

Category: **Management**  
Sub-Category: Capital Allocation  
Subject: **Paying out dividends or retaining the money**

*MM = Modigliani-Miller thesis.*

“The most important objective of an investor is a rewarding total return.” Geraldine Weiss<sup>1</sup>

## INTRODUCTION

The central issue can be stated quite simply. **It is whether the surplus, freely available earnings of the company will earn more for the shareholders if left in the business or if distributed to them, either as cash dividends or by share repurchases.** All the freely available earnings—what we call available cash flow—are potentially available for distribution to shareholders rather than being routinely reinvested to expand old businesses or diversify into new.

Economists tell us that a company’s dividend policy will have no effect on its stock price. How can that be? If it is a mature company, shareholders rightly expect it to pay out a high percentage of its earnings and not to go off on a (probably) wasteful diversification spree. Keeping the money, or paying it out to shareholders, should be a major concern for management. The ***dividend irrelevance theory*** assumes that the investment policy of the company is known and fixed, as if the fact that excess earnings are sloshing around in the company’s treasury might not tempt a CEO to buy a jet or expand a corporate empire. No matter how talented or foolish the CEO may be, we are asked to believe that (taxes aside) a dollar left inside the company with little or no control over how it is utilized, as valuable to investors as one outside.

Scholars have been straining to make of finance a hard science that can be reduced to algebraic compositions and tests by quantifiable data. They stuff off history and social insights that do not fit the algebra. The price of this mathematical elegance is that it obscures hard, practical questions that executives should be asking, even one as basic as whether to pay a dividend or keep the money for internal growth.

On average (as of 1990), American industry has been paying out as dividends a little over 40% of earnings and many companies seem to believe that if they follow the crowd or pay out just a bit more than the crowd, they have given shareholders “their due”.<sup>2</sup> Depending on the investment opportunities available to management, shareholders have a moral claim—there is no legal one—to something more than that. It is a more exacting and appropriate way to run the business.

**There is no benefit in owning a good business if the profits are neither distributed to the shareholders nor reinvested wisely.** There are not very many, in the sense of being able to earn returns on capital that are consistently above average. **What is striking is how difficult it has been for the managers to reinvest the earnings well.** Undaunted by past failures,

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<sup>1</sup> Geraldine Weiss and Gregory Weiss, *The Dividend Connection*, Chicago, Dearborn Financial Publishing, 1995, p. 2. The average yearly dividend yield of the 30 DJIA stocks was 4.4 percent that compounded stock returns look respectable again.

<sup>2</sup> See Appendix for a recent dataset on dividend yields

many of them insist on buying businesses that are inferior to what they already own and know, buying good ones at excessive prices, or buying ones outside the area of their experience and expertise.<sup>3</sup> Far better to have paid dividends.

How much should companies pay out as dividends, as against what they keep for investment—has been a puzzle. Just how much do dividends really matter to shareholders? *Ben Graham* liked to think about the theoretical possibility of a “frozen corporation,” one that by its charter was forbidden to pay dividends or even merge or liquidate. If they could never, ever see any cash or other distribution from the company, why would ordinary investors want to own the shares? At what price would the shares trade? Fortunately companies that can pay dividends eventually do.

According to *MM*, a company’s dividend policy is irrelevant even for shareholders who want a present cash return. If the company does not pay dividends, investors are free to do what the shareholders of any “frozen corporation” can do: sell some shares periodically in the open market. Depending on the tax status of the shareholder, these “homemade” dividends may even be the preferred course.

Since the famous *MM* thesis states that dividend policy is irrelevant, it tends to reinforce the preference of corporate managers to keep dividends as low as possible. The *MM* theory puts a patina on management’s self-serving tendencies to hold on to the money, expand their business, buy and try a new one, or just feel more secure with more cash in the drawer. If dividends are irrelevant for shareholders, they won’t pay more for dividend-paying stocks. Thus, dividends are irrelevant for corporate managers, too. How convenient.

Economists and finance people are thinking almost entirely about the impact of dividend policies on the current market value of the company, not the impact on the business itself. The professors do not address the critical issue of **how a company should reinvest its cash flow**. The scholars assume that they know how the money will be invested, thus the only question left is the purely financial one of where the money comes from:

1. Retained earnings or
2. The market place if a dividend is paid.

And, according to efficient market hypothesis (“EMH”) theorists, because the source of the money—a company’s choice between debt and equity—is said to be irrelevant in market terms (*CAPM or capital asset pricing market*), dividend policy is irrelevant too. In other words, the very issue that a business person sees as paramount—the choice between putting money back in the business or paying it to shareholders—they break up into two ostensibly unrelated ones.

Economists are mystified by the market’s preference for dividends, but ask yourself why if you consider human nature. Investors are fearful of managements in businesses that barely meet their cost of capital who retain capital rather than return it to shareholders. More money could be squandered. Economists and analysts love to build econometric models and the *MM* theory fits beautifully. They want to find and test universal principles, particularly quantifiable ones, that will support the econometric modeling on which they are so keen (*how can you earn a PhD in common sense?*). But how can a business decision on how to allocate capital (pay out cash to shareholders or retain in the business or buyback shares) be separate

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<sup>3</sup> Coca-Cola once diversified (read Di-worsified) into shrimp farming. Yes, shrimp farming. The venture failed because what connection is there in the customers’ mind between drinking Coke and buying shrimp—a branded good and an agricultural commodity? Former Coca-Cola Chief Marketing Officer Sergio Zyman explains why renovation of an existing brand is a better way to go. Associations can learn from the innovation errors of the corporate world. Coke, for instance, once got into the shrimp farming business. No, I’m not making this up. Coca-Cola had fantastic core competencies in purchasing, distribution, sales, logistics, and global operational capabilities. Where it all fell apart was that Coke never thought about why customers would buy shrimp from them in the first place. Shrimp farming was not the company’s core essence. Consumers simply made no connection between shrimp and Coke. What are you doing that makes members raise an eye or give a quizzical look when (or if) they learn about your association’s involvement?

from the specific social and institutional context in which they arise? If a business has to increase their investment due to a competitive threat or to maintain its competitive position, the modelers can't have too many variables or their models melt down. Thus, they ignore empirical evidence. All investing like deploying retained earnings or paying out excess cash is dependent upon context not models.

The following chapter on dividends synthesizes *Buffett's* and *Graham's* thoughts on cash dividends as well as *Mr. Louis Lowenstein's* business experience as a corporate board member and manager. The chapter will be followed by the writings of those two authors so you will have the original references and historical context to understand how durable the principles and questions are for an investor and corporate manager. Finally, there will be a summary and case study for you to study.

## CORPORATE FINANCE

SENSE & NONSENSE in CORPORATE FINANCE: An Antidote to Conventional Thinking About LBOs, Capital Budgeting, Dividend Policy, and Creating Shareholder Value by Louis Lowenstein (Addison Wesley, 1991) Pages 121-143.

### Chapter 7: Cash Dividends—To Keep the Money or Pay It Out, That is the Question

The potential for mischief in the *Modigliani-Miller* thesis that dividend policy is irrelevant is considerable because it tends to reinforce the obvious preference of corporate managers to keep dividends as low as possible. Many managements would rather hold on to the money, expand the X business, buy and try the Y one, or just feel as cozy as one can feel only with plenty of cash in the drawer (not your own cash, the investors' cash). Then along comes the MM theory, blessed by virtually everyone, to put a patina of intellectual legitimacy on these self-serving preferences. If dividends are irrelevant and, beyond that, tax foolish, why not let management keep the money?

### A PROPER AND SIMPLE POLICY FOR DIVIDENDS

Dividends are irrelevant for economists. They are consistently applauded by shareholders. They are an afterthought for corporate managements, who often allot to dividends only what is convenient. **Properly seen, however, dividends are the framework in which business managers are forced to make quite hard decisions about whether the company or its shareholders should have the money.** Has the company demonstrated over time an ability to reinvest earnings successfully, or like all too many others, should it be making significantly larger distributions to the shareholders, where they can be put to better use? While not always easy to apply, no other policy issue could be more basic or analytically uncomplicated.

### THE CASE FOR HIGHER DIVIDENDS

Examples of companies that have been unable to put their retained earnings to good use, and should have distributed more to their shareholders long ago, are easy to find. In 1980, for example, *National Steel*, an integrated steel company that had been quite profitable, began to diversify into a grab bag of unrelated businesses. Renamed *National Intergroup*, it bought a number of thrift institutions, a wholesale distributor of pharmaceuticals, a franchisor and supplier of general merchandise stores, an aluminum foil producer, a hospital supply business, a pipe and tubing producer, an oil gathering and distribution operations, and others, at a total cost of \$1 billion. It sold off most of its steel operation, including all of *Weirton Steel* and a major interest in *National Steel*. Quickly disillusioned with its new investments, however, the company sold (or planned to sell) everything but *FoxMeyer*, a lackluster distributor of pharmaceuticals with operating margins well below industry standards.

The cost of this erratic behavior was staggering. After two years of steel profits at the beginning of the 1980s equal to \$9 per share, *National Intergroup* proceeded to lose \$42.45 per share over the next seven years. **Dividends would have been—they should have been—the issue on which a more rational use of capital was forged, but the opportunity was missed.** The annual dividend, which had been at least \$2 a share from the mid-1970s through 1981, was slashed to 25 cents in 1983 as the diversification program heated up. Later still, the dividend was ripped altogether. In 1988, as even as the losses continued and the banks were imposing tighter controls, the CEO who had been in charge throughout this so-called restructuring continued to talk casually of building a base for steady growth<sup>4</sup> by then the stock of *National Intergroup* had fallen from an average of \$28 a share in 1980 to \$16, and book value had plummeted from about \$75 a share to \$31.

Fortunately for the shareholders, a dissident group of shareholders won a proxy fight in 1990 and forced a decision by the board of directors of *National Intergroup* to liquidate what little was left.

Like *National Intergroup*, *Nortek, Inc.*, bought and sold a number of quite different businesses—over thirty—during the years 1980-1988. Ostensibly a defense contractor, *Nortek* had asked *Drexel Burnham Lambert* in 1985 to raise \$150 million in a junk bond financing: bankers responded by raising \$300 million (and eventually \$600 million in all).<sup>5</sup> *Nortek* used some of the proceeds to buy other Drexel Burnham junk issues, which for a time covered the high cost of capital. But the company was not able to put its capital to a sustained good use.

Table 7-1 contains data for the years 1980-1988 for *National Intergroup* and *Nortek*. Despite a rapidly rising stock market and 50 percent overall inflation,<sup>6</sup> the shareholders' total return for the period was nonexistent at *National Intergroup* and slender at *Nortek*. (By 1989, it would be nonexistent at *Nortek*, too). **Huge sums that could have been distributed as dividends or in liquidation were instead squandered on a program of acquiring unrelated businesses that soon turned to ashes.** At *National Intergroup*, dividends were modest by any yardstick. *Nortek* was reporting earning by paying out less than 5 percent of its earning as dividends.

| <b>Per Share Data</b>                            | <i>National Intergroup</i> | <i>Nortek</i> |
|--|----------------------------|---------------|
| Earnings 1980-1988 <sup>a</sup>                  | -\$33.45                   | \$14.58       |
| Less Dividends, 1980-1988                        | \$6.91                     | \$0.64        |
| Retained Earnings, 1980-1988                     | -\$40.36                   | \$12.48       |
| Cap-Ex plus acquisitions, 1980-1988 <sup>b</sup> | \$92.40                    | \$75.10       |
| Ratio of capex to retained earnings              | n.a.                       | 6             |
| 1980 average stock price                         | \$28                       | \$5           |
| 1988 average stock price                         | \$16                       | \$8           |

<sup>4</sup> National Intergroup, Inc. 1988 Annual Report, cover page, 4.

