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Published in *Eureka Report* on February 17

Value Line: Why dividends don't matter

By Roger Montgomery

PORTFOLIO POINT: As much as I enjoy receiving dividends, I struggle to accept them. Here's why.

I like receiving my dividend cheques. I like tearing along that perforated line when I can. I take particular delight in those that are especially large in comparison to the price I paid for the shares.

So it almost seems churlish of me then to hold a view about dividends that would take out the fun of opening those innocuous, white, windowed envelopes that arrive in my letter box.

As much as I like receiving dividends, I struggle to accept them. Perhaps it's the tax structure that forces companies to behave irrationally that I dislike.

So instead of summarising predictable results from the likes of Telstra and the predictable performance of Myer's share price, this week I want to take you on a journey of discovery about dividends.

When a company's revenues exceed the cost of generating them, a profit accrues. Owners of the business share in those profits through the payment of dividends. The board decides what proportion of the profit will be paid out, and this should be done with regard to the future maintenance and growth requirements of the business rather than their own personal financial requirements.

Additionally, after-tax profits produce a credit against the dividends, known as franking, and while these have no value to the company they have enormous value to Australian shareholders.

The investment community focuses on these outflows but in doing so it often misses one important thing: the inflows, the amount of money that was invested back into the business to maintain it and its revenues. And looking at these inflows changes everything.

By way of example, suppose you own a business that generates a 45% return on the money you have invested and left in the business. Given the returns available elsewhere, for example, 8% in a five-year term deposit, where would you prefer to invest your money?

Suppose I send you a prospectus for an investment in this business with a reasonable certainty of generating 45%. Would you not take your funds out of the term deposit and invest it here?

If, as the Efficient Market academics suggest, investors are rational and profit-motivated, they should all be transferring funds out of the term deposit and into the business. But in reality, the funds go in the opposite direction! Investors demand the business pay them dividends so that they can put them in a term deposit! Crazy!

I am deeply sorry to all the Efficient Market academics out there

The ValueLine portfolio, as at February 16, 2010

Company	Buy price	Today	Est value	Margin of safety	Shares purchased	Invested	Cap value	Divs rec	Total return	Total return
JB Hi Fi	14.8	20.15	25.76	21.8%	845	$12,500	$17,019	0.62	$5,042	40.34%
Cochlear	56.36	62.5	56.3	-11.0%	102	$5,744	$6,370	1.97	$827	14.39%
CSL	31.81	33.66	32.87	-2.4%	163	$5,197	$5,500	0.4	$368	7.07%
Woolworths	26.16	26.06	26.85	2.9%	206	$5,377	$5,357	0.56	$95	1.76%
Reece	17.8	25.5	14.83	-71.9%	236	$4,209	$6,030	0.33	$1,899	45.11%
Platinum Asset Mgt	4.06	5.24	3.95	-32.7%	854	$3,467	$4,475	0.12	$1,110	32.02%
CommBank	46.51	52.91	52.81	-0.2%	215	$10,000	$11,376	1.2	$1,634	16.34%

Since July 1

Security Value	$56,125
Cash Value	$57,268
Total Value	$113,393
Total Return ($)	$13,393.09
Return Invested (%)	27.77%
Total Return (%)	13.39%
XAO Change	18.40%
* Outperformance of investments	9.37%
* Outperformance of total including cash	-5.01%

Negative watch

Company	July 1	Today	Est value	Margin of safety*	Total return
ISOFT	0.635	0.52	0.19	-173.7%	18.11%
Amcor	4.79	5.96	3.63	-64.2%	-24.43%

because people are not rational, nor it seems, profit motivated.

So why do the investors demand dividends and why do boards pay them if there is a reasonable certainty of very high returns? Let me start by saying too much money is not a bad problem to have. No doubt airlines globally would love this problem but fortunately it's one they'll never have to worry about.

Dividends are paid or not paid for a host of reasons but generally they fall into one legitimate category and two illegitimate categories.

The legitimate category is that profits cannot continue to be retained and expected to generate high rates of return. In this situation, the company and its board are doing the right thing in handing the profits back to shareholders. This is certainly preferred to making an ill-advised acquisition.

The first of the illegitimate categories is the payment of dividends to create the impression of being a "good" company. I cannot tell you how many times I have heard someone sing a company's praises by saying "but it pays a good dividend".

It would not be hard to find a listed company in this country engaging in price promotion – paying dividends they cannot afford only to replace the funds dispensed with either debt or equity via dilutionary capital raisings. When such a revolving door of capital is in operation, its time to head for the exits because when profits are inappropriately retained, so are the executives.

The other illegitimate reason is ignorance. When management fails to understand that retaining profits at low rates of return on equity destroys shareholder wealth, their intelligence does not run as deep as their mediocrity or, worse, their arrogance.

As shareholders we may not always be rational but we aren't blind. The corporate track record in this country when it comes to salaries and ill-fated acquisitions has caused many investors to prefer the certain dollar in the hand rather than the uncertain two in the bush.

Profits have been retained to pay unjustified salaries, make nonsensical acquisitions or to maintain businesses that if not for their commercial aspirations, might otherwise be known as sheltered workshops. With history like this fresh in the mind of investors, is it any wonder that they want the cheque in the mail?

But importantly it is true that if there is a good prospect for a high return on equity, more value is created for shareholders if capital is retained rather than paid out as dividends. If, however, low returns are expected, then the profits should not be retained and, arguably, neither should shares in the company. ◆

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