PART I

Dividends and Dividend Policy: History, Trends, and Determinants

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CHAPTER 1

Dividends and Dividend Policy: An Overview

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INTRODUCTION

An assumption underlying much of the academic finance literature is that managers make decisions that lead to maximizing the wealth of their firm's shareholders as reflected in common stock share prices. As Jensen (2001, p. 8) notes:

> *How do we want the firms in our economy to measure their own performance? How do we want them to determine what is better versus worse? Most economists would answer simply that managers have a criterion for evaluating performance and deciding between alternative courses of action, and that the criterion should be maximization of the long-term market value of the firm. . . . This Value Maximization proposition has its roots in 200 years of research in economics and finance.*

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The decisions of corporate financial managers fall into two broad categories: investment decisions and financing decisions (Baker and Powell, 2005). Investment decisions involve determining the type and amount of assets that the firm wants to hold, reflected on the left-hand side of its balance sheet. Financing decisions concern the acquisition of funds in the form of both debt and equity to support a firm's operating and investment activities. The right-hand side of a firm's balance sheet reflects these sources of financing.

Dividend decisions, as determined by a firm's dividend policy, are a type of financing decision that affects the amount of earnings that a firm distributes to shareholders versus the amount it retains and reinvests. Dividend policy refers to the payout policy that a firm follows in determining the size and pattern of cash distributions to shareholders over time. A company's board of directors, with the input of senior management, sets a corporation's dividend policy.

Under real-world conditions, determining an appropriate payout policy often involves a difficult choice because of the need to balance many potentially conflicting forces. According to conventional wisdom, paying dividends affects both shareholder wealth and the firm's ability to retain earnings to exploit growth opportunities. Because investment, financing, and dividend decisions are interrelated (Pruitt and Gitman, 1991), management cannot consider dividend policy in isolation from these other decisions. For example, if a firm decides to increase

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the amount of dividends paid, it retains fewer funds for investment purposes, which may force the company into the capital markets to raise funds. In practice, many corporate managers carefully consider the choice of dividend policy because they believe such decisions affect firm value and hence shareholder wealth (Baker, Farrelly, and Edelman, 1985; Baker and Powell, 1999). In addition, many investors view dividend policy as important because they supply cash to firms with the expectation of eventually receiving cash in return. Thus, managers typically act as though their firm's dividend policy is relevant despite the controversial arguments set forth by Miller and Modigliani (1961) that dividends are irrelevant in determining the value of the firm.

Yet much academic debate surrounds the role, if any, of how dividend decisions lead to achieving the goal of value maximization. The notion that dividends affect the value of a firm's shares is not new. For example, in writing his influential but underappreciated classic, *The Theory of Investment Value*, John Burr Williams (1938) was among the first economists to view stock prices as determined by intrinsic value and to articulate the theory of dividend-based valuation. According to Williams, a stock is worth only what you get out of it. Thus, the intrinsic value, or long-term worth, of a common stock is the present value of its future net cash flows in the form of dividend distributions and selling price. Graham and Dodd (1951) also believe that stock prices reflect an intrinsic value related to dividends and earnings. Building on the beliefs of Graham and Dodd, Gordon (1959) develops a valuation model in which the only relevant variables that determine a stock's value are dividends and the discount rate.

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Others are less sanguine about how dividends affect the value of a firm's shares. In their pioneering study, Miller and Modigliani (1961) (hereafter MM) provide an elegant analysis of the relationships among dividend policy, growth, and the valuation of shares. On the basis of a well-defined but simplified set of perfect capital market assumptions (e.g., no taxes, transaction and agency costs, and information freely available to everyone), MM set forth a dividend irrelevance theorem. In their idealized world, investment policy is the sole determinant of firm value. Therefore, if managers focus on making prudent investment choices, payout policy and capital structure should take care of themselves. MM's irrelevance message suggests that payout policy is an economically trivial issue that managers can largely ignore if they make sensible investment decisions. Early studies by Black and Scholes (1974), Miller (1986), and Miller and Scholes (1978, 1982) support the dividend irrelevance argument.

As DeAngelo and DeAngelo (2007) point out, MM's dividend irrelevance principle rests on an unstated assumption that forces firms to choose among payout policies that distribute 100 percent of the free cash flow generated each period by investment policy. In addition, stockholders are indifferent to receiving a given amount of cash as a dividend or through stock repurchases. Thus, MM's theory leads to the contentious conclusion that all feasible payout policies are equally valuable to investors. Yet DeAngelo and DeAngelo contend that the set of possible payout policies is not as limited as MM assume and that payout policy matters.

