# Common Stock Dividends: What Are They Worth?

The thought of dividends excites some investors to a point of financial ecstasy while moving others to bouts of slumber. Some investors seek only common stocks with high and predictable dividend payments, and other investors search out stocks with exceptional growth potential, eschewing those that pay any dividend.

There are a series of dividend issues facing the individual investor, and they are worth discussing. However, ultimately the question of dividends reduces to expected return and risk, and the question: How should a stock be valued when significant dividends are paid?

## Dividend Basics

Dividends are viewed by many investors as reducing the risk of uncertainty. It is argued that dividends lower this risk because they are more certain than capital gains. For firms with a history of uninterrupted dividends, dividend payments can reasonably be expected to continue through periods of stock market weakness, periods where common stocks are experiencing capital losses. Dividends, however, are not guaranteed, and history has shown that even firms thought to be immune to dividend problems have cut dividends or ceased dividend payments.

From a total return standpoint, consistent dividends shore up returns in a down market. If a firm pays a dividend that averages 4% of the market price of the common stock (also known as dividend yield), then that 4% can essentially offset 4% of capital losses. As stocks decline in price, dividend yields rise, assuming no change in dividend payments. High dividend yields attract investors, thereby supporting the prices of stocks paying a significant dividend.

Dividend-paying stocks, in general, tend to be less price volatile than non-dividend-paying stocks. Of course, nothing is without cost, and dividends usually are a trade-off for growth and capital gains. The lower risk engendered by dividend-paying stocks also translates into lower expected total return, as expected growth is lessened.

Why less growth? Firms that have abundant profitable investment opportunities usually reinvest all excess cash generated, while at the same time turning to debt and sales of additional common stock to finance their investment programs. In other words, they can earn a higher rate of return for the investor by reinvesting earnings than the investor would earn receiving dividends. As firms mature and their investment opportunities are reduced along with their growth potential, dividend payments are usually initiated. Firms are cautious to start or increase dividends, and they do so only when

they are extremely confident that the new level can be maintained in all expected market and business environments. Elimination of dividends or dividend cuts is a strong negative signal to markets that usually results in a sharp drop in share price.

To avoid paying a dividend that the firm may not be able to continue, some firms on occasion pay an extra dividend that varies in magnitude. In these cases, if the dividend yield is unusually high, it indicates that the market is discounting the extra dividend as truly extra and nonrecurring. Dividends are normally paid quarterly, or in some instances semiannually. These are termed regular dividends. The extra dividends can be declared anytime, but usually, are declared in conjunction with a regular dividend.

Investors should be careful when examining annual dividend quotes because they can have several different meanings. For instance, the dividend amount noted could be dividends for the calendar year-to-date, total dividends paid during the most recent calendar year, dividends paid over the last 12 months, or an indicated annual dividend. The indicated dividend is usually calculated by multiplying the most recent quarterly dividend by four, or the semiannual dividend by two. On occasion, any extra dividends paid are added to the indicated dividend to arrive at the total indicated dividend.

## Dividend Distributions

A potentially confusing dividend question for individual investors is: If I buy the stock, am I entitled to the next dividend?

The answer is "maybe." The dividend distribution procedure starts with the board of directors of the firm, which on a particular date declares a dividend, payable on a later date (the payment date) to shareholders of record as of a particular date (the record date). On the fourth business day before the record date, the stock goes ex-dividend—it is traded without the right to the recently declared dividend. The difference between the ex-dividend date and the shareholders-of-record date allows determination of who has the right to the dividend. The schematic in **Figure 1** may help to sort out the sequence of these dates and what they mean for the individual investor. [Editor's Note: Today, the ex-dividend date is usually one business day before the record date.]

