More to dividend policy than paying out a good yield

Dividends are important, but only in the context of the quality of a company's management and its prospects for the future.

It's reporting season, which means investors are focused on the profit results of big companies – and also on the dividends they are announcing.

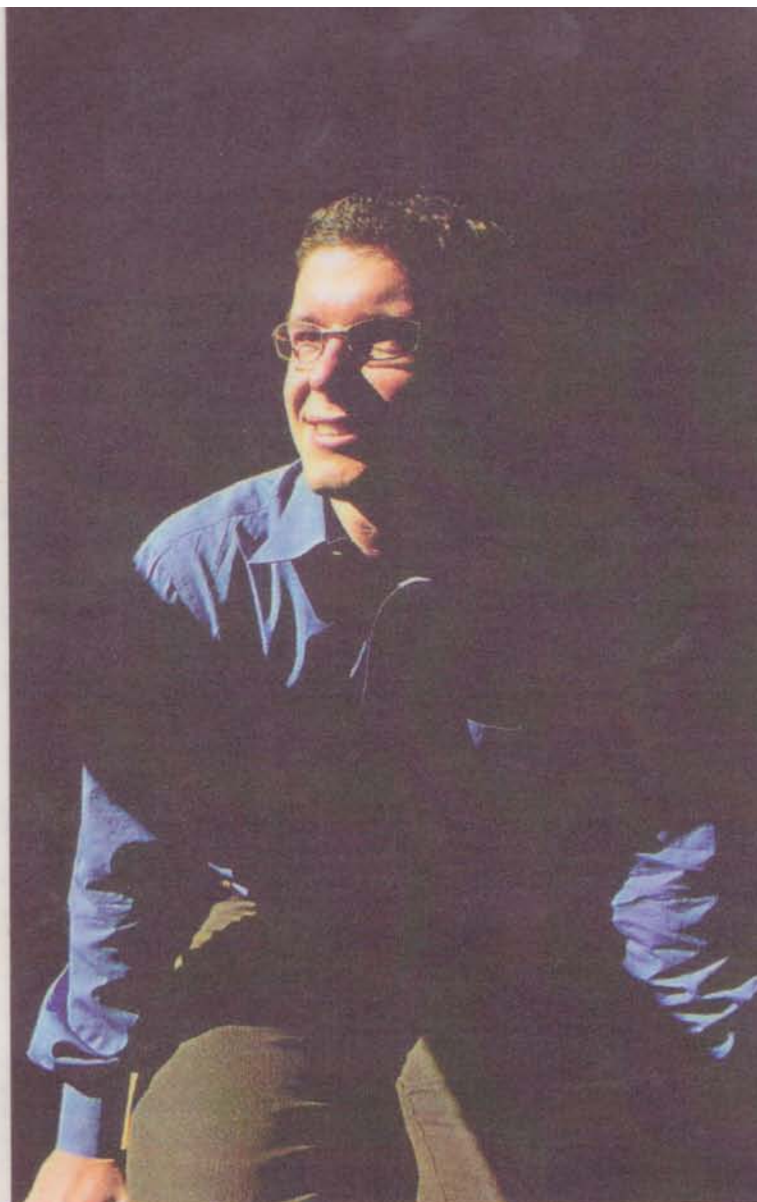
Australia, more than almost any other major stock market, has a sharp focus on the dividend, and rightly so: a strong dividend (also referred to as yield) means that no matter what happens to a share's value, an investor can rely on some income. Banks in particular have tended to pay dividends about the 6 per cent mark, fully franked – meaning tax is already paid on them – suggesting that even if a bank stock's value stays flat all year, the dividend still represents a better return than any cash account.

Dividends are particularly in vogue this reporting season because many companies, with cash on hand after a good year but with an uncertain growth environment ahead, are being encouraged to return capital to shareholders, often in the form of a one-off special dividend. Commonwealth Bank of Australia is the most striking recent example of this, delivering a 19 per cent increase in the full-year dividend to $1.83 per share.

But there is a danger in being too black and white about dividends. It's not as straightforward as saying the best companies deliver the best yield, and that any company with a low dividend is doing badly and should be avoided.

This theme has been addressed by Roger Montgomery, managing director of Clime Asset Management, in a paper called *The Dividend Myth*.

Montgomery notes that in Australia it is common for dividend policies to go unexplained by directors for many years. "A company may state that its policy is to pay out 50 per cent of earnings as dividends but this pronouncement will not be accompanied by any justification that the policy adopted is best for shareholders," he says.



Roger Montgomery: 'not all earnings can be distributed'. Photo Tamara Dean

And investor response can be equally irrational. "Conversely, investors may punish a company (and themselves) by selling the shares of a company that significantly changes its policy, particularly if that change involves a reduction in the dividend payout ratio."

This raises several points, Montgomery says. One is that investors must understand that not all earnings can be distributed. For companies with a high ratio of assets to profits, much of the earnings will be required to maintain those assets and preserve the company's economic position. Companies paying dividends from those earnings – so-called "inhibited earnings" – would lose ground because they'd lack the capital to grow and keep production at necessary levels. "By distributing inhibited earnings the company is destined to collapse unless additional funds are injected," he says.

Some companies should not pay dividends at all, and indeed not all do, or at least not of any consequence: News Corp is the most obvious example, with a yield well below the 1 per cent mark, though whether that is the right approach is open to contention.

That said, investors should also be suspicious about companies that hang on to the earnings they don't need – uninhibited earnings, so to speak. "We are concerned about the motives and intelligence of management that elects to retain a portion of uninhibited earnings at below attractive rates of return simply because it is the policy of the company," says Montgomery.

It's tricky for ordinary investors to form a view on whether a dividend policy is appropriate or not, but it would at least be comforting to find some guidance on dividend policy in annual results announcements.

Montgomery notes the popular phenomenon of "investors being romantically attached to their dividends at the expense of better financial returns". But it's understandable that investors should be blinded by the attractions of good yield, particularly in a nation with such draconian levels of personal taxation.

The issue of tax and dividends is the subject of a paper compiled for super funds by State Street Global Advisors' portfolio manager Thomas Reif.

Investors who receive fully-franked dividends receive franking credits – income tax credits that a company can pass on to investors. If an investor's tax rate is higher than the company rate (30 per cent) then the investor pays the extra tax. But the reverse is also true – and your super fund, paying a tax rate of 15 per cent, actually gets a reduction in the level of income tax it has to pay by getting a fully-franked dividend.

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Reif thinks we ought to remember this when looking at the performance of managers. "Clearly, franking credits, while not forming part of most performance surveys, are an important part of post-tax returns," he says. "High franking levels and low turnover have the potential to improve long-term after-tax returns by up to 1 per cent per annum."

So, to take the lessons from both these reports: dividends, and especially fully-franked dividends, are a useful and reliable way of bolstering returns. But a slavish following of the highest dividend, and a policy of abandoning companies that pay lower ones, is not the right way to go either: think instead about the quality and prospects of the companies themselves.