MM's unconventional and controversial conclusion about dividend policy irrelevance stirred a heated debate that has reverberated throughout the finance community for decades. Early criticism focused on MM's unduly restrictive assumptions as unrealistic. Consequently, if dividend policy is important to shareholders and affects stock prices, some of MM's assumptions must be wrong.

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Bernstein (1992, p. 176) notes, however, that the "MM theory was admittedly an abstraction when it was originally presented," and "no one—least of all Modigliani and Miller—would claim that the real world looks like this." Although examining dividend policy in perfect capital markets can provide useful insights about the conditions under which dividends may affect stock prices, the dividend irrelevance theorem can also be misleading. As Bernstein (p. 180) notes, "The final test of any theory is how accurately it portrays the real world, blemishes and all."

Upon leaving MM's abstract world of economic theory and entering the real world, the issue of dividend irrelevance becomes more debatable. Researchers responded to MM's conclusion of dividend policy irrelevance by offering competing hypotheses about why corporations pay dividends and why investors want them—the "dividend puzzle," as Black (1976) coined. For instance, some early theories that explain the potential relevance of dividends involve taxes, agency costs, and asymmetric information. Lease, John, Kalay, Loewenstein, and Sarig (1956, p. 46) refer to these explanations for dividend relevance as the "big three" frictions and to transaction costs, flotation costs, and irrational investor behavior as the "three little" frictions. Lease et al. (p. 196) conclude, "Dividend policy *can* have an impact on shareholder wealth because of various market imperfections." Because these imperfections affect firms differently, dividend policies may vary substantially among firms. In fact, Lease et al. develop a dividend life cycle incorporating market frictions to illustrate how dividend policy differs according to the phase of that cycle: start-up, initial public offering (IPO), rapid growth, maturity, and decline.

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In a much-cited article, Black (1976, p. 5) assesses the contributions of dividend researchers post-MM and concludes, "The harder we look at the dividend picture, the more it seems like a puzzle, with pieces that just don't fit together." Feldstein and Green (1983, p. 17) echo Black's sentiments, stating, "The nearly universal policy of paying substantial dividends is the primary puzzle in the economics of corporate finance." Miller (1986) also recognizes that one of the "soft spots" in the current body of theory is the preference that many corporations have for paying dividends. In fact, the surge of dividend research after MM led Ang (1987, p. 55) to observe: "Thus, we have moved from a position of not enough good reasons to explain why dividends are paid to one of too many." Despite a plethora of existing explanations, researchers developed additional theories to explain the dividend puzzle, including behavioral explanations and dividend theories involving the firm life cycle and catering theory. Empirical tests of these theories often result in conflicting results.

In a controversial paper, DeAngelo and DeAngelo (2006) claim that, contrary to MM (1961), payout policy is not irrelevant and that investment policy is not the sole determinant of value, even in frictionless markets. They point out that by relaxing MM's assumptions to allow for retention, payout policy matters. They also claim that Black's (1976) dividend puzzle is a nonpuzzle because the crux of the puzzle rests on the mistaken idea that MM's irrelevance theorem applies to payout and retention decisions, which it does not. If DeAngelo and DeAngelo's claims have merit, then MM sent researchers off searching for frictions that would make payout policy matter, when it has mattered all along.

The main objective of this book is to provide a synthesis of the literature on dividends and dividend policy that is an accessible discussion for students, managers,

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investors, and others interested in these topics. The book's central focus concerns how corporate decisions on distribution policy affect shareholder wealth. Using evidence from various methods, including survey research, the authors describe managers' views on dividends and how managers make dividend policy decisions. The book also documents researchers' attempts to model dividend behavior mathematically and relates dividend policy to share prices. Such attempts reflect varying degrees of success and failure.

The book concentrates mainly on dividends and share repurchases because they are the principal mechanisms by which corporations distribute cash to shareholders. Although most chapters deal with these distribution methods, others cover such dividend-related topics as dividend reinvestment plans, stock splits and stock dividends, and corporate governance. Although much dividend research centers on North American financial markets, the book also examines dividend studies from around the world. A brief of synopsis of each chapter in the book's six parts follows.

DIVIDENDS AND DIVIDEND POLICY: HISTORY, TRENDS, AND DETERMINANTS

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The remaining four chapters (Chapters 2–5) of the first part of this book discuss the history, trends, and determinants of dividends and dividend policy. Understanding the evolution and trends of dividend policy provides insights into dividend decisions, as does the identification of factors influencing dividends.