**Figure 1.**
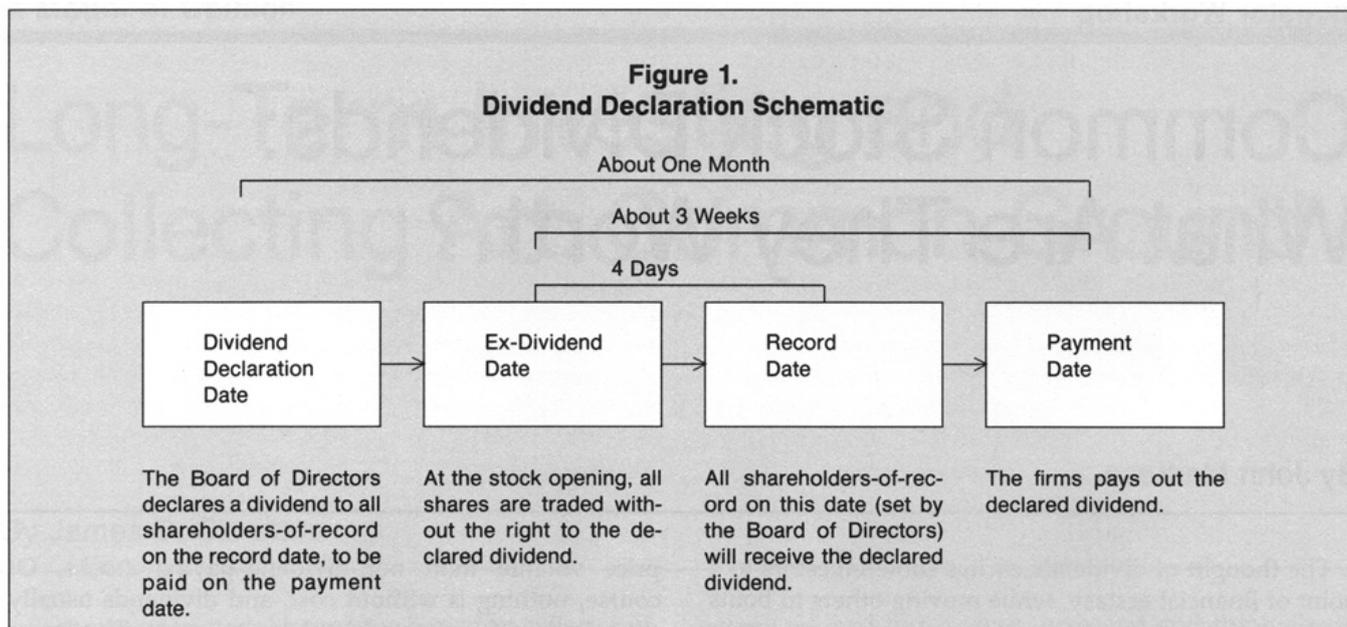**Dividend Declaration Schematic**

Figure 1

The four business days between the ex-dividend date and the date of record is a general rule; the other time spans indicated in **Figure 1** are typical but vary. The ex-dividend date precedes the record date to avoid confusion about which investors are entitled to the dividend when transactions are made close to the record date. Since settlement occurs over a five-day period, an investor who purchases the stock the day before it goes ex-dividend will be a shareholder of record on the record date, and thus receive the dividend; an investor who purchases the stock after it goes ex-dividend will not be a shareholder-of-record on the record date and will not receive the dividend. However, this latter investor also will not have paid for the dividend: Whatever the closing price for the stock on the day before ex-dividend, it will be lower by the amount of the dividend when the stock opens the next day, assuming no other market effects. In the quarter preceding the dividend payment, the stock price will have risen, barring market movements, by approximately the amount of the quarterly dividend.

One other issue investors face when receiving dividends is taxation. Dividends paid, unless sheltered in a pension environment, are taxable in the year received. In this sense, dividend-paying stocks are at a disadvantage to those that don't pay dividends, since taxes on capital gains can be deferred into the future and are payable when the securities are sold and the gain is realized. On the other hand, one long-time disadvantage of dividends—that capital gains were given preferential treatment with a lower tax rate—is no more. Dividends and capital gains are taxed at the same rate.

# Putting a Value on Dividends

The overriding question facing investors is how to value dividends. If a common stock pays significant dividends—for example, its average dividend yield is 3% or more—how can the dividends be evaluated in order to value the common stock?