<sup>5</sup> Bruck, *Predators' Ball*, 213

<sup>6</sup> Economic Report of the President, January 1989 (Washington, D.C.:U.S. Government Printing Office, 1989), 377.

|  |        |        |
|--|--------|--------|
| Shs compounded ann. rate of total return   | -2.21% | 6.27%  |
| Comp. ann. rate of tot. return, S&P 500  | 15.90% | 15.90% |
| <sup>a</sup> Includes nonrecurring and extraordinary items   |        |        |
| <sup>b</sup> Both companies made substantial divestitures, which would reduce the net cost of these investments. |        |        |

*National Intergroup*<sup>7</sup> and *Nortek* followed misconceived and costly diversification programs that were carried on long after the time that even a modestly diligent board of directors would have called a halt. Cases such as these cry out for more generous distributions to shareholders, because, by definition, the money invested in acquisitions was not needed in the core business of the company. Surplus funds and borrowing power were drained while the board slept.

The fact that a management has one set of skills does not mean that it also has others or that it is wise to pay a substantial premium over market, as it must usually do, to acquire a business that, if the same funds were distributed, the shareholders could purchase on their own. Do not buy company X stock yourself, these managements are saying to shareholders, when we can buy it “wholesale,” at twice the *retail* price. (*This is “disworsification”--a term coined by Money Manager, Peter Lynch—at its best!*)

### THE WISDOM OF “NEGLECTING” A CORE BUSINESS

Diversification programs are suspect. Sometimes, however, the problem goes directly to the core business of a company. Perhaps it should not be liquidated straight off because it is capable of generating a better return alive than dead. But quite often one can see that there is no reason to plough new dollars into it, and then the dilemma is serious. Managements that are wise or timid or prudent enough not to go into unrelated businesses may still be reluctant to wind down the ones they are already in without trying to sustain them in some “productive” fashion. A high payout would be a confession of failure, and who wants to do that?

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#### <sup>7</sup> NATIONAL INTERGROUP, INC.

American holding company established in 1983 to facilitate the diversification of National Steel Corporation. Formerly headquartered in Pittsburgh, Pa., NII moved to Dallas, Texas, in 1991, and National Steel moved to Mishawaka, Ind., in 1992.

The steel company was formed in 1929 by Ernest T. Weir (1875–1957) through an amalgamation of Weirton Steel Company, Great Lakes Steel Corporation, and Hanna Iron Ore Company; the company controlled not only steel mills but also iron-ore mines and coalfields. National Steel was consistently one of the most profitable steel companies throughout the Great Depression of the 1930s and the only one to make a profit in 1932. A self-made rugged individualist, Weir was an outspoken opponent of many New Deal programs and battled successfully for many years to forestall unionization of his Weirton plant. He deftly undermined the appeal of the ironworkers, steelworkers, and tin workers union among his men by unilaterally granting wage hikes as company profits rose.

*National Steel* diversified into aluminum manufacturing with the acquisition of *Hastings Aluminum Products* in 1968 and *Pittsburgh Aluminum Alloys* in 1970 and the creation of National Aluminum Corporation. In 1984 it formed a new computer-data and information-services subsidiary, GENIX. The company also engaged in the distribution of pharmaceuticals, petroleum products, and other goods.

*National Intergroup* sold 50 percent of its interest in *National Steel* to Tokyo-based Nippon Kōkan KK in 1984 and another 20 percent to the same company in 1990.

Mining companies are a classic case in point. Often the profits of one year's digging go right back into the ground, although the company's history is that the average returns on capital have been quite poor. To be sure, there are companies with deep, rich mines that should be developed. Many of the rest, however, ear a decent return only in a few flush years, when copper or silver prices, say, are unusually high. Perhaps they were overexposed as children to the Con Ed signs in New York, "Dig we must." The managements are mining people; that is the business they know and love, and they seem unable to resist the temptation to pour the solid (not great) earnings of those few good years into new holes rather than treating them as a windfall and making liberal payments to shareholders. It is true that the dividend alternative is tantamount to a policy of slow liquidation, or at least stagnation. **The fact, however, is that only if they are treated like cash cows will most mining companies produce acceptable results.**

In the good years, when even poor mines show good profits, the managers seem to suffer from amnesia. Rather than paying dividends they speak of building a base for long term growth. Then the cycle turns; money is back in the ground, and shareholders, and the company too, have nothing to show for the profits. *Helca Mining (HL)*--See Chart on next page--for example, was generally paying a nominal dividend of \$0.05 a share annually in the 1980s while reinvesting on average almost twenty times that much in capital spending. The company boasted in its 1985 annual report that it owned the largest silver-producing mine in the country but also acknowledged that the mine was unprofitable. (When losing money, it would be better if the mine were smaller.) Undaunted by its past failure, the company periodically announced new exploration programs. To what avail? In 1989 it lost money, as it had during much of the rest of the decade. The stock price, which had averaged about \$24 in 1980, fell below \$7 in 1990.



*Denison Mining* was no better. In its 1989 annual report, it waxed poetic about mining, saying that "carving a mine out of the wilderness... (is) a highly precise science and a finely tuned art." Perhaps, but not from a shareholder point of view. Between 1986 and 1989, the company experienced heavy losses, cutting the book value in half, even while it continued to invest heavily in capital spending and glossy, four-color annual reports.

## MAKING THE REINVESTMENT VERSUS DIVIDEND DECISION PATIENTLY

We should be careful not to over generalize. Not all companies that reinvest without prospects for an immediate return are necessarily pouring money down a black hole. A clear case for patience could have been made for *Caterpillar*, the world's leading producer of earthmoving equipment. The company sustained substantial losses in 1982-84, and only in 1988 did earning return to the level of 1980, before declining again. On the numbers, the performance was subpar, as evidenced by a compounded annual total return (dividends plus appreciation) for shareholders of only 3.19 percent over the entire decade of the 1980s. Did that make of *Caterpillar* another self-serving management, one that would rather reinvest at almost any cost? I don't think so. In an era when American industry was being accused of short-sightedness, when the Japanese could steal market share simply by lowering profit margins for a time, *Caterpillar* was defending a world class franchise—first in the industry worldwide—that had been highly profitable for many years. The company still was the nation's second largest exporter, second only to *Boeing*, and an acknowledged leader in quality. Like other American businesses, *Caterpillar* was facing vigorous price and product competition from Japan, in this case from *Komatsu Ltd*. But it was fighting back, holding prices steady as long as possible. Dividends were cut, and capital expenditures in 1989 alone were about \$1 billion, more than triple the level just a few years earlier, with more reportedly to come. Admittedly it had been slow to react, but now the company was overhauling virtually all its seventeen U.S. plants, installing robots and streamlining its operation, hoping to trim 20 percent from its production costs.<sup>8</sup>

There was no way to know the eventual outcome. With most of its plants in the United States, *Caterpillar's* export are sensitive to currency fluctuations, and in the spring of 1990, for example, the dollar rose sharply and unexpectedly against the yen. Demand in some markets turned soft, and the cost cutting program may have been moving too slowly. But *Caterpillar* has an enormous amount of what *Charlie Munger* calls “social momentum,” meaning people, relationships with suppliers and customers, and organizational systems and values that have been built up over decades. It should not relinquish that momentum lightly.

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<sup>8</sup> *Robert L. Rose*, “Currency Squeeze: *Caterpillar* Sees Gains in Efficiency Imperiled by Strength of Dollar,” *Wall Street Journal*, April 6, 1990, p.A-1, col. 6.



### THE DANGERS OF STOCKPILING CASH

Still, executives may be tempted to pour money down black holes because the money is not theirs—it is the shareholders’—and because they often measure their eminence and success by revenues rather than profits per dollar invested. **As long ago as 1934, *Graham and Dodd*, writing on dividend policy, said that reinvesting a substantial part of the earnings must be clearly justified to the shareholders on the basis of concrete benefits exceeding the value of the foregone dividends.**<sup>9</sup> Even if the retention of earnings is a necessity, they added, stockholders should be advised of that fact. And that was said at a time before so many companies had set off on programs of random diversification away from the very business—the only business—in which the shareholder had consented to invest. With any decent regard for those owners, a company that makes steel would not have turned itself into a jobber of pharmaceuticals without consulting them.

The problem may go deeper still. Cash sitting around for any length of time can be unbearable, even it is your own. We all would like to create a notable business or product; we would all like to create a notable business or product; we would all like to head up a large company rather than a small one. Perhaps it is not the money. Perhaps it is the game that counts. Indeed, the profit motive may be little more than a cover, a rationalization. We want to run a global enterprise, we want to create something significant to put on our psychic tombstones, and, yes, sometimes we just enjoy trying to beat the odds and conquer an uncertain world. The *Hunt* family of Texas and others, too, has squandered Texas sized fortunes searching for personal fulfillment or just excitement. The odds that *Robert Campeu* would win his overleveraged bet on *Federated Department Stores* were terrible from the start. But the game itself is almost irresistible even if its generic name is speculation. Being enthusiastic—and sometimes manic—we tell shareholders and ourselves, too, that the bold new merger will be very profitable, at least in the long run. That is why the projections in those strategic long term plans go straight up.

<sup>9</sup> Graham and Dodd, *Security Analysis*, 1<sup>st</sup> ed., 636-637.

Impatience is the other part of the problem. There is a proverb that genius is patience, and CEOs are not geniuses any more than the rest of us. It is painful to sit with a pile of dollars, doing “nothing,” looking like a coward, with security analysts yelling “Jump,” even if what you might jump into looks suspiciously like a black hole. Good finance executives recognized the problem and try to protect against it. At one paper company, the financial chief squirreled money away as an “investment” rather than showing it as cash so that the CEO would not think of it as spend able money. (It worked.) *Exxon* has a conscious plan not to “stockpile” dollars but instead to pay dividends and to repurchase stock lest impatience get the best of them. But it takes discipline.

Patience may seem foolish in an era of random takeovers when cash is still something of a dangerously hot item. But for companies with the means to ward off takeovers, and ultimately even for those that don't, investment decisions should not be made hurriedly. Good opportunities do not necessarily come along every year or even every two or three. *Ford Motor (F)*, which at the beginning of the 1980s had the lowest working capital and was in acute financial distress, engineered a solid turnaround. Still, just a few years later, it was being severely criticized for holding onto \$9 billion of cash despite the fact that its routine capital expenditure were running \$4.7 billion a year and the industry once again seemed headed for hard times. Soon after that, the company, either stung by the criticism or, more likely, having lost patience, allowed the swelling cash to burn a hold it its pocket. Toward the end of the 1980s, it spent about \$8 billion on the Jaguar nameplate and some other acquisitions peripheral to its core business. By the end of 1990, the weakly to report that it would have to sell assets and delay new models. For those who do not have a friendly control shareholder, and even for those such as Ford who do, cash may be impolitic, but it is not sinful.