Chapter 2: The Historical Evolution of Dividends

Chapter 2 summarizes the evolution of dividend policy from the sixteenth century to modern times. The first corporations were short-term ventures that ended in full liquidation. As corporations became longer lived, managers faced the issue of how to make distributions to shareholders, and numerous firm-specific policies as well as laws developed to address how much corporations could pay shareholders. From the seventeenth to the nineteenth century, managers used dividends to influence share prices and to attract new capital. In the twentieth century, researchers developed various hypotheses to explain dividend policies. An overview of recent surveys and observed firm reactions to changes in tax laws provide additional insights into current dividend policies.

Chapter 3: Trends in Dividends: Payers and Payouts

Chapter 3 reviews recent trends in dividends and dividend payers and focuses on the phenomenon of disappearing dividends, which appeared in the United States during the end of the twentieth century, as first observed by Fama and French (2001). Researchers have advanced several possible explanations for the decrease in the propensity to pay dividends. To date, there is no universally accepted explanation. While one strand of the literature questions the existence of this phenomenon, another strand argues that the phenomenon has been only temporary, as the propensity to pay dividends has been on the increase since the new

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millennium. Finally, although studies on countries other than the United States have observed a similar decline in the propensity to pay dividends, the magnitude of the phenomenon is much less pronounced and much more recent.

Chapter 4: Factors Influencing Dividends

Chapter 4 synthesizes the academic evidence on the cross-sectional and time-series determinants of dividends. This evidence shows that dividends are associated with several firm characteristics, such as size, profitability, growth opportunities, maturity, leverage, equity ownership, and incentive compensation. The chapter also examines the relationship between dividends and characteristics of the market in which the firm operates, such as tax law, investor protection, product market competition, investor sentiment, and public or private status, as well as the availability of substitute forms of corporate payout, primarily repurchases. These findings have several implications for existing theories of dividend policy and suggest avenues for future research.

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Chapter 5: Cross-Country Determinants of Payout Policy: European Firms

Most research in dividend policy focuses on the North American financial markets and their associated regulatory environment. Chapter 5 focuses on dividend policies of European firms and other legal and regulatory regimes. It begins by examining the evolution of dividend policy to determine whether the key trends identified in the United States, such as the declining fraction of dividend payers and the concentration of dividend payers among large firms, also occur in Europe. The chapter then examines the major determinants of European payout policy, drawing largely from Bancel, Bhattacharyya, and Mittoo (2006). The chapter provides some reassuring evidence that the major factors influencing dividend policy are similar across countries. However, some country-specific differences exist, indicating that dividend policy is a complex interaction of a country's legal and institutional structure with firm characteristics such as ownership structure.

CASH DIVIDENDS: THEORETICAL AND EMPIRICAL EVIDENCE

Part II contains eight chapters (Chapters 6–13) and focuses on the critical issue of whether dividend policy is relevant or irrelevant. At the heart of the dividend puzzle is whether dividend policy affects share prices. Some believe that payout policy is irrelevant because they contend that only investment policy affects value. Thus, one dividend policy is as good as any other. Others support dividend relevance, in which case dividend policy affects value. Despite voluminous study, researchers have been unable to identify the "true" relationship between dividend payments and stock prices.

Although dividend policies may take many forms, two generic classifications are a residual dividend policy and a managed dividend policy. With a residual dividend policy, a firm pays dividends from earnings left over after meeting its

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investment needs while maintaining its target capital structure. This passive approach assumes that investors prefer that firms keep and reinvest earnings. A managed dividend policy is one in which management attempts to achieve a specific pattern of dividend payments. According to certain MM assumptions, a managed dividend policy is irrelevant because such a policy would not increase shareholder wealth. Thus, corporate managers who believe that dividend policy is relevant would engage in some type of managed dividend policy.

Chapter 6: Dividend Irrelevance Theory

In their pioneering work, MM (1961) show that, under certain assumptions, dividends are irrelevant to total firm value. Their work represents a radical departure from previous views of dividend policy and is one of the first to use analytically rigorous techniques to address a finance issue. In addition, the influence of dividend irrelevance theory on finance research has been profound. Researchers have attempted to find reasons that dividends exist, and the focus has usually been either on market frictions, such as taxes, transaction costs, and imperfect information, or on behavioral considerations, such as investor preferences. Despite the hallowed status of MM's work, DeAngelo and DeAngelo (2006) have attacked the irrelevancy proof as well as the related research stream that attempts to find reasons for relevance.