The dividend valuation model assumes a long-term perspective of growth in dividends and that dividends are growing at the same rate as earnings. From this basis it follows, therefore, that share price is also expected to grow at the rate of growth of dividends. The model starts with the required total return on a common stock, which can be divided into dividend yield and growth, as follows:

$$r = \frac{D_{Next\ Year}}{P} + g$$

Where: $D_{Next\ Year}$ = Next expected annual dividend

$r$ = Required total return on the stock

$g$ = Long-term expected annual growth of the dividend

$P$ = Share price, estimated value

$\dfrac{D_{Next\ Year}}{P}$ = Dividend yield

*Formula 1*

Rearranging this return calculation produces the dividend valuation model:

$$P = \frac{D_{Next\ Year}}{r - g}$$

Where: r must be greater than g

*Formula 2*

In essence, this formulation states that the higher the current dividend, the higher the anticipated growth in future dividends; and the lower the required total return (r must be greater than g or the model blows up and gives irrational answers), the higher the value of the stock.

Comparing the price derived from this model to the price of the stock in the market gives an indication of whether the stock is overvalued, correctly valued or undervalued. Of course, investors should seek undervalued securities because when the market eventually (hopefully) comes around to your viewpoint, you will earn returns greater than would be expected given the risk of the stock.

As an example of the method, assume that the current dividend is $1.00, the expected growth rate in dividends is 6%, and the stock is of average risk, indicating that a long-term total return of 10% is appropriate. First, it is necessary to derive next year's dividend:

$$D_{\text{Next Year}} = D_{\text{Current}} (1 + g)$$

$$\text{Where: } D_{\text{Current}} = \text{Current dividend}$$

*Formula 3*

Substituting the values into the dividend valuation model, the stock would be valued at $26.50:

$$P = \frac{\$1.00 (1 + 0.06)}{0.10 - 0.06}$$

$$= \frac{\$1.06}{0.04}$$

$$= \$26.50$$

*Formula 4*

If the common stock were trading in the market for less than $26.50, by this model and the estimates required, the stock would be undervalued and thus a purchase candidate. If the stock had a market price above $26.50, it would be overvalued and a sale candidate.

Sounds easy, but how do you derive the variables necessary for the calculation? The important variables in a dividend valuation model are the current cash dividend, an estimate of the long-term expected annual growth in the dividend and a required total return on the common stock that takes risk into consideration.

The current cash dividend, either the last 12 months of regular dividends or the indicated dividend, is readily available in the financial section of most newspapers or from financial publications found in most libraries. The difficult variable to find is the expected growth rate in dividends. The simplest technique to estimate the future growth rate is to find the five- to 10-year annual historical growth rate in dividends, being careful to look at only regular, and not extra, dividends. **Table 1** provides the calculations for determining this rate. Value Line not only calculates the historical dividend growth rate over the last five and 10 years but also gives a forecast for the next five years of dividend growth. The higher the anticipated growth rate in dividends, the greater the value of the common stock.

## Table 1.
## Calculating the Historical Dividend Growth Rate

The historical dividend growth rate calculation compares the most recent dividend to the dividend five years ago:

$$\text{Growth Rate} = \left[\left(\frac{D_{\text{Current}}}{D_{5\text{ Years Ago}}}\right)^{1/n} - 1.0\right] \times 100$$

Where: $D_{\text{Current}}$ = Dividend for most recent year

$D_{5\text{ Years Ago}}$ = Dividend 5 years ago

$n$ = Number of compounding periods

Remember that 5 years of dividend payments result in only 4 compounding periods (the first payment to the second; second payment to third; third payment to fourth; and fourth payment to fifth). Also, the fractional power $1/n$ is the nth root of the figure in parentheses. Substituting 4 for n, the equation is taking the 4th root of the figure in parentheses.