No doubt the management of *National Intergroup* produced “solid” projections for each new business that it bought, but , given the dismal record, the board of directors should have assessed the projected results for new investments by the poor performance of the old. (One wonders where the *National Intergroup* board of directors could have been during these years of inept management. On paper, it was a picture board, one that included senior executives of several major corporations and banks, the presidents of a university, the dean of a major business school, and other “distinguished” people.) Note, of course, the past performance that matters is not the spectacular but old winners. A supermarket chain, for example, may not cannibalize existing stores. Without suggesting a preoccupation with any one year's results, only an analysis of recent store openings will reveal whether sufficient new opportunities are being found.

*Graham & Dodd* had it just right. **A decision to retain and reinvest a significant part of the earnings should be explained to shareholders, and shareholders should insist on more than the usual bromide that dividends will “keep pace” with earnings.** Think of it in this way: companies make money in order to distribute it (eventually) to shareholders. Assuming that the business is successful, some of the money must be kept to protect the business and to comply with legal and social obligations. Still more money may be kept if the company can reinvest it more profitably than the shareholders can manage on their own. Beyond that, however, the dollars should be distributed. The choice is the simple one of allocating capital, of deciding where it can be better used: by the company or by its owners. (If the latter, then the distribution might take the usual form of a cash dividend or it might be done by the share repurchase, which for tax and other reasons can be an extraordinarily attractive alternative. (See section on stock buy backs) The crossover point, the one at which money should be paid out rather than retained by the company, is an issue that will be discussed. But whether the number is a bit lower or higher is not significant. What matters most is to see the issue in the proper framework.

## JUSTIFYING THE DIVIDEND-VERSUS-REINVESTMENT DECISION: THE HURDLE RATE

Finance people in and out of industry are accustomed to thinking about new projects in terms of the cost of capital, sometimes called the hurdle rate. That cost is the minimum amount that must be earned to justify the investment. What is meant is not literally the cost, because the debt portion, for example, may have been borrowed years ago at much lower interest rates. And to calculate the “cost” of retained earnings is almost impossible. Instead, we define the cost of capital as the *opportunity* cost. Money is valuable, whatever its source, and a good measure of that value is what the money would earn in whatever other comparable opportunities are available. In this context, it means that a company should not reinvest earnings in discretionary projects unless it reasonably expects, and has demonstrated its ability, to earn at least as much as history tells that the shareholders could, on average, earn on their own if only the money were paid out.

Defining the cost of capital in these terms is quite consistent with the traditional view of dividend policy. Companies were not expected to expand just for the sake of it, and it was commonplace to distribute earnings, even all the earnings, to shareholders. That is what investments were about. For the first quarter of this century, there were speculators, to be sure, but the line between them and investors was much more sharply drawn than today. Investors were not supposed to think in terms of price appreciation or “total return” as we now call it. They bought securities for income—interest or dividends. While a corporation might retain its earnings, the burden of proof, so to speak, was on management.<sup>10</sup>

Some people in management still think in these traditional terms. *Charles R. Sitter*, senior VP of *Exxon* and its chief financial officer, believes that debt and equity are alike in the sense that in both cases the company is simply the custodian of investors’ money. Shareholders, like creditors, have given the company only the temporary use of their funds. If the available opportunities are not sufficiently attractive, the company should have no greater compunction about returning money to shareholders—paying dividends or buying back stock—than it would have about prepaying debt. The trick, he said, is not be “macho” about building a large cash kitty and then stretching to find uses for it.;

You will not find anything that resembles *Sitter’s* views in today’s finance literature. The only similar discussion is in the 1984 annual report of *Berkshire Hathaway*, where the chairman, *Warren Buffett*, concluded that if a company’s internal rate of return does not at least equal that available to investors in the financial markets, the money should be distributed to shareholder. Otherwise, he said, the company might be investing to earn eight percent when shareholders could on their own buy stocks with an average annual return of, say, 10 percent. In a world where the dollar that a company keeps won’t be worth a dollar in the market price of its shares unless it can produce a return of 10 percent on that dollar, dollars invested at 8 percent will soon be marked down in market price, and the shareholders will have suffered a loss. His conclusion, stated in terms of long term market values, was:

Unrestricted earnings (roughly equivalent to “available cash flow”) should be retained only when there is a reasonable prospect—backed preferably by historical evidence or, when appropriate, by a thoughtful analysis of the future—**that for every dollar retained by the corporation, at least one dollar of market value will be created for owners.**

In short, don’t expect to find many companies with the necessary discipline. The corollary is that companies that over time demonstrate a genuine concern for their shareholders are highly valued by analysts and investors.

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<sup>10</sup> Guthmann and Dougall, *Corporate Financial Policy*, 532-33. To be “traditional” is not a good thing in the lexicon of modern financial theory. Brealey and Myers, for example, state flatly that “with hindsight we see that (traditionalists) did not think too clearly, “*Principles*,” 393. **Only in the rigorously mathematical world would one be so certain.**

## CREATING A DOLLAR OF VALUE FOR A DOLLAR OF RETAINED EARNINGS

What does it mean to create a dollar of market value for a dollar of retained earnings? There is Delphic quality to that standard. If for several years our mythical drug company, *Middle American*, has been earning over 20 percent on equity, should we reject any proposals that would dilute that record? At first blush, it might seem so. The current price of the stock probably reflects the market's expectation that the company will continue to produce 20 percent returns or something close to that. If instead the company now "settles" for projects with only a 14 percent expected annual return, the price of the stock may well drop. Would those new projects create market value of a dollar for a dollar, or would they erode the value?

A drug company with exceptionally high returns on equity is admittedly special. But the stocks of most other public companies also sell above their book values. While industrial companies earn about 13 percent on their common equity, investors in stocks earn, over very long periods of time, a compounded total return (dividend plus price appreciation) of about 10 percent a year. And they are quite pleased with that. **In other words, while investors have come to expect management to produce a better than 10 percent compounded return on equity capital, they, as investors, are content with a 10 percent return, and so they mark up the average industrial stock to a price above book value.** That is a very important concept. Shareholders assume that industry can be better managing money actively than they can do passively. And history confirms that, on average, they are can do passably. And history confirms that, on average, they are right. A number of factors could affect the relationship, notably inflation, but until now, on average, a dollar left in the business, and not distribution in dividends has created, say \$1.30 of market value for shareholders, if, as has been the case, the business could earn on that dollar of equity a 13 percent return.

Now suppose that an average company—not just an exceptional drug company but one that has been earnings 13 percent on its company equity—sees that the opportunities for a 13 percent return are drying up, and the problem is more than a passing episode. Shareholders will suffer a permanent loss of market value no matter what the company does, because the market price probably reflects a more optimistic set of expectations.

That is not very appealing. From the CEO's point of view, the prospect of investing capital in projects that yield less than 13 percent is also not very appealing. Why would a CEO want to have a business epitaph that he or she was content to dwell in the bottom portion of the class?

The answer may not be appealing to an ambitious CEO, but it is realistic and a major improvement over some of the alternatives. The answer is that while no one wants to be below average, approximately half of American industry has no choice. Entire groups, ranging from airlines to oil drilling equipment, have shown returns consistently below average. Banks, too, few of which consistently earn 13 percent on their equity. To insist we all be first or second in each segment of our business, as *General Electric (GE)* (with some shuffling of the cards) has largely succeeded in doing, is not a useful standard for the community as a whole unless we want to legislate away the half that lives on the "other side" of the tracks. A minimum hurdle rate of 13 percent is simply too high as an absolute cutoff.

To paraphrase the Duchess's advice to Alice, there must be an acceptable hurdle rate somewhere, if only we can find it. We can—by looking at the problem in terms of dividend policy. In other words, if stocks and, if on average, those investments produce a 10 percent compounded annual rate of total return, including appreciation, that so called opportunity cost represents a highly suitable threshold or cutoff point for companies faced with the decision of whether to retain earnings or to distribute them. Only if the company can do as well or better should it reinvest.

**We must be careful not to fall into the trap of trying to quantify this cost of capital precisely.** There is no magic at 10 percent. For example, the compounded total return from stocks had been 10 percent a year; the average annual return has

been about 12 percent.<sup>11</sup> The difference is so large because of what *Martin L. Leibowitz* of *Salomon Brothers* calls “volatility drag”: the greater the fluctuations in the annual returns of a stock or group of stocks, the more the compounded annual rate of return, which is how portfolios are generally measured, will fall below the average annual return. Since investors as a whole cannot go in and out of the market, I prefer the more conservative compounded 10 percent return. Even that number does not represent an irreducible minimum, however. We can justify a figure even lower than 10 percent by taking into account the personal income tax that individual shareholders, for example would have to pay on a dividend. Assuming the ability and integrity of management are unquestioned, that may be the right thing to do. Eight dollars, for example, would ordinarily be an inadequate return on \$100 of shareholders equity, but it would represent a respectable tax equivalent yield on the \$65 which would be the after-tax proceeds of a dividend to a taxable shareholder.

There is no one number that is so compelling as to exclude all others: precision is an illusion. We are talking about hurdle rates that are to be applied by people who are working within a complex, often highly political setting--people who get bored, go on vacation, or just want to (dis) prove a project in order to have done with the issue. Using a different method from the one used here, one that among other things blends the cost of both debt and equity, *Quaker Oat's* hurdle rate for new investments was a little over 11 percent and *Coca-Cola's* was 12 percent. (The discussion of risk as an element in the calculation of the cost of capital or hurdle rate has, for convenience, been left for chapter 10.) Those are useful numbers and they are the product of extensive experience. In the interest of stability, Coca Cola's rate was allowed to remain unchanged for at least four years despite fluctuation interest rates. But however arrived at, in today's financial and economic climate, a hurdle rate, or assumed cost of capital, in the 10-11 percent range seems quite appropriate. It is somewhat below the 13 percent return on equity currently enjoyed by the industry as a whole and so is suitable as a minimum rate of return. To be sure, if interest rates were to rise significantly and for a sustained period, the minimum would have to be set higher; otherwise shareholders would no longer be getting a full dollar of market value per dollar of retained earnings.

Does that mean that companies should accept any and all projects that walk in the door offering an 11 percent return? Obviously not. Companies approve first all new projects that offer a rate of return above the hurdle rate. Highly profitable companies may well exhaust their available funds long before reaching the 11 percent proposals. It is only for the marginal, tail-end project, after the better ones have been approved, that this cost of capital concept has any bit.

It is true, of course, the companies like *Coca Cola* enjoy high price earnings ratios (1990) because they have heretofore been able to deliver high returns on invested capital. But it is easy to draw a wrong inference from that fact. It is true that if *Coke* cannot do better than 11 percent, its stock price will soon drop. But it does not follow that because *Coke* has been so successful up to now in finding better than 11 percent opportunities, an 11 percent project today should necessarily be rejected. While a high price earnings ratio reflects an expectation on wall tree that the company had bright prospects, Wall Street may simply be wrong. If so, the business operations should not be distorted by the fact that expectations and outcome may be destined to differ for reasons wholly beyond management's control. If in fact the security analysts' expectations are wrong—if there is a continuing dearth of high return opportunities—that high price earnings ratio will ultimately have to be corrected. Management has not guaranteed the current stock price. Or to put it somewhat differently, any proposed new project needs to be analyzed on an independent, stand-alone basis. The fact that a company now owns an extraordinary business should not deter it from investing in an ordinary but still satisfactory one. (*If the marginal return on invested capital or MROIC is lower than the core business but still higher than its cost of capital, then invest*). If the ordinary one will producer returns of 11 percent and it the best available, then in the current economic climate, the investment should satisfy the principle of a dollar of market value for each dollar invested.