Chapter 7: Residual Dividend Policy

The concept of a residual dividend policy has deep roots in the financial literature and underlies important theoretical work. Among the recommendations of agency theory is a residual dividend policy specifying that managers pay shareholders the free cash flows remaining after funding all profitable investments. Empirical evidence suggests that firms generally do not follow this type of policy. Instead, firms generally maintain a smoothed dividend sequence that is as strongly related to past dividends as it is to current earnings. In addition, firms build up cash balances to fund future investments. When a funding shortage occurs, firms often use short-term borrowing rather than cut the dividend. Managers' responses to surveys about residual dividend policy generally indicate that if the free cash flow versus dividend time series appears to indicate a residual dividend policy, this is largely coincidental and not a product of the firm's intended policy.

Chapter 8: Taxes and Clientele Effects

According to tax preference theory, rational investors prefer that firms retain cash instead of paying dividends when tax rates are higher on dividends than on long-term capital gains. Thus, firms should keep dividend payments low if they want to maximize share price. Supporters of this theory also contend that investors in high tax brackets prefer stocks with low dividend yields while investors in low brackets prefer stocks with high dividend yields. These situations represent clientele effects. Studies often use variations in the tax rates on dividend income and capital gains to examine the effects of taxation on dividend policy. Given a lack

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of compelling tax changes and fully convincing research designs, previous studies provide conflicting results. More recent studies offer new insights by showing that a firm's ownership and governance structure affect the relationship between taxation and payout policy.

Chapter 9: Agency Costs and the Free Cash Flow Hypothesis

MM (1961) posit that dividend policy is irrelevant to firm value, but empirical evidence shows that a firm's stock price typically moves in the same direction as that of the dividend change. According to the free cash flow model, the market reacts positively (negatively) to the news of dividend increases (decreases) because the potential for managers to misuse excess funds decreases (increases). This model implies that the market reaction to dividend-change announcements is greater for firms with higher overinvestment potential than for those with lower overinvestment potential. Empirical evidence typically supports this hypothesis. Another implication of this model is that the role of dividends varies depending on the severity of the agency problem. Consistent with this supposition, studies report that variations in corporate governance mechanisms may explain the variations in dividend policies across countries. In addition, there is little evidence to suggest a relationship between dividend changes and changes in future profitability. The cumulative evidence suggests that the free cash flow model helps to explain the market reaction to dividend changes.

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Chapter 10: Asymmetric Information and Signaling Theory

The basis of signaling theory is the premise of asymmetric information, where managers have access to information that the market does not. Thus, corporate financial decisions can be viewed as signaling devices that a company's managers send to investors to communicate information, which reduces asymmetries. Changes in dividend policy are one such device at the managers' disposal to communicate information to the market about the future prospects of the firm. Chapter 10 explores the research into whether abnormal returns result from various financial decisions that managers make. Overall, most empirical evidence tends to support theoretical models regarding the ability of dividend changes to affect share price. Unexpected dividend increases (decreases) are associated with significant share price increases (decreases).

Chapter 11: Behavioral Explanations of Dividends

Chapter 11 develops a behaviorally based theory for why individual investors find dividends attractive and presents a combination of anecdotal evidence and empirical evidence supporting the implications of the theory. The behavioral elements underlying the theory include self-control, mental accounting, hedonic editing, and regret aversion. The theoretical implications pertain to the impact of age, income, and retirement status on two relationships involving the preference for dividends: the relationship between consumer expenditures and the preference for dividends and the relationship between tolerance for risk and the preference for dividends.

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Chapter 12: The Firm Life Cycle Theory of Dividends

The firm life cycle theory of dividends contends that the optimal dividend policy of a firm depends on the firm's stage in its life cycle. The underlying premise is that firms generally follow a life cycle trajectory from origin to maturity that is associated with a shrinking investment opportunity set, declining growth rate, and decreasing cost of raising external capital. The optimal dividend policy, derived from a trade-off between the costs and benefits of raising capital for new investments, evolves with these life cycle related changes. As the firm becomes more mature, the optimal payout ratio increases. The empirical evidence generally supports the theory in that dividend payment propensity is related to life cycle characteristics—dividend payers are mature firms with a high ratio of earned capital to contributed capital, while young, high-growth firms do not pay dividends.

Chapter 13: The Catering Theory of Dividends

Chapter 13 reviews the catering theory of dividends, which is a recent theory based on investor sentiment. Catering theory highlights the importance of investor sentiment in decisions about dividend policies. Managers cater to investor demand by paying dividends when investors prefer dividend-paying firms and by not paying dividends (or reducing the dividend) when investors prefer non-dividend-paying companies. The dividend premium captures the relative market valuation of dividend payers versus nonpayers.