For example: The current dividend is $1.00, and 5 years ago it was $0.79:

$$\text{Growth Rate} = \left[\left(\frac{\$1.00}{\$0.79}\right)^{1/4} - 1.0\right] \times 100$$

$$= [1.06 - 1.0] \times 100$$

$$= 6.0\%$$

*Table 1*

The last variable, required total return, is used to discount the future cash dividends to arrive at an estimated share value today. Large common stocks have returned about 10% annually over the long term. Using this historical performance as a guide, stocks with significantly above-average risk might be required to return 12% and stocks with risk substantially below average might be required to return 8%. Still another way to judge long-term required returns is to use the difference between the return on stocks and Treasury bills, about a 6% average difference. If Treasury bills are expected to return 8% in the future, then 14% (8% plus the 6% average difference) might be a starting point for required return.

This also highlights the relationship of interest rates to stock prices, particularly stocks that pay high dividends. If interest rates fall, required returns fall and stock values rise. There are certainly sophisticated theoretical models to determine the required return as a function of statistically determined risk measures, but the intuitive approach may prove more useful to individual investors.

## Dividend Definitions

**Dividend:** A portion of a corporation's earnings that are paid to shareholders on a per-share basis. Dividends are usually made quarterly or semiannually.

**Dividend Declaration Date:** The date that the board of directors of a firm announces that a dividend will be paid.

**Dividend Growth Rate:** The rate at which dividends are growing each year.

**Dividend Yield:** Indicated divided by market price of the stock.

**Ex-Dividend Date:** The first date on which all shares are traded without the right to the recently declared dividend. At the market opening on this day, the share price will drop by the amount of the dividend.

**Extra Dividend:** A dividend that is in addition to the regular dividend payment and is unlikely to recur. It can be declared at any time, but it is usually declared in conjunction with the regular dividend.

**Indicated Dividend:** The most recent quarterly dividend multiplied by 4, or the most recent semiannual dividend multiplied by 2.

**Total Indicated Dividend:** The indicated dividend plus any extra dividends paid that year.

**Record Date:** The date, set by the board of directors when a dividend is declared, on which an investor must be a shareholder of record to be entitled to an upcoming dividend.

**Regular Dividend:** The dividend that is normally paid by the firm, barring changes in corporate dividend policy.

**Payment Date:** The date when the corporation actually pays the declared dividend.

**Payout Ratio:** Indicated dividend per share divided by earnings per share. The ratio indicates the percentage of earnings that is paid out to shareholders in cash.

## Evaluating Risk

While dividends can be useful in valuing stock, investors must be careful to evaluate the risk that dividends will not continue to be paid as they have in the past.

Dividends are cash flows to investors, unlike firm earnings—they are the only payments made to the stock investor. Earnings support dividend payments, but for short periods of time, dividends can exceed earnings. And even if earnings are substantial, the earnings may not have generated sufficient cash flow to meet the dividend payment, requiring the firm to draw down existing cash balances or to borrow to pay the dividend.

To get an idea of the risk of elimination or reduction in the dividend payment you may face as an investor, a few basic financial values can be observed. Probably the easiest is the dividend history. Data sources including Dividend.com, Morningstar.com and Value Line give historical dividend records and may include how many years of uninterrupted dividends the firm has experienced, usually stated as cash dividends each year since a particular date. The longer the record of uninterrupted dividends and the longer the record of dividend growth with no dividend cuts, the more certain the future dividend.

Another measure used to judge the riskiness of the dividend is the payout ratio, which is the annual dividend per share divided by annual earnings per share. The higher the payout ratio, the greater the risk that earnings will fall short of covering the dividend. If dividends are only a small percentage of earnings, then the dividend is more secure.

Firms with large amounts of outstanding debt, and therefore substantial interest obligations, are also riskier dividend payers. The dividend does not have to be paid, but failure to pay interest on the debt is the first step toward bankruptcy. The most secure dividend firms would have stable but growing earnings, a low payout ratio, low debt, a high cash position and a long history of dividend payments and dividend growth.

## Conclusions

Investors interested in dividend income need to understand the mechanics, tax implications and terminology of dividends.

The valuing of dividend-paying common stock requires an intuitive feel for risk and a willingness to judge dividend growth prospects. Contrary to some popular thought, the returns on dividend-paying stocks can be exciting.

*This article was written by John Markese for the July 1989 issue of the* AAII Journal. *At the time, Markese was director of research at AAII. He is also a former president of AAII and is currently the chairman of AAII.*