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<sup>11</sup> Ibbotson studies

## PAYING DIVIDENDS IS NOT AN ADMISSION OF FAILURE

If a company does not earn a decent return on its newly retained earnings over time, and many do not, then the money should be paid out so that investors can put it in one that does. Some companies are in industries that are growing and profitable, and some are not. **In a mature economy, the fact that a great many companies do not have exciting prospects is a truism.** The question is, “How ready are managers to acknowledge that reality?” Companies that have only meager opportunities should not also be frozen, as *Ben Graham* described those that keep all their earnings. Dividends are important. Over time, they affect the allocation of capital by society. Setting a floor, hurdle rate, somewhere is a step forward for all concerned. Such a test would have dictated a much higher dividend payout by *Helca Mining*, for example, a company that over a nine year period reinvested almost all of its earnings with very little to show for it. *Nortek* invested almost all of its earnings with very little to show for it. *Nortek* falls into the same category.

A higher payout is not a confession of failure. Dividends are often an act of managerial candor that mark the company as a corporate all-star. Perhaps the payout should take the form of share repurchases rather than cash dividends. But however the money is returned to shareholders, managers must recognize that they sometimes run out of good opportunities. The ancient Greeks knew better than to go to war when the gods were not smiling on them and the odds were poor. It seems more difficult in business, perhaps because our corporate warriors have read less history. *Exxon* is one of a growing number of exceptions, willing to acknowledge that acceptable projects are not always available. In addition to substantial dividends, *Exxon* bought back out of excess cash flow during the 1980s over \$15 billion of stock, which not only served shareholders well but maintained an essential aspect of corporate discipline.

## LIMITATIONS OF ANY PURELY FINANCIAL OR QUANTITATIVE ANALYSIS

A central theme of this book is that the importance of finance—and, of course, finance teachers—has been greatly exaggerated. That applies also to this discussion of whether available cash flows should be retained or paid out. Unless a company decides to abandon a business altogether, the fact is that many of the expenditures are obligatory; management simply has no choice. We have seen, for example, that short of liquidating the company, *Caterpillar* (CAT) had an array of investments that it had to make if it was to maintain its competitive position, particularly in relation to Komatsu, the ***Japanese intruder***. ***No financial analyst could add very much***. Perhaps years ago the company should have gone into the electronics business, but instead it went into earth-moving equipment. That is where it is, and an enormous investment and goodwill have been built around that decision. Just about all of the stepped-up capital expenditures at *Caterpillar* appear to have been “no-brainers,” meaning that they were designed to lower the cost or increase the quality of the product rather than to increase overall capacity or go off in new directions. Absent a decision to liquidate the business—either immediately or by milking it over time—there was virtually no issue as to most of these expenditures.

*Coca-Cola* has formalized this distinction by exempting from the hurdle rate any projects that are not “optional” by its standards. *Exxon*, *Liz Claiborne*, and *FMC* do pretty much the same thing.

For easy reference, *Munger* divides investments into several rough categories. To begin with, there are lots of **no-brainers**—investments that must be made if the business is to continue with any chance of success. Others may not be very profitable in their own right, but they produce synergies or positive trade-offs elsewhere in the product line. Still others may be desirable because the losses are able. In addition to these no-brainers, there are also gold mines, cash traps, and cash cows. Gold mines are few and far between, but if we think of owning one of the network television stations (or the dominant newspaper) in Chicago a few years ago, the concept is clear. A gold mine is a business that is expected to produce substantial

earnings for a long while and without depleting the course. *Helca Mining* seems to have been a cash trap.<sup>12</sup> If the money that came out of those silver and gold mine, and more, ended up going back into the ground. The profits should have been paid out to shareholders, except for some minimal mounts necessary to limp along. In that case the mines might have been reasonable valuable as cash cows: the cash flow would have been maximized, though eventually it would have dried up.

The relevance of this once-over lightly view of Munger's analysis is that it underscores the fact that nicely calculated financial hurdle rates and cost of capital have little to do with real world business and dividend decisions. If we push the analysis of a project far enough, it is true, we could produce some numbers that could then be subjected to a cost of capital test. But what would it add? We are talking about investment returns over long periods of time, and the numbers soon get fuzzy. Economists like to talk about making all investments that show a positive net present values, as if even small positive numbers are a significant signal. If that were, then it might be useful to calculate the cost of capital to a tenth of a percentage point. But it is not. **As Exxon found, the effort to fix the cost of capital by the uncertainties of the business.** In projects affected by oil prices, for example, the company uses at least two different crude oil scenarios, one likely and one pessimistic, and the difference in the expected returns between those two can be as much as ten percentage points.

Calculating its cost of capital for 1988, *Quaker Oats* fixed the cost of the equity component at "approximately 14.3%," a seemingly precise figure.<sup>13</sup> I am skeptical about the value of this highly quantitative approach. The analysis of a proposed capital investment depends so much on the context of the industry, the nature of the competition, and other imponderables. Beyond that, managements should always leave a reasonable margin of the inevitable error of optimism. As *William H. Schumann III*, Treasurer of *FMC*, commented, the optimism usually takes the form of not realizing that the competition is probably deciding to expand its capacity at the very time that you are deciding to expand yours, and one against you end up waging war at a time when the gods are not smiling. (Every inventor in a garage likes to think that the other garages house only the family car). In capital budgeting, it is the analysis and the discipline that are valuable, not the close tweaking of the numbers. Companies such as *FMC* and *Coca-Cola* recognize this reality by not changing hurdle rates often. *Exxon* does so by defining its cost of capital only within a range of one to two percentage points. The company's chief financial officer, *Sitter*, summed it up well; while the theory is that you stop investing when the lines cross at X.X percent, "the lines are not lines but bands, and the investment return band is frequently quite a wide band."

## SOME CONCLUDING OBSERVATIONS ON DIVIDEND POLICY

### A YARDSTICK FOR DETERMINING DIVIDENDS: CASH FLOW VS. EARNINGS

How much money is available for dividends? Companies frequently say that they pay out 40 percent or so of earnings, but it is an answer that has not been thought out. It implies a certain consistency, which is what shareholders want, but why at 40 percent and not some other level, say 80 percent?

Certainly earnings are important, but a better starting point would be the cash flow from operations (CFO), a useful concept but one that needs definition. There is no single definition of operating cash flow, but it is customary to add back to a company's net earnings from operations several non-cash items that were charged to earnings in the income statement, the

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<sup>12</sup> See Appendix for HNR-cash bargain or value trap with entrenched management?

<sup>13</sup> See 1988 Quaker Oats Annual Report.

most important of which are (1) depreciation, (2) amortization, if any, of intangible assets (typically those that arise from a business acquisition), and (3) increases in deferred taxes, to the extent they are likely to be permanent. (That is how the term “operating cash flow” is used here.) Depreciation is usually the largest of these items. It is an accounting proxy for the wear and tear and the obsolescence of a company’s existing assets.

Operating cash flow is sometimes treated as if it were freely disposable income, but that is a serious mistake. We are entitled to think of cash flow as a source of dividends if and only if we first deduct those obligatory expenditures that must be made simply to enable a company to maintain its existing, stand in place business and competitive position (Forklifts do wear out, and machine tools do become obsolete.) If the core business is a black hole, one into which dollars disappear, never to be seen again, those no growth expenditures should be reexamined, but otherwise they are obligatory. Deducting them from operating cash flow leaves the amount that is realistically available for dividends, expansion, business acquisitions, prepayments of debt, and so on, referred to here as available cash flow.

The operating cash flow will invariably be larger than the earnings, but often the available cash flow is not. Indeed, in a capital intensive business there may be times when the cash flow that is available after obligatory expenditures is a negative number. At the end of the 1970s, for example, *Ford Motor* enjoyed a large and positive operating cash flow (earnings plus Depreciation and Amortization), but its available cash flow was either negative or at least not large enough to cover the dividend. *Ford* was reinvesting heavily to make its cars more fuel-efficient, an investment that had to be made if only to protect market share (*in other words, Ford was investing maintenance cap-ex to maintain its earnings power or owner earnings*). Earnings in 1979 of about \$1.2 billion were substantial, and depreciation and amortization of equipment added \$1.6 billion more to cash flow. But net capital expenditures totaled \$3.4 billion. While operating cash flow was \$2.8 billion, available cash flow was negative as much as \$600 million. On top of that, Ford paid a cash dividend of \$470 million. **Although the earnings and operating cash flow covered the dividend, the available cash flow did not. The dividend should have been dropped.** Instead, the company paid out over \$900 million in dividends in the years 1979-1981. It did not eliminate the dividend until 1982, by which time its working capital had been seriously eroded.

Much the same pattern could be seen more recently at *Caterpillar*, where, despite its already discussed, costly fight for survival, the company was maintaining in 1990 and early 1991 a dividend rate that was unsupported by available cash flows.

There is frequently a debate over which is more useful as an analytic tool: earnings or cash flow. The answer is that both are useful, and neither one alone tells you all that you need to know. Since both earnings and cash flow statements are required by the SEC, I have never understood the need to choose between them, except for those people who are unable to work with more than one number at a time. Cash flow statements, however, do show more readily that, even apart from capital expenditures, **some businesses are more capital intensive than others are and are likely to have less freely available cash.** Department stores are a good example. They require large amounts of capital to carry the necessary inventory and counts receivable. Supermarkets, by contrast, require much less capital because they have no accounts receivable and their inventory turns over so much more rapidly that very little money is tied up. Often they are able to operate with negative working capital. These differences in cash flow characteristics are enormously important.

It is inadvisable for companies to contemplate paying dividends on a regular basis except out of available cash flow. **One of the few aspects of dividend policy on which there is widespread agreement is that a dividend rate, once established, should not be cut casually.** Consistency, where practicable, is important. Leading corporations encourage individual investors, in particular, to think of a dividend as income that can be spent freely in day-to-day living without impairing their real, (that is inflation-adjusted) capital. Since investors typically do arrange their budgets so that their living expenses are covered by dividend, interest, and other ordinary income, once a dividend has been set, companies have an implicit responsibility to maintain it through the normal vicissitudes of a business cycle—that is, through bad years and good.

Otherwise investors will be forced to rearrange their financial affairs at what may be the sort possible moment. Unless the regular dividend is set at a level within the expected available cash flow, the company will be borrowing to pay it in the best times; and when earnings drop, the dividend will soon be cut or dropped altogether. On the other hand, companies that shape their dividend policy properly are demonstrating their loyalty and respect for shareholders in a concrete way. That is not to say, however, that the dividends may never exceed the available cash flow but likely that it should not do so on a regular basis. Because there may be exceptional years, the world regular is key.

