such action would be seen as consistent with the objective of a company being able to create wealth for its shareholders. Equally, a reduction of dividend would be interpreted by investors as bad news, causing share-price weakness.

The results of this study support the hypothesis that institutional investors perceive that dividend increases have a positive effect on a firm’s stock price. Table 2 indicates that the second statement ("An increased dividend increases a firm's stock price") received most first-place rankings. This result seems to justify the close attention given by policy-makers to making and implementing dividend policy.

**Dividends vs capital gains**

Mixed evidence emerged in respect of the hypothesis relating to investor preferences for dividends or capital gains. Table 3 shows that the respondents, on the basis of first rankings, believed that investors either preferred capital gains or valued them equally with dividends. Dividends individually were less preferred than capital gains. When second rankings are included, the "equal value for dividends and capital gains" point of view is the most highly ranked choice. Capital gains by themselves are preferred by 69.2%, while dividends by themselves are preferred by only 46.2%.

**Imputation — before and after**

The Australian government introduced dividend imputation to apply from 1 July 1987 to the payment of dividends by resident companies to resident natural shareholders. Before imputation, the classical system for the taxation of company profits distributed as dividends operated in Australia. Under this system a company’s profits were taxable at the company tax rate. Shareholders were then taxed at their marginal rate on any dividends received. Effectively, profits were being taxed twice, first in the hands of the company and second in the hands of shareholders receiving dividends.

Under imputation, company tax is assessed in the normal way at the corporate tax rate (33 cents in the dollar). Dividends paid out of a company’s after-tax profit are referred to as franked dividends. For each dollar of franked dividends received the shareholder is allowed a tax credit equal to the grossed-up dividend multiplied by the corporate tax rate. Recipients of dividends from companies resident in Australia which have paid tax on the profits at the corporate tax rate (franked dividends) will have to pay tax only if their marginal rate is greater than the corporate rate. Unfranked dividends will be taxed in the hands of the recipients at their marginal tax rate.

Any capital gain realised is taxable at the recipient's marginal tax rate after an inflation adjustment for any change in value. Dividends have different effects on different categories of shareholders:

**Superannuation funds**

A superannuation fund for taxation purposes can be a complying fund or a non-complying fund. Whether or not a fund is complying or non-complying.

**Table 1: Profile of respondents (n = 26)**

<table>
<thead>
<tr>
<th>Years of involvement in investment business</th>
<th>Highest degree received</th>
</tr>
</thead>
<tbody>
<tr>
<td>20 years</td>
<td>Master's 19.2%</td>
</tr>
<tr>
<td>11-20 years</td>
<td>Bachelor's 80.8%</td>
</tr>
<tr>
<td>10 years</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>Total 100.0%</td>
</tr>
</tbody>
</table>

**Table 2: Dividend policy and share price**

The questionnaire states:
There is considerable controversy about how dividend policy affects share prices. Three opposing points of view are listed below. Based on your own knowledge and experience, please rank these three viewpoints in order of your level of agreement. That is, indicate the statement that you agree with most with a 1, the one that you agree with next with a 2, and the statement that you agree with least with a 3. (Use each rank only once.)

**Points of View**

A. Dividend policy has no effect on a firm’s share price (that is, dividends don’t matter).
B. An increased dividend increases a firm’s share price.
C. An increased dividend reduces a firm’s share price.

**RESPONSES**

<table>
<thead>
<tr>
<th>(n = 26)</th>
<th>Dividend policy effect on share price</th>
<th>Ranked &quot;1&quot;</th>
<th>Ranked &quot;2&quot;</th>
<th>Ranked &quot;3&quot;</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. No effect</td>
<td>11.5%</td>
<td>69.2%</td>
<td>19.3%</td>
<td>100.0%</td>
<td></td>
</tr>
<tr>
<td>B. Increase</td>
<td>88.5%</td>
<td>11.5%</td>
<td>-</td>
<td>100.0%</td>
<td></td>
</tr>
<tr>
<td>C. Decrease</td>
<td>-</td>
<td>23.0%</td>
<td>77.0%</td>
<td>100.0%</td>
<td></td>
</tr>
</tbody>
</table>

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ing will determine not only whether the fund will be taxed at concessional rates but also whether it will be entitled to special deductions, exemptions and other concessions.

To qualify as a complying superannuation fund, the fund must have a notice from the Insurance and Superannuation Commissioner stating that he is satisfied it meets conditions imposed under the Occupational Superannuation Standards Act 1987 or that he is satisfied that the fund should be treated as if it has met those conditions. These conditions include complying with prescribed operating standards and supplying the Insurance and Superannuation Commissioner with prescribed information.