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SHARE REPURCHASES

Part III contains four chapters (Chapters 14–17) about share repurchases. Instead of paying cash dividends, corporations may choose to pay out earnings to owners by buying back shares of outstanding common stock. Over the past several decades, there is a growing trend for U.S. firms to use repurchases as the preferred method to distribute cash to shareholders. Companies have several methods of repurchasing stock, including fixed-price tender offers, Dutch auction tender offers, open-market share repurchases, transferable put-rights distributions, and targeted stock repurchases. Although each mechanism has its advantages and disadvantages, most companies use open-market share repurchases. Numerous studies examine the impact of repurchase announcements on a firm's stock price. The market reaction around the announcement date depends largely on the repurchase method.

There are many potential reasons for companies to buy back their own stock. Some of the more common motives for share repurchases include regulatory and tax considerations, agency costs of free cash flows, signaling and undervaluation, capital structure, takeover deterrence, and employee stock options. These motives may differ on the basis of the type of repurchase method used.

Chapter 14: Stock Repurchases: Theory and Evidence, Part 1

This chapter surveys the theoretical and empirical studies on share repurchases. In the United States, share repurchases have surpassed cash dividends and

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become the dominant form of corporate payouts since the last decade. The chapter provides a brief description of five major types of share repurchases and considers the motives that influence firms' repurchase decisions. Specifically, the chapter examines regulatory and tax considerations, agency costs of free cash flows, and signaling and undervaluation. The review indicates that the existing literature provides ample support for several of these motivations while others merit further investigation. Few studies provide possible explanations for the phenomenon of increasing total payouts over time that is largely attributable to share repurchases.

Chapter 15: Stock Repurchases: Theory and Evidence, Part 2

Chapter 15 continues the review of the theoretical and empirical studies on share repurchases. It provides a discussion of three other motives that influence firms' repurchase decisions: capital structure, takeover deterrence, and employee stock options. Overall, the existing research provides support for these three influences. In addition, the chapter explores why firms may prefer one method of payout to another—cash dividends versus stock repurchases.

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Chapter 16: Stock Repurchases and Dividends: Trade-Offs and Trends

Corporations routinely distribute cash to equity investors in two forms: cash dividends and share repurchases. Since the adoption of SEC Rule 10b-18 in 1982, which eliminated the risk that market participants would interpret open-market repurchases as possible share price manipulation, there has been a steady movement toward open-market repurchases as the preferred method to distribute cash to shareholders. Although this chapter discusses various explanations for this trend, the predominant one is that managers believe that repurchases offer flexibility that dividends do not. The trend toward repurchases is even stronger among new firms contemplating payout for the first time. As a result, analysts must interpret per-share data and apply valuation models with care. Unlike cash dividends that tend to vary little over time, repurchases can change markedly in the short run. This makes defining what is meant by a company's "typical" payout difficult.

Chapter 17: Beating the Market with Share Buybacks

The purpose of this chapter is to provide an overview of anomalous price behavior around various repurchase methods such as fixed-price tender offers, private repurchases, and open-market buyback programs. All these anomalies allow investors to earn excess returns, that is, beat the market on the basis of publicly available information. All anomalies have a common characteristic: Markets tend to be too skeptical about the ability of managers to time the market. That is, the market questions whether managers can buy back stocks when they are cheap. The chapter provides some evidence on why such anomalies may persist despite being widely publicized in the literature.

OTHER DISTRIBUTION METHODS

Part IV contains three chapters (Chapters 18–20) and focuses on distribution methods other than regular cash dividends and stock repurchases. Occasionally, corporations issue a specially designated dividend, which management labels as "extra," "special," or "year-end." Such labeling enables a firm to increase the dividend without the implicit need to continue paying that dividend in the future. Firms often declare a special dividend after experiencing good earnings over the previous year.

Some firms issue stock splits or pay stock dividends. Both types of stock distributions increase the number of outstanding shares of stock and should cause a proportionate decline in the stock's market price. These methods differ mainly in the size of the stock distribution and their accounting treatment. According to conventional wisdom, shareholders gain no real benefits from such distributions. While both stock splits and stock dividends increase the number of equity shares outstanding, they do not provide the firm with new funds or its stockholders with any added claims to company assets. Theoretically, neither type of distribution should affect shareholder wealth. In practice, such distributions are more than merely cosmetic changes because they involve wealth effects. Empirical studies often show that a company's stock price, on average, reacts favorably to the announcement of stock splits and stock dividends. Baker, Phillips, and Powell (1995) refer to the market reaction to announcements of stock splits and dividends as the "stock distribution puzzle."