### **TO BORROW OR NOT TO BORROW, THAT IS THE QUESTION**

Many companies regularly enjoy significantly positive available cash flows because those cash flows reflect only the investments necessary to enable them to maintain existing positions. What if a company has in addition a variety of other attractive investment opportunities? Should it still not pay a dividend? Or should it borrow to pay dividends? On the assumption that any borrowing would be within reasonable bounds, the usual answer is to go ahead and pay a dividend. True, it sounds imprudent to borrow with one hand to pay dividends with the other, and in a closely held corporation management might be less inclined to do so. But for public corporations, history argues that if there is available cash flow, dividends would be the norm, even in the face of major capital expenditures. There is too much evidence, both anecdotal and systematic, that corporate executives who keep all the money tend to get sloppy. Obviously, there are exceptions. Emerging high technology companies that are already starved for capital do not need the discipline of going to the bank to borrow the next quarter's dividend to keep them on their toes. There are exceptions, too, for brilliant CEOs with already impressive records. But that is the point: they are exceptional.

There are, however, large numbers of dividend paying companies with shareholders who have come to expect dividends even though they are being financed by floating new debt or stock issues. In reality the companies have committed themselves to dividends and growth—cakes and ale—regardless of whether the available cash flow is sufficient to cover the dividends or whether interest rates are high or low. Are the managements being candid with shareholders about the source of the payout?

*Southern Company* was a typical utility of the late 1970s and 1980s. During the nine years 1975-1983, shareholders received total dividends of about \$3.7 billion, well in excess of the company's earnings and cash flow after deducting the capital expenditures necessary just to sustain the existing operations. Where did the money come from? The company issued over \$5 billion of new securities to replace the dividend payments, as well as to invest. **The so-called earnings from which the dividend was implicitly being paid were a myth. Shareholders who thought of those dividends as ordinary income were misled because they were largely a return of capital.** Over that nine year period, book value per share of common stock fell by 5 percent in nominal dollars and in inflation adjusted dollars by more than half.

*Southern Company* was a public utility and arguable had a mandate to invest in new generating capacity even if it was unprofitable to do so, but it did not have a mandate to pay dividends out of non-existent earnings—a problem of the company's own making. It, and other utilities like it, had catered for too long to a crowd of dividend junkies—shareholders who wanted a high “yield” even if there was no substance to it. Married to that group of investors—the better ones had long ago left—the company was caught in a catch-22. The business was not producing a real income sufficient to pay the dividend. But if the company had sought to switch to a rational dividend policy or even to explain the foolishness of this one, it would have jeopardized its ability to sell the new shares that enabled it to replenish its cash reserves. A lesson or two in corporate finance early on might have helped.

### **DIVIDEND REINVESTMENT PROGRAMS**

Having raised the possibility of paying dividends out of something other than available cash flows, some mention should be made of the increasingly common practice of declaring dividends on the one hand and asking for the money back on the other. These dividend reinvestment programs, under which shareholders are entitled to buy additional shares with their cash dividends, sometimes at a discount from market, have become quite popular—and not just with the odd-lot holder, for whom they are a convenience. The sales pitch is that shareholders can build up their stock holdings in this fashion, although obviously their real investment in the company would have been “built up” much more cheaply if the board had declared no (or a smaller) cash dividend. *Graham & Dodd* long ago pointed out the foolishness of paying out a taxable dividend and then urging shareholders (or their look-a-likes) to use the 65 percent of so of the money that is left to buy more shares. To the cheers of the IRS, over 1,000 companies have ignored that advice.

### A FINAL WORD ABOUT DIVIDEND NONSENSE

The central issue of dividend policy is how well a company uses its resources compared to the available alternatives, notably those available to shareholders. That point of view, however, necessarily tends to ignore other, short-term considerations, such as day-to-day happenings in the stock market. A great deal of ink has been spilled by scholars who believe that dividends are useful as a signal to the market co management’s expectations about future earnings. **A higher dividend is said to signal its conviction that the earnings are real and will continue to grow, and this signal, in turn, is expected to produce a higher stock price.** None of this makes much sense to me. Dividends can give inaccurate prophecies, as happened at Fort in 1979-1981, as well as accurate ones. But prophetic or not, if a company allocates capital intelligently and if it communicates those decisions with candor, dividends signals are irrelevant. Dividends are too important a business issue to be relegate to the role of (trivial) news carrier for the stock market.

### SUMMARY

Rarely is dividend policy linked to investment policy. Management submits its capital budgets and dividends are paid out of what is left, even at companies with proven knack for wasting money. Even rarer still are managements that will discuss dividend policy in a rational manner with shareholders. Dividends do matter; they are at the heart of the difficult choice that managers must make in allocating their capital resources: reinvesting the money within the company or distributing to shareholders. The crux of the analysis is fairly simple: reallocate the capital internally to noncompulsory uses only if the opportunities are better than those available generally to investors or, as it is sometime put, only if the expected returns from the available invests exceed the opportunity cost of capital. That opportunity cost cannot be fixed with any precision, but looking at the compounded returns available to shareholders over long periods, a number in the range of 10 to 11% seems appropriate in the early 1990s. Interest rate fluctuations and other factors would cause it to change. This cost of capital represents only the minimum hurdle rate and so would affect only the tail end of the projects on management’s list.

### END

*A company’s dividend policy is important in understanding how well management allocates capital and reports to its shareholders. Managements may pay dividends to mindlessly copy peers and/or to try to support their stock price. Conversely, managements may not pay out excess cash without explaining why management can put this cash to better use than shareholders. This discussion completely contradicts the academic theorists like MM who say dividends do not matter to shareholders. Hogwash!*

*BUFFETT* on Dividend Policy pages 164-168, The Essays of Warren Buffett: Lessons for Corporate America by Lawrence A. Cunningham. *Berkshire* Annual Report (1984)

### Mr. *Buffett* on Dividend Policy:

Dividend policy is often reported to shareholders, but **seldom explained**. A company will say something like, “Our goal is to pay out 40% to 50% of earnings and to increase dividends at a rate at least equal to the rise in the CPI”. And that’s it - no analysis will be supplied as to why that particular policy is best for the owners of the business. Yet, allocation of capital is crucial to business and investment management. Because it is, we believe managers and owners should think hard about the circumstances under which earnings should be retained and under which they should be distributed.

**The first point to understand is that all earnings are not created equal.** In many businesses particularly those that have high asset/profit ratios - inflation causes some or all of the reported earnings to become ersatz. The ersatz portion - let’s call these earnings “restricted” - cannot, if the business is to retain its economic position, be distributed as dividends. Were these earnings to be paid out, the business would lose ground in one or more of the following areas: its ability to maintain its unit volume of sales, its long-term competitive position, and its financial strength. No matter how conservative its payout ratio, a company that consistently distributes restricted earnings is destined for oblivion unless equity capital is otherwise infused.<sup>14</sup>

Restricted earnings are seldom valueless to owners, but they often must be discounted heavily. In effect, they are conscripted by the business, no matter how poor its economic potential. (This retention-no-matter-how-unattractive-the-return situation was communicated unwittingly in a marvelously ironic way by *Consolidated Edison* a decade ago. At the time, a punitive regulatory policy was a major factor causing the company’s stock to sell as low as one-fourth of book value; i.e., every time a dollar of earnings was retained for reinvestment in the business, that dollar was transformed into only 25 cents of market value.

But, despite this gold-into-lead process, most earnings were reinvested in the business rather than paid to owners. Meanwhile, at construction and maintenance sites throughout New York, signs proudly proclaimed the corporate slogan, “Dig We Must”.)

Restricted earnings need not concern us further in this dividend discussion. Let’s turn to the much-more-valued unrestricted variety. These earnings may, with equal feasibility, be retained or distributed. In our opinion, management should choose whichever course makes greater sense for the owners of the business.

This principle is not universally accepted. For a number of reasons managers like to withhold unrestricted, readily distributable earnings from shareholders - to expand the corporate empire over which the managers rule, to operate from a position of exceptional financial comfort, etc. But we believe there is only one valid reason for retention. Unrestricted earnings should be retained only when there is a reasonable prospect - backed preferably by historical evidence or, when appropriate, by a thoughtful analysis of the future - that **for every dollar retained by the corporation, at least one dollar of market value will be created for owners**. This will happen only if the capital retained produces incremental earnings equal to, or above, those generally available to investors.

To illustrate, let’s assume that an investor owns a risk-free 10% perpetual bond with one very unusual feature. Each year the investor can elect either to take his 10% coupon in cash, or to reinvest the coupon in more 10% bonds with identical terms; i.e., a perpetual life and coupons offering the same cash-or-reinvest option. If, in any given year, the prevailing interest rate on long-term, risk-free bonds is 5%, it would be foolish for the investor to take his coupon in cash since the 10%

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<sup>14</sup> Here Mr. *Buffett* is saying that in capital intensive businesses, more earnings must be set aside to maintain and replenish the depletion of capital intensive property plant and equipment to remain competitive and maintain its current earnings power. See appendix for an example between a capital intensive and a business with lower capital intensity.

bonds he could instead choose would be worth considerably more than 100 cents on the dollar. Under these circumstances, the investor wanting to get his hands on cash should take his coupon in additional bonds and then immediately sell them. By doing that, he would realize more cash than if he had taken his coupon directly in cash. Assuming all bonds were held by rational investors, no one would opt for cash in an era of 5% interest rates, not even those bondholders needing cash for living purposes.

If, however, interest rates were 15%, no rational investor would want his money invested for him at 10%. Instead, the investor would choose to take his coupon in cash, even if his personal cash needs were nil. The opposite course - reinvestment of the coupon - would give an investor additional bonds with market value far less than the cash he could have elected. If he should want 10% bonds, he can simply take the cash received and buy them in the market, where they will be available at a large discount.

An analysis similar to that made by our hypothetical bondholder is appropriate for owners in thinking about whether a company's unrestricted earnings should be retained or paid out. Of course, the analysis is much more difficult and subject to error because the rate earned on reinvested earnings is not a contractual figure, as in our bond case, but rather a fluctuating figure. Owners must guess as to what the rate will average over the intermediate future. However, once an informed guess is made, the rest of the analysis is simple: **you should wish your earnings to be reinvested if they can be expected to earn high returns, and you should wish them paid to you if low returns are the likely outcome of reinvestment.**

Many corporate managers reason very much along these lines in determining whether subsidiaries should distribute earnings to their parent company. At that level, the managers have no trouble thinking like intelligent owners. But payout decisions at the parent company level often are a different story. Here managers frequently have trouble putting themselves in the shoes of their shareholder-owners.

With this schizoid approach, the CEO of a multi-divisional company will instruct Subsidiary A, whose earnings on incremental capital may be expected to average 5%, to distribute all available earnings in order that they may be invested in Subsidiary B, whose earnings on incremental capital are expected to be 15%. The CEO's business school oath will allow no lesser behavior. But if his own long-term record with incremental capital is 5% - and market rates are 10% - he is likely to impose a dividend policy on shareholders of the parent company that **merely follows some historical or industry-wide payout pattern.**<sup>15</sup> Furthermore, he will expect managers of subsidiaries to give him a full account as to why it makes sense for earnings to be retained in their operations rather than distributed to the parent-owner. But seldom will he supply his owners with a similar analysis pertaining to the whole company.