The rate of tax imposed on the normal taxable income of a complying fund is 15 per cent. Dividend imputation is attractive because when dividends are fully franked the after-tax dividend income is greater and the franking rebate can be used to reduce tax on other income such as taxable contributions and interest.

Non-complying superannuation funds are genuine superannuation funds which do not comply with one or more of the standards required by the Insurance and Superannuation Commissioner. They are taxed on the income liable to taxation at the top personal marginal income tax rate.

The responses documented in Table 3 may well be influenced by the taxation status of respondents. However, it would be reasonable to expect that the bulk of, if not all, participants who were responding from a superannuation viewpoint were doing so from a complying fund perspective.

**Life insurance**

The introduction of imputation has a varying impact on life insurance companies. For normal taxpaying “ordinary” life funds, imputation credits will be important, and at the margin such funds will be less interested in capital gains on which they would be liable to taxation at the top personal marginal income tax rate.

The responses documented in Table 3 may well be influenced by the taxation status of respondents. However, it would be reasonable to expect that the bulk of, if not all, participants who were responding from a superannuation viewpoint were doing so from a complying fund perspective.

**Table 3: Dividends versus capital gains**

The questionnaire states: There is also dispute over investor preferences toward dividends versus capital gains. Based on your own knowledge and experience, please rank these three viewpoints in order of your level of agreement. As above, indicate the statement that you agree with most with a 1, the next with a 2, and the least with a 3. (Use each rank only once.)

**Points of View**

A. Investors as a group prefer dividends to capital gains.
B. Investors as a group prefer capital gains to dividends, since present tax laws favor capital gains.
C. Investors as a group place the same value on dividends and capital gains so that returns (relative to risk) are the same for high-yield and low-yield portfolios of equivalent risk.

**RESPONSES**

\( n = 26 \)

<table>
<thead>
<tr>
<th>Point of View (Dividend policy ranked on share price)</th>
<th>Ranked “1”</th>
<th>Ranked “2”</th>
<th>Ranked “3”</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Preference of dividends</td>
<td>30.8%</td>
<td>15.4%</td>
<td>53.8%</td>
<td>100.0%</td>
</tr>
<tr>
<td>B. Preference for capital gains</td>
<td>34.6%</td>
<td>34.6%</td>
<td>30.8%</td>
<td>100.0%</td>
</tr>
<tr>
<td>C. Value dividends and capital gains equally</td>
<td>34.6%</td>
<td>50.0%</td>
<td>15.4%</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

**Table 4: Investor dividend preferences**

A. All taxable investors with \( t_p > 0 \) will prefer earnings which have been subject to zero Australian corporate tax to be retained rather than distributed as unfranked dividends.
B. All taxable investors with \( t_p < t_c \) will prefer earnings which have been subject to full Australian corporate tax to be distributed as a fully franked dividend rather than retained within the firm.
C. Investors with \( t_p > t_c \) will prefer earnings which have been subject to full Australian corporate tax to be retained rather than distributed as a fully franked dividend.
D. Investors with \( t_p = t_c \) will prefer earnings which have been subject to full Australian corporate tax to be retained rather than distributed as a fully franked dividend provided \( t_g > 0 \).

\[
\begin{align*}
\text{where} & \quad t_c = \text{corporate tax rate} \\
& \quad t_p = \text{personal tax rate} \\
& \quad t_g = \text{capital gains tax}
\end{align*}
\]

**Other corporate investors**

Dividends received by other corporate investors form part of their assessable income but the recipients may receive a tax rebate if they satisfy the conditions of Section 46 of the Income Tax Assessment Act. The investors will also be entitled to any franking credit in relation to the dividends received. In effect, this means that the investor will pay no tax on the dividend and will also be entitled to a franking credit equal to the full amount of the dividend (if the dividend is fully franked).

**Dividend policy issues**

The final part of the study examined the opinions of institutional investors on 17 closed-end statements about various dividend issues. Table 4 lists the responses in the order of their mean values from the highest level of agreement to the highest level of disagreement.

There was a significant level of agreement with several statements relating to the information content of dividends. In particular, institutional investors are highly sensitive to the impact of changes in dividend policy on share prices. This is consistent with the empirical evidence (Woolridge 1983, Handjiinicolaon and Kalay 1984, Benesh, Kown and Pinkerton 1984).

Other evidence both supported and conflicted with prior studies. For instance, views on the riskiness of dividends compared with future capital gains were similar to the responses in an earlier study by Baker, Farrelly and Edelman (1985).