Unlike stock splits and stock dividends, a reverse stock split reduces the number of shares outstanding and increases the price per share. Although reverse stock splits theoretically are noneconomic events, they can result in material changes in stock price behavior. Stock prices generally decline with the announcement of a reverse split. Thus, engaging in reverse splits may be inconsistent with maximizing shareholder wealth and may be of questionable value to firms.

A dividend reinvestment plan (DRIP) entitles shareholders enrolled in the plan to automatically buy additional shares of a firm's stock with their cash dividends. There are two basic types of DRIPs. The most common type of DRIP is a market plan, which involves buying shares in the open market for the accounts of shareholders reinvesting their dividends. A new issue plans allows shareholders to buy new shares directly from the company. Thus, new issue plans provide firms with an alternative way to raise new equity capital without directly using the primary market.

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Chapter 18: Special Dividends

Chapter 18 focuses on the use of specially designated dividends. When a firm wants to make a single large cash distribution to shareholders, special dividends can serve as a way to distribute that cash without shareholders anticipating repeated distributions. Such large cash distributions are appropriate when a firm has accumulated cash in excess of its investment needs either from continuing operations or from sale of assets. In the past, firms paid special dividends more often and in smaller amounts but now generally pay special dividends infrequently and in larger amounts. Firms also use stock repurchases to distribute large amounts of

cash, but they do so infrequently. Important determinants of the choice between the two means of distributing cash are tax considerations and the firm's stock price.

Chapter 19: Stock Splits, Stock Dividends, and Reverse Stock Splits

Chapter 19 explores the costly process of altering the number of shares in a publicly traded company, akin to changing the number of pieces of a cake without changing the size of the cake. Although the act of a stock split, stock dividend, or reverse stock split is purely cosmetic, researchers observe abnormal stock market reactions at the announcement date and sometimes at the ex-date. What is especially puzzling is the positive stock market reaction to stock splits and stock dividends, as these actions are costly and offer questionable benefits to the firm. Possible explanations include the signaling hypothesis and the optimal price range hypothesis. This chapter reviews the empirical research findings and examines the hypotheses put forth in the research literature.

Chapter 20: Dividend Reinvestment Plans

Dividend reinvestment plans have gained popularity as a low-cost, convenient way to invest over the past four decades. The DRIPs may serve as a financing alternative for corporations and as an investment option for investors. The DRIPs offer both benefits and limitations from the viewpoints of corporations and investors. The chapter discusses the financial theory and empirical evidence related to DRIPs concerning the factors determining the adoption and discontinuation of DRIPs, the choice between open market and new issue DRIPs, and the implications of DRIPs for other investment alternatives to corporations and investors.

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SURVEY EVIDENCE ON DIVIDENDS AND DIVIDEND POLICY

Part V contains three chapters (Chapters 21–23) that report views about dividends and dividend policy based on survey-based research. In conducting empirical research, researchers rely on the two broad categories of data, namely primary and secondary data. Most empirical research on dividends and dividend policy relies on the analysis of secondary data, such as stock prices and accounting data. Secondary data already exist and often can satisfy the research requirements of the study at hand. For the data to depict how people operate, researchers typically must gather primary data, which are data collected firsthand directly from those under study for a specific purpose. A survey is the most common method of collecting primary data.

Because each type of data collection has its strengths and weaknesses, the combination of survey and nonsurvey research can provide a potentially richer and more complete view of an issue than using a single data source. Survey and nonsurvey research are both important in their own way and can complement one another. As Bruner (2002, p. 50) notes, "The task must be to look for patterns

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of confirmation across approaches and studies much like one sees an image in a mosaic of stones."

Chapter 21: Cash Dividends and Stock Repurchases

Survey research focusing on dividends and stock repurchases provides important insights into management's views about their firms' corporate payout policies. Although survey findings often confirm theoretical and empirical predictions about management behavior, sometimes they refute them. For example, Lintner's (1956) classic dividend study reveals that managers believe that shareholders prefer stable dividend payments, set their dividend levels to avoid having to reverse dividend increases, and gradually increase dividends toward a target payout ratio when earnings increase. Later surveys confirm many of Lintner's findings and provide additional evidence about managerial motives for dividends.

Chapter 22: Stock Splits, Stock Dividends, and Dividend Reinvestment Plans

Chapter 22 documents the views of managers on dividend policy by synthesizing the survey evidence on stock splits, stock dividends, and DRIPs. Managers report that stock splits enable small stockholders to buy round lots more easily and to keep a firm's stock price in an optimal price range. Stock splits also increase the number of a firm's shareholders, make stocks more attractive to investors by increasing the number of shares outstanding, increase liquidity, and signal management's optimistic expectations about the future of the firm. The reasons for issuing stock dividends include maintaining historical firm practice, conserving cash, increasing the yield to stockholders, expanding the amount of equity, having a positive psychological impact on investors, and signaling optimistic expectations about the future. Finally, financial managers believe that firms benefit from DRIPs by raising equity capital through new issue plans, improving shareholder goodwill, and allowing plan participants to acquire stocks at a reduced fee.