In judging whether managers should retain earnings, shareholders should not simply compare total incremental earnings in recent years to total incremental capital because that relationship may be distorted by what is going on in a core business. During an inflationary period, companies with a core business characterized by extraordinary economics can use small amounts of incremental capital in that business at very high rates of return (as was discussed in last year's section on Goodwill). But, unless they are experiencing tremendous unit growth, outstanding businesses by definition generate large amounts of excess cash. **If a company sinks most of this money in other businesses that earn low returns, the company's overall return on retained capital may nevertheless appear excellent because of the extraordinary returns being earned by the portion of earnings incrementally invested in the core business.** The situation is analogous to a Pro-Am golf event: even if all of the amateurs are hopeless duffers, the team's best-ball score will be respectable because of the dominating skills of the professional.

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<sup>15</sup> Part of the reason for this management behavior is the Institutional Imperative that *Buffett* discusses as mindless imitation of peers.

Let's take a time-out to reflect on a few of *Buffett's* words. There are three factors that influence the rate of dividend growth:

***The quantity of resources retained and reinvested within the business***

This relates to the percentage of earnings not paid out as dividends (the retention rate or 1- dividend rate). The more a firm invests the greater its *potential* for growth.

***The rate of return earned on those retained resources***

The efficiency with which retained earnings are used will influence value. A company with high returns on invested capital or ROIC will generate value.

***The rate of return earned on existing assets***

This concerns the amount earned on the existing baseline set of assets, that is, those assets available before reinvestment of profits. This category may be affected by a sudden increase or decrease in profitability. If the firm, for example, is engaged in oil exploration and production, and there is a worldwide increase in the price of oil, profitability will rise on existing assets.<sup>16</sup>

Incremental returns on capital is another name for the marginal return on invested capital ("*MROIC*")

Many corporations that consistently show good returns both on equity and on overall incremental capital have, indeed, employed a large portion of their retained earnings on an economically unattractive, even disastrous, basis. Their marvelous core businesses, however, whose earnings grow year after year, camouflage repeated failures in capital allocation elsewhere (usually involving high-priced acquisitions of businesses that have inherently mediocre economics). The managers at fault periodically report on the lessons they have learned from the latest disappointment. They then usually seek out future lessons. (Failure seems to go to their heads.)

In such cases, shareholders would be far better off if earnings were retained only to expand the high-return business, with the balance paid in dividends or used to repurchase stock (an action that increases the owners' interest in the exceptional business while sparing them participation in subpar businesses). **Managers of high-return businesses who consistently employ much of the cash thrown off by those businesses in other ventures with low returns should be held to account for those allocation decisions, regardless of how profitable the overall enterprise is.**

Nothing in this discussion is intended to argue for dividends that bounce around from quarter to quarter with each wiggle in earnings or in investment opportunities. Shareholders of public corporations understandably prefer that dividends be consistent and predictable. Payments, therefore, should reflect long-term expectations for both earnings and returns on incremental capital. Since the long-term corporate outlook changes only infrequently, dividend patterns should change no more often. But over time distributable earnings that have been withheld by managers should earn their keep. **If earnings have been unwisely retained, it is likely that managers, too, have been unwisely retained.**

Let's now turn to *Berkshire Hathaway* and examine how these dividend principles apply to it. Historically, *Berkshire* has earned well over market rates on retained earnings, thereby creating over one dollar of market value for every dollar retained. Under such circumstances, any distribution would have been contrary to the financial interest of shareholders, large or small.

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<sup>16</sup> The Handbook of Corporate Finance: A Business Companion to Financial Markets, Decisions and Techniques by Glen Arnold (2005)

In fact, significant distributions in the early years might have been disastrous, as a review of our starting position will show you. Charlie and I then controlled and managed three companies, *Berkshire Hathaway Inc.*, *Diversified Retailing Company, Inc.*, and *Blue Chip Stamps* (all now merged into our present operation). *Blue Chip Stamps* paid only a small dividend, *Berkshire* and *DRC* paid nothing. If, instead, the companies had paid out their entire earnings, we almost certainly would have no earnings at all now - and perhaps any capital as well. The three companies each originally made their money from a single business: (1) textiles at *Berkshire*; (2) department stores at *Diversified*; and (3) trading stamps at *Blue Chip*. These cornerstone businesses (carefully chosen, it should be noted, by your Chairman and Vice Chairman) have, respectively, (1) survived but earned almost nothing, (2) shriveled in size while incurring large losses, and (3) shrunk in sales volume to about 5% its size at the time of our entry. (Who says “you can’t lose ‘em all”?) **Only by committing available funds to much better businesses were we able to overcome these origins.** (It’s been like overcoming a misspent youth.) Clearly, diversification has served us well.

We expect to continue to diversify while also supporting the growth of current operations though, as we’ve pointed out, our returns from these efforts will surely be below our historical returns. **But as long as prospective returns are above the rate required to produce a dollar of market value per dollar retained, we will continue to retain all earnings.** Should our estimate of future returns fall below that point, we will distribute all unrestricted earnings that we believe can not be effectively used. In making that judgment, we will look at both our historical record and our prospects. Because our year-to-year results are inherently volatile, we believe a five-year rolling average to be appropriate for judging the historical record.

Our present plan is to use our retained earnings to further build the capital of our insurance companies. Most of our competitors are in weakened financial condition and reluctant to expand substantially. Yet large premium-volume gains for the industry are imminent, amounting probably to well over \$15 billion in 1985 versus less than \$5 billion in 1983. These circumstances could produce major amounts of profitable business for us. Of course, this result is no sure thing, but prospects for it are far better than they have been for many years.

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Of course, *Mr. Buffett* was repeating what *Mr. Benjamin Graham* stated, “Stockholders are entitled to receive the earnings on their capital except to the extent they decide to reinvest them in the business. **The management should retain or reinvest earnings only with the specific approval of the stockholders.** Such “earnings” as must be retained to protect the company’s position are not true earnings at all. They should not be reported as profits but should be deducted in the income statement as necessary reserves, with an adequate explanation thereof. A compulsory surplus is an imaginary surplus.”

*Graham* goes into detail about dividend analysis in Chapter 29, *The Dividend Factor in Common-Stock Analysis* pages 372-388 in *Security Analysis* (1940, 2nd Ed.) as shown here:

### **Benjamin Graham on Dividend Policy in Security Analysis (1940)**

A NATURAL classification of the elements entering into the valuation of a common stock would be under the three headings:

1. The dividend rate and record.
2. Income-account factors (earning power).
3. Balance-sheet factors (asset value).

The dividend rate is a simple fact and requires no analysis, but its exact significance is exceedingly difficult to appraise. From one point of view the dividend rate is all-important, but from another and equally valid standpoint it must be considered an accidental and minor factor. A basic confusion has grown up in the minds of managements and stockholders alike as to what constitutes a **proper dividend policy**. The result has been to create a definite conflict between two aspects of common-stock ownership: one being the possession of a marketable security, and the other being the assumption of a partnership interest in a business. Let us consider the matter in detail from this twofold approach.

#### **Dividend Return as a Factor in Common-stock Investment.**

Until recent years the dividend return was the overshadowing factor in common-stock investment. This point of view was based on simple logic. **The prime purpose of a business corporation is to pay dividends to its owners.** A successful company is one that can pay dividends regularly and presumably increase the rate as time goes on. Since the idea of investment is closely bound up with that of dependable income, it follows that investment in common stocks would ordinarily be confined to those with a well-established dividend. It would follow also that the price paid for an investment common stock would be determined chiefly by the amount of the dividend.

We have seen that the traditional common-stock investor sought to place himself as nearly as possible in the position of an investor in a bond or a preferred stock. He aimed primarily at a steady income return, which in general would be both somewhat larger and somewhat less certain than that provided by good senior securities. Excellent illustrations of the effect of this attitude upon the price of common stocks are afforded by the records of the earnings, dividends and annual price variations of *American Sugar Refining* between 1907 and 1913 and of *Atchison, Topeka, and Santa Fe Railway* between 1916 and 1925 presented herewith.

#### **AMERICAN SUGAR REFINING COMPANY**

| <b>Year</b> | <b>Range for stock</b> | <b>Earned per share</b> | <b>Paid per share</b> |
|-------------|------------------------|-------------------------|-----------------------|
| 1907        | 138-93                 | \$10.22                 | \$7.00                |
| 1908        | 138-99                 | 7.45                    | 7.00                  |
| 1909        | 136-115                | 14.20                   | 7.00                  |
| 1910        | 128-112                | 5.38                    | 7.00                  |
| 1911        | 123-113                | 18.92                   | 7.00                  |
| 1912        | 134-114                | 5.34                    | 7.00                  |
| 1913        | 118-100                | 0.02(d)                 | 7.00                  |

#### **ATCHISON, TOPEKA, AND SANTA FE RAILWAY COMPANY**

| <b>Year</b> | <b>Range for stock</b> | <b>Earned per share</b> | <b>Paid per share</b> |
|-------------|------------------------|-------------------------|-----------------------|
| 1916        | 109-100                | \$14.74                 | \$6                   |
| 1917        | 108-75                 | 14.50                   | 6                     |

|      |         |        |   |
|------|---------|--------|---|
| 1918 | 100–81  | 10.59* | 6 |
| 1919 | 104–81  | 15.41* | 6 |
| 1920 | 90–76   | 12.54* | 6 |
| 1921 | 94–76   | 14.69† | 6 |
| 1922 | 109–92  | 12.41  | 6 |
| 1923 | 105–94  | 15.48  | 6 |
| 1924 | 121–97  | 15.47  | 6 |
| 1925 | 141–116 | 17.19  | 7 |

- Results for these years based on actual operations. Results of federal operation were: 1918—\$9.98; 1919—\$16.55;

† Includes non-recurrent income. Excluding the latter the figure for 1921 would have been \$11.29.

The market range of both issues is surprisingly narrow, considering the continuous gyrations of the stock market generally during those periods. The most striking feature of the exhibit is the slight influence exercised both by the irregular earnings of *American Sugar* and by the exceptionally well-maintained and increasing earning power on the part of *Atchison*. It is clear that the price of *American Sugar* was dominated throughout by its \$7 rate and that of *Atchison* by its \$6 rate, even though the earnings records would apparently have justified an entirely different range of relative market values.

#### **Established Principle of Withholding Dividends.**

We have, therefore, on the one hand an ingrained and powerfully motivated tradition which centers investment interest upon the present and past dividend rate. But on the other hand we have an equally authoritative and well established principle of corporate management which subordinates the current dividend to the future welfare of the company and its shareholders. It is considered proper managerial policy to withhold current earnings from stockholders, for the sake of any of the following advantages:

1. To strengthen the financial (working-capital) position.
2. To increase productive capacity.
3. To eliminate an original overcapitalization.