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Chapter 23: Why Individual and Professional Investors Want Dividends

Chapter 23 summarizes evidence on how individual and professional investors consider dividends in their investment decisions. Surveys of individual Dutch and Greek investors have found that most of the investors surveyed prefer dividends. Their responses are consistent with signaling theory but not with uncertainty resolution or agency theories of dividend policy. Their views of cash (stock) dividends are inconsistent (consistent) with the behavioral theory of Shefrin and Statman (1984). The chapter also presents new evidence about dividends and dividend policy from interviews with a small sample of professional investors in Canada and readings of analysts' reports. The professional investors tend to agree that their clients want dividends because of the comfort dividends provide, despite that they do not withdraw much of their dividend income. Professionals often mention that dividends provide valuable information content but view such information

as less important than cash flow. In particular, Canadian analysts do not appear to incorporate dividends into their investment evaluation.

OTHER DIVIDEND ISSUES

Part VI has five chapters (Chapters 24–28) and covers other important issues related to dividends and dividend policy. Specifically, Chapter 24 is an empirical study investigating dividend initiation and firms' motivations for paying regular cash dividends to shareholders. The remaining four chapters investigate how dividend policy relates to corporate governance, regulated industries, the global perspective, and emerging markets.

Chapter 24: Why Firms Begin Paying Dividends: Value, Growth, and Life Cycle Effects

This chapter investigates the signaling, agency, and risk explanations for dividends within the context of the life cycle hypothesis, which proposes that dividend initiation conveys information about firms' transition to a slower-growth, "mature" phase. Companies initiating dividends have different characteristics, depending upon their life cycle stage. Low market-to-book (M/B) stocks display the most positive price reaction to dividend initiation announcements. High M/B firms have greater profits, cash levels, and capital expenditure but more closely resemble the low M/B firms in terms of these characteristics within three years after dividend initiation. Excess returns earned by low M/B firms are related to decreases in systematic risk, while the returns of high M/B firms are related to their greater profitability.

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Chapter 25: Dividend Policy and Corporate Governance

In recent years, academics' and practitioners' interests in corporate governance have increased substantially. The extant finance literature shows that shareholder-manager agency conflicts strongly influence corporate financial policies such as capital structure and dividend payouts. However, the literature on the relationship between agency theory and a firm's dividend policy is limited but is now growing at a rapid pace. This chapter focuses on different external (e.g., shareholder rights and legal environment) and internal (e.g., managerial and block-holder ownership, executive compensation and board structure) corporate governance mechanisms that may influence a firm's dividend policy. The literature shows that these variables affect dividend policy, but considerable variations exist in the results. Given the changing business and regulatory environment, the role of dividends in mitigating the agency costs of firms appears to be an ongoing process to study.

Chapter 26: Dividend Policy in Regulated Industries

In theory, the dividend policies of regulated and nonregulated firms could differ. This chapter focuses on the research evidence on dividends for the banking, insurance, utility, real estate investment trust (REIT), petroleum, and other

industries, which are sometimes identified as regulated. In general, stock price reactions to announcements of dividend changes are similar for both regulated and nonregulated firms. Management surveys and empirical studies examining dividend payout policies provide evidence that dividend policies of regulated and nonregulated firms differ, but the evidence is far from conclusive. Overall, the research findings lead to the conclusion that studies should control for regulated and nonregulated firms.

Chapter 27: Dividend Policy in a Global Perspective

Chapter 27 focuses on the role of dividends and the patterns of dividend policy across various national settings. There is now ample empirical evidence that corporate control varies substantially between the United States and the United Kingdom on one side and the rest of the world on the other side. Hence, the role of dividends as well as their level and flexibility are also likely to vary across countries. The limited existing evidence suggests that dividend policy reflects the characteristics of national corporate governance regimes and the control structure of individual firms.

Chapter 28: Dividend Policy in Emerging Markets

Chapter 28 synthesizes the extant research on dividend policies in emerging financial markets. The environments conditioning or constraining dividend payments in these markets differ from those in developed financial markets, specifically in terms of legal mandates on the amounts paid out, legislation relating to share repurchases, concentrated ownership structures, and overall macroeconomic volatility. Although the proportion of dividend-paying firms is higher in emerging financial markets than in the United States, this proportion has fluctuated considerably. The magnitude of dividend distributions, as measured by dividend payout and dividends-to-sales ratios, has in many cases become comparable to that in the United States while remaining more volatile. Macroeconomic fluctuations and ownership structure rank as important determinants of dividend policy.