When a management withholds and reinvests profits, thus building up an accumulated surplus, it claims confidently to be acting for the best interests of the shareholders. For by this policy the continuance of the established dividend rate is undoubtedly better assured, and furthermore a gradual but continuous increase in the regular payment is thereby made possible. The rank and file of stockholders will give such policies their support, either because they are individually convinced that this procedure redounds to their advantage or because they accept uncritically the authority of the managements and bankers who recommend it. But this approval by stockholders of what is called a “conservative dividend policy” has about it a peculiar element of the perfunctory and even the reluctant. The typical investor would most certainly

prefer to have his dividend today and let tomorrow take care of itself. No instances are on record in which the withholding of dividends for the sake of future profits has been hailed with such enthusiasm as to advance the price of the stock. The direct opposite has invariably been true. Given two companies in the same general position and with the same earning power, the one paying the larger dividend will always sell at the higher price.

### **Policy of Withholding Dividends Questionable.**

This is an arresting fact, and it should serve to call into question the traditional theory of corporate finance that the smaller the percentage of earnings paid out in dividends the better for the company and its stockholders. Although investors have been taught to pay lip service to this theory, their instincts—and perhaps their better judgment—are in revolt against it. If we try to bring a fresh and critical viewpoint to bear upon this subject, we shall find that weighty objections may be leveled against the accepted dividend policy of American corporations.

Examining this policy more closely, we see that it rests upon two quite distinct assumptions. The first is that it is advantageous to the stockholders to leave a substantial part of the annual earnings in the business; the second is that it is desirable to maintain a steady dividend rate in the face of fluctuations in profits. As to the second point, there would be no question at all, provided the dividend stability is achieved without too great sacrifice in the amount of the dividend. Assume that the earnings vary between \$5 and \$15 annually over a period of years, averaging \$10. No doubt the stockholder's advantage would be best served by maintaining a stable dividend rate of \$8, sometimes drawing upon the surplus to maintain it, but on the average increasing the surplus at the rate of \$2 per share annually.

This would be an ideal arrangement. But in practice it is rarely followed. We find that stability of dividends is usually accomplished by the simple expedient of paying out a small part of the average earnings. By a *reductio ad absurdum* it is clear that any company that earned \$10 per share on the average could readily stabilize its dividend at \$1. The question arises very properly if the shareholders might not prefer a much larger aggregate dividend, even with some irregularity. This point is well illustrated in the case of *Atchison*.

### **The Case of *Atchison*.**

*Atchison* maintained its dividend at the annual rate of \$6 for the 15 years between 1910 and 1924. During this time the average earnings were in excess of \$12 per share, so that the stability was attained by withholding over half the earnings from the stockholders.

Eventually this policy bore fruit in an advance of the dividend to \$10, which rate was paid between 1927 and 1931, and was accompanied by a rise in the market price to nearly \$300 per share in 1929. Within six months after the last payment at the \$10 rate (in December 1931) the dividend was omitted entirely. Viewed critically, the stability of the *Atchison* dividend between 1910 and 1924 must be considered as of dubious benefit to the stockholders. During its continuance they received an unduly small return in relation to the earnings; when the rate was finally advanced, the importance attached to such a move promoted excessive speculation in the shares; finally, the reinvestment of the enormous sums out of earnings failed to protect the shareholders from a complete loss of income in 1932. Allowance must be made, of course, for the unprecedented character of the depression in 1932. But the fact remains that the actual operating losses in dollars per share up to the passing of the dividend were entirely insignificant in comparison with the surplus accumulated out of the profits of previous years.

### ***United States Steel*, Another Example.**

The *Atchison* case illustrates the two major objections to what is characterized and generally approved of as a “conservative dividend policy.” The first objection is that stockholders receive both currently and ultimately too low a return in relation to

the earnings of their property; the second is that the “saving up of profits for a rainy day” often fails to safeguard even the moderate dividend rate when the rainy day actually arrives. A similarly striking example of the ineffectiveness of a large accumulated surplus is shown by that leading industrial enterprise, *United States Steel*.

The following figures tell a remarkable story:

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|   |                 |
|---|-----------------|
| Profits available for the common stock, 1901–1930 . . . . .         | \$2,344,000,000 |
| Dividends paid:   |                 |
| Cash . . . . .  | .891,000,000    |
| Stock . . . . .   | .203,000,000    |
| Undistributed earnings . . . . .                                    | 1,250,000,000   |
| Loss after preferred dividends Jan. 1, 1931–June 30, 1932 . . . . . | .59,000,000     |

Common dividend passed June 30, 1932.

A year and a half of declining business was sufficient to outweigh the beneficial influence of 30 years of practically continuous reinvestment of profits.

**The Merits of “Plowing-back” Earnings.**

These examples serve to direct our critical attention to the other assumption on which American dividend policies are based, viz., that it is advantageous to the stockholders if a large portion of the annual earnings are retained in the business. This may well be true, but in determining its truth a number of factors must be considered that are usually left out of account. The customary reasoning on this point may be stated in the form of a syllogism, as follows:

Major premise—Whatever benefits the company benefits the stockholders.

Minor premise—A company is benefited if its earnings are retained rather than paid out in dividends.

Conclusion—Stockholders are benefited by the withholding of corporate earnings.

The weakness of the foregoing reasoning rests of course in the major premise. Whatever benefits a business benefits its owners, provided the benefit is not conferred upon the corporation at the expense of the stockholders. Taking money away from the stockholders and presenting it to the company will undoubtedly strengthen the enterprise, but whether or not it is to the owners’ advantage is an entirely different question. It is customary to commend managements for “plowing earnings back into the property”; but, in measuring the benefits from such a policy, the time element is usually left out of account. It stands to reason that, if a business paid out only a small part of its earnings in dividends, the value of the stock should increase over a period of years, but it is by no means so certain that this increase will compensate the stockholders for the dividends withheld from them, particularly if interest on these amounts is compounded.

An inductive study would undoubtedly show that the earning power of corporations does not in general expand proportionately with increases in accumulated surplus. Assuming that the reported earnings were actually available for

distribution, then stockholders in general would certainly fare better in dollars and cents if they drew out practically all of these earnings in dividends. An unconscious realization of this fact has much to do with the tendency of common stocks paying liberal dividends to sell higher than others with the same earning power but paying out only a small part thereof.

### **Dividend Policies Arbitrary and Sometimes Selfishly Determined.**

One of the obstacles in the way of an intelligent understanding by stockholders of the dividend question is the accepted notion that the determination of dividend policies is entirely a managerial function, in the same way as the general running of the business. This is legally true, and the courts will not interfere with the dividend action or inaction except upon an exceedingly convincing showing of unfairness. But if stockholders' opinions were properly informed, it would insist upon curtailing the despotic powers given the directorate over the dividend policy.

Experience shows that these unrestricted powers are likely to be abused for various reasons. Boards of directors usually consist largely of executive officers and their friends. The officers are naturally desirous of retaining as much cash as possible in the treasury, in order to simplify their financial problems; they are also inclined to expand the business persistently for the sake of personal aggrandizement and to secure higher salaries. This is a leading cause of the unwise increase of manufacturing facilities which has proved recurrently one of the chief unsettling factors in our economic situation. The discretionary power over the dividend policy may also be abused in more sinister fashion, sometimes to permit the acquisition of shares at an unduly low price, at other times to facilitate unloading at a high quotation.

The heavy surtaxes imposed upon large incomes frequently make it undesirable from the standpoint of the large stockholders that earnings be paid out in dividends. Hence dividend policies may be determined at times from the standpoint of the taxable status of the large stockholders who control the directorate. This is particularly true in cases where these dominant stockholders receive substantial salaries as executives. In such cases they are perfectly willing to leave their share of the earnings in the corporate treasury, since the latter is under their control and since by so doing they retain control over the earnings accruing to the other stockholders as well.

### **Arbitrary Control of Dividend Policy Complicates Analysis of Common Stocks.**

Viewing American corporate dividend policies as a whole, it cannot be said that the virtually unlimited power given the management on this score has redounded to the benefit of the stockholders. In entirely too many cases the right to pay out or withhold earnings at will is exercised in an unintelligent or inequitable manner. Dividend policies are often so arbitrarily managed as to introduce an additional uncertainty in the analysis of a common stock. Besides the difficulty of judging the earning power, there is the second difficulty of predicting what part of the earnings the directors will see fit to disburse in dividends.

It is important to note that this feature is peculiar to American corporate finance and has no close counterpart in the other important countries. The typical English, French, or German company pays out practically all the earnings of each year, except those carried to reserves.<sup>1</sup> See Appendix Note 46, p. 781, for discussion and examples. (See next page for example)

Hence they do not build up large profit-and-loss surpluses, such as are common in the United States. Capital for expansion purposes is provided abroad not out of undistributed earnings but through the sale of additional stock. To some extent, perhaps, the reserve accounts shown in foreign balance sheets will serve the same purpose as an American surplus account, but these reserve accounts rarely attain a comparable magnitude.

### **Plowing Back Due to Watered Stock.**

The American theory of “plowing back” earnings appears to have grown out of the stock-watering practices of prewar days (*Graham is speaking here of WWI*). Many of our large industrial companies made their initial appearance with no tangible assets behind their common shares and with inadequate protection for their preferred issues. Hence it was natural that the management should seek to make good these deficiencies out of subsequent earnings. This was particularly true because additional stock could not be sold at its par value, and it was difficult therefore to obtain new capital for expansion except through undistributed profits.<sup>2</sup>

Examples: Concrete examples of the relation between overcapitalization and dividend policies are afforded by the outstanding cases of *Woolworth* and *United States Steel Corporation*. In the original sale of *F. W. Woolworth Company* shares to the public, made in 1911, the company issued preferred stock to represent all the tangible assets and common stock to represent the good-will. The balance sheet accordingly carried a good-will item of \$50,000,000 among the assets, offsetting a corresponding liability for 500,000 shares of common, par \$100.3 As *Woolworth* prospered, a large surplus was built up out of earnings, and amounts were charged against this surplus to reduce the good-will account, until finally it was written down to \$1. See Footnote -4 on page 27.

**NOTE 46 (PAGE 383 OF TEXT)**

The corporation statutes of most continental countries prescribe certain compulsory reserves, one of the functions of which is to facilitate maintenance of regular dividends. These reserves are accumulated from annual profits but ordinarily do not reach large proportions. The power to declare dividends usually resides in the stockholders assembled at the “general meeting” which is an annual affair, although provision for interim dividends is also made.

In England the Companies Act does not limit the dividend-declaring function to the annual “general meeting” of the shareholders; but the recommended form of by-laws (Table A of the statute) provides for this mode of declaration and it is the general custom in framing articles of association to stipulate that “the company in general meeting” or “the directors with the sanction of a general meeting,” may declare annual dividends. See First Schedule, Table A of the

Companies Act, 1929, 19 & 20 Geo. V., Chap. 23. A discussion of British dividend law and policies is available in Palmer’s *Company Law*, 13th ed., pp. 222–223, 628, London, 1929.