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CONCLUSIONS

Despite much study, researchers still do not have all the answers to the dividend puzzle. The extant literature contains various theories on taxes and clientele effects, agency costs, asymmetric information, behavior, life cycle, and catering, but none by itself fully explains dividend behavior. Some are at best second-order explanations for real-world payout policies. The voluminous body of work on the dividend puzzle suggests that solving this thorny issue has not been simple or obvious. After reviewing extensive evidence on the dividend puzzle, Baker, Powell, and Veit (2002, p. 256) conclude:

> *While not fully solving the dividend puzzle, theoretical and empirical studies over the past four decades have provided additional puzzle pieces that move us closer in the direction of resolution. In reality, there is probably some truth to all of the explanations of why corporations pay dividends or repurchase stock at least for some firms.*

Baker et al. (2002, p. 242) also note, "Despite exhaustive theoretical and empirical analysis to explain their pervasive presence, dividends remain one of the thorniest puzzles in corporate finance." Thus, fully resolving this enigma has eluded theoretical modeling and empirical detection, but researchers have made considerable progress.

What explains the difficulty of resolving the dividend puzzle, if such a puzzle actually exists? Why do managers choose one method of cash distribution over the other, given that dividends and share repurchases are similar but imperfect substitutes? Baker, Saadi, and Dutta (2008) suggest that two major reasons account for the inability to fully resolve these questions. First, some financial economists have been striving to develop a universal, or one-size-fits-all, explanation, despite the well-known fact that dividend policy is sensitive to factors such as market frictions, firm characteristics, corporate governance, and legal environments. In this same vein, Frankfurter and Wood (1997, p. 31) remark:

> *Dividend-payment patterns (or what is often referred to as "dividend policy") of firms are a cultural phenomenon, influenced by customs, beliefs, regulations, public opinion, perceptions and hysteria, general economic conditions and several other factors, all in perpetual change, impacting different firms differently. Accordingly, it cannot be modeled mathematically and uniformly for all firms at all times.*

As previous evidence reveals, concentrating on a single piece of the dividend puzzle at a time is unlikely to provide a satisfactory resolution because the puzzle contains many pieces. Lease et al. (2000) offer a competing frictions model that involves combining various pieces (market imperfections) and understanding their interactions. Their dividend life cycle model consists of five stages: start-up, IPO, rapid growth, maturity, and decline. According to their model, a firm should pay no dividends during the start-up and IPO stages but should pay a low, growing, and generous dividend during the three latter stages, respectively. Lease et al. (p. 179) conclude:

> *We believe that the lack of empirical support for a particular dividend policy theory is the result of problems in quantitatively measuring market frictions and the statistical complications in dealing with the myriad interactive imperfections that likely affect individual firms differently. In other words, since each firm faces a combination of potentially different market frictions with varying levels of relevance, the optimal dividend policy for each firm* may *be unique. If each firm has a uniquely optimal dividend policy, we should not be surprised that significant statistical generalizations still elude researchers. Current models of the impact of dividend policy on firm's values cannot fully reflect the complexity of the market environment.*

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Although the model of Lease et al. (2000) provides a framework for bringing together key pieces of the dividend puzzle, it excludes other factors that may help explain differences in dividend policy such as corporate governance and legal environments. Thus, while their integrative model of market frictions represents a step forward, it is likely to be incomplete. DeAngelo and DeAngelo (2007) also present a corporate life cycle approach that provides a useful framework for understanding real-world payout policies. They show that optimal or payout decisions evolve

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over the corporate life cycle with a firm's ability to generate cash internally and in its scale of profitable investment opportunities.

Second, Baker et al. (2008) note that the proposed explanations rely heavily on economic modeling approaches without an in-depth understanding of how investors and managers behave and perceive dividends. Thus, the main line of research in dividends uses market data that can explain surface reality but cannot measure motivation, which is the underlying force behind generating such data. Chiang, Frankfurter, Kosedag, and Wood (2006) conclude that the cardinal thrust of academic research should turn toward learning about motivation and the perceptions underlying this motivation.

Although all the pieces of the dividend puzzle may not be in place, the following chapters feature a wealth of information that is useful in providing guidance to identify determinants of payout policy in the real world. Now, let's begin our journey into one of the most intriguing topics of corporate finance—dividends and dividend policy.

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