The following statements summarize more detailed information concerning dividend policies of certain foreign corporations, given on p. 669–670 of the 1934 edition of this work, as well as the subsequent record in each case:

1. **Royal Dutch Co.** for the Working of Petroleum Wells in the Netherlands Indies, for the period 1920–1938, inclusive:

|  |               |
|--|---------------|
| (a) Available for ordinary stock Fl. ....                | 1,530,396,000 |
| (b) Paid on ordinary stock Fl.....                       | 1,497,293,000 |
| (c) Percentage of earnings distributed in dividends..... | 97.84         |

2. **Siemens & Halske A. G.**, for the period 1925–1938, inclusive:

|                                     |                 |
|-------------------------------------|-----------------|
| (a) Net profit .....                | Rm. 150,893,000 |
| (b) Dividends.....                  | 124,419,000     |
| (c) Directors’ statutory bonus..... | 3,458,000       |

|                           |               |
|---------------------------|---------------|
| (d) Special reserves..... | 125,550,000   |
| (e) Balance .....         | 2,534,000(d.) |

1 Including 3,000,000 Rm. for welfare fund.

3. **British-American Tobacco Co., Ltd.**, for fiscal years ending Sept. 30, 1921

to Sept. 30, 1938, inclusive:

|   |             |
|---|-------------|
| (a) Net income available for ordinary stock | £91,934,000 |
| (b) Dividends on ordinary stock             | 87,240,000  |
| (c) Percentage of earnings distributed      | 94.9        |

4. In the case of **General Electric Co., Ltd.**, the American policy of retaining a fair proportion of the earnings has apparently been followed. The greater part of these surplus earnings, however, were carried to “Reserve Account.” The following figures summarize the period 1925 through Mar. 31, 1939:

- (a) Net income £10,433,000
- (b) Preferred dividends 3,468,000
- (c) Dividends on ordinary stock 4,521,000
- (d) Appropriation for reserves 1,847,000
- (e) Balance to surplus 597,000

*End of Note 46 (page 379 of Text)*

2 The no-par-value device is largely a post-1918 development.

3 This was for many years a standard scheme for financing of industrial companies. It was followed by *Sears Roebuck*, *Cluett Peabody*, *National Cloak and Suit*, and others.

In the case of *United States Steel Corporation*, the original capitalization exceeded tangible assets by no less than \$768,000,000, representing all the common and more than half the preferred stock. This “water” in the balance sheet was not shown as a good-will item, as in the case of *Woolworth*, but was concealed by an overvaluation of the fixed assets (i.e., of the “Property Investment Accounts”). Through various accounting methods, however, the management applied earnings from operations to the writing off of these intangible or fictitious assets. By the end of 1929 a total of \$508,000,000—equal to the entire original common-stock issue—had been taken from earnings or surplus and deducted from the property account. The balance of \$260,000,000 was set up separately as an intangible asset in the 1937 report and then written off entirely in 1938 by means of a reduction in the stated value of the common stock.

Some of the accounting policies above referred to will be discussed again, with respect to their influence on investment values, in our chapters on Analysis of the Income Account and Balance-sheet Analysis. From the dividend standpoint it is clear that in both of these examples the decision to retain large amounts of earnings, instead of paying them out to the stockholders, was due in part to the desire to eliminate intangible items from the asset accounts.

### **Conclusions from the Foregoing.**

From the foregoing discussion certain conclusions may be drawn. These bear, first on the very practical question of what significance should be accorded the dividend rate as compared with the reported earnings and, secondly, upon the more theoretical but exceedingly important question of what dividend policies should be considered as most desirable from the standpoint of the stockholders' interest.

Experience would confirm the established verdict of the stock market that a dollar of earnings is worth more to the stockholder if paid him in dividends than when carried to surplus. The common-stock investor should ordinarily require both an adequate earning power and an adequate dividend.

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Footnote – 4. It should be noted that when the good-will of Woolworth was originally listed in the balance sheet at \$50,000,000, its actual value (as measured by the market price of the shares) was only some \$20,000,000. But when the good-will was written down to \$1, in 1925, its real value was apparently many times \$50,000,000.

If the dividend is disproportionately small, an investment purchase will be justified only on an exceptionally impressive showing of earnings (or by a very special situation with respect to liquid assets). On the other hand, of course, an extra-liberal dividend policy cannot compensate for inadequate earnings, since with such a showing the dividend rate must necessarily be undependable.

To aid in developing these ideas quantitatively, we submit the following definitions:

The dividend rate is the amount of annual dividends paid per share, expressed either in dollars or as a percentage of a \$100 par value. (If the par value is less than \$100, it is inadvisable to refer to the dividend rate as a percentage figure since this may lead to confusion.) The earnings rate is the amount of annual earnings per share, expressed either in dollars or as a percentage of a \$100 par value. The dividend ratio, dividend return or dividend yield, is the ratio of the dividend paid to the market price (e.g., a stock paying \$6 annually and selling at 120 has a dividend ratio of 5%). The earnings ratio, earnings return or earnings yield, is the ratio of the annual earnings to the market price (e.g., a stock earning \$6 and selling at 50 shows an earnings yield of 12%).

Let us assume that a common stock A, with average prospects, earning \$7 and paying \$5 should sell at 100. This is a 7% earnings ratio and 5% dividend return. Then a similar common stock, B, earning \$7 but paying only \$4, should sell lower than 100. Its price evidently should be somewhere between 80 (representing a 5% dividend yield) and 100 (representing a 7% earnings yield). In general the price should tend to be established nearer to the lower limit than to the upper limit. A fair approximation of the proper relative price would be about 90, at which level the dividend yield is 4.44%, and the earnings ratio is 7.78%. If the investor makes a small concession in dividend yield below the standard, he is entitled to demand a more than corresponding increase in the earning power above standard. In the opposite case a similar stock, C, may earn \$7 but pay \$6. Here the investor is justified in paying some premium above 100 because of

The term earnings basis has the same meaning as earnings ratio. However, the term dividend basis is ambiguous, since it is used sometimes to denote the rate and sometimes the ratio the larger dividend. The upper limit, of course, would be 120 at which price the dividend ratio would be the standard 5%, but the earnings ratio would be only 5.83%. Here again the proper price should be closer to the lower than to the upper limit, say, 108, at which figure the dividend yield would be 5.56% and the earnings ratio 6.48%.

### **Suggested Principle for Dividend Payments.**

Although these figures are arbitrarily taken, they correspond fairly well with the actualities of investment values under what seem now to be reasonably normal conditions in the stock market. The dividend rate is seen to be important, apart from the earnings, not only because the investor naturally wants cash income from his capital but also because the earnings that are not paid out in dividends have a tendency to lose part of their effective value for the stockholder. Because of this fact American shareholders would do well to adopt a different attitude than hitherto with respect to corporate dividend policies. We should suggest the following principle as a desirable modification of the traditional viewpoint:

Principle: Stockholders are entitled to receive the earnings on their capital except to the extent they decide to reinvest them in the business. **The management should retain or reinvest earnings only with the specific approval of the stockholders. Such “earnings” as must be retained to protect the company’s position are not true earnings at all.** They should not be reported as profits but should be deducted in the income statement as necessary reserves, with an adequate explanation thereof. *A compulsory surplus is an imaginary surplus*<sup>17</sup>. (Buffett spoke many years later of the concept of “owner earnings” where EBIT has added back Depreciation and Amortization (non cash charges) and true maintenance capital expenditures are deducted).

Were this principle to be generally accepted, the withholding of earnings would not be taken as a matter of course and of arbitrary determination by the management, but it would require justification corresponding to that now expected in the case of changes in capitalization and of the sale of additional stock. The result would be to subject dividend policies to greater scrutiny and more intelligent criticism than they now receive, thus imposing a salutary check upon the tendency of managements to expand unwisely and to accumulate excessive working capital.<sup>18</sup>

If it should become the standard policy to disburse the major portion of each year’s earnings (as is done abroad), then the rate of dividend will vary with business conditions. This would apparently introduce an added factor of instability into stock

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<sup>17</sup> We refer here to a surplus which had to be accumulated in order to maintain the company’s status, and not to a surplus accumulated as a part of good management.

<sup>18</sup> The suggested procedure under the British Companies Act of 1929 requires that dividend payments be approved by the shareholders at their annual meeting but prohibits the approval of a rate greater than that recommended by the directors. Despite the latter proviso, the mere fact that the dividend policy is submitted to the stockholders for their specific approval or criticism carries an exceedingly valuable reminder to the management of its responsibilities, and to the owners of their rights, on this important question.

Although this procedure is not required by the Companies Act in all cases, it is generally followed in England. See Companies Act of 1929, Sections 6–10; Table A to the Companies Act of 1929, pars. 89–93; Palmer’s Company Law, pp. 222–224, 13th ed., 1929.

For a comprehensive study of the effects of withholding earnings on the regularity of dividend payments, see O. J. Curry, Utilization of Corporate Profits in Prosperity and Depression, Ann Arbor, 1941.

values. But the objection to the present practice is that it fails to produce the stable dividend rate which is its avowed purpose and the justification for the sacrifice it imposes. Hence instead of a dependable dividend that mitigates the uncertainty of earnings we have a frequently arbitrary and unaccountable dividend policy that aggravates the earnings hazard. The sensible remedy would be to transfer to the stockholder the task of averaging out his own annual income return. Since the common-stock investor must form some fairly satisfactory opinion of average earning power, which transcends the annual fluctuations, he may as readily accustom himself to forming a similar idea of average income. As in fact the two ideas are substantially identical, dividend fluctuations of this kind would not make matters more difficult for the common-stock investor. In the end such fluctuations will work out more to his advantage than the present method of attempting, usually unsuccessfully, to stabilize the dividend by large additions to the surplus account.<sup>8</sup> On the former basis, the stockholder's average income would probably be considerably larger.

### A Paradox.

Although we have concluded that the payment of a liberal portion of the earnings in dividends adds definitely to the attractiveness of a common stock, it must be recognized that this conclusion involves a curious paradox. Value is increased by taking away value. The more the stockholder subtracts in dividends from the capital and surplus fund the larger value he places upon what is left. It is like the famous legend of the *Sibylline Books*, except that here the price of the remainder is increased because part has been taken away.

This point is well illustrated by a comparison of *Atchison* and Union Pacific—two railroads of similar standing—over the ten-year period between January 1, 1915, and December 31, 1924.

### [388] SECURITY ANALYSIS

#### Per share of common

| Item                                      | Union Pacific | <i>Atchison</i> |
|---|---------------|-----------------|
| Earned, 10 years 1915–1924                | \$142.00      | \$137           |
| Net adjustments in surplus account        | dr. 1.50*     | cr. 13          |
| Total available for stockholders          | \$140.50      | \$150           |
| Dividends paid                            | \$97.50       | \$60            |
| Increase in market price                  | 33.00         | 25              |
| Total realizable by stockholders          | \$130.50      | \$85            |
| Increase in earnings, 1924 over 1914      | 9%†           | 109%†           |
| Increase in book value, 1924 over 1914    | 25%           | 70%             |
| Increase in dividend rate, 1924 over 1914 | 25%           | none            |
| Increase in market price, 1924 over 1914  | 28%           | 27%             |
| Market price, Dec. 31, 1914               | 116           | 93              |

|                                    |         |        |
|------------------------------------|---------|--------|
| Market price, Dec. 31, 1924        | 149     | 118    |
| Earnings, year ended June 30, 1914 | \$13.10 | \$7.40 |
| Earnings, calendar year 1924       | 14.30   | 15.45  |

\* Excluding about \$7 per share transferred from reserves to surplus.

† Calendar year 1924 compared with year ended June 30, 1914.

It is to be noted that because *Atchison* failed to increase its dividend the market price of the shares failed to reflect adequately the large increase both in earning power and in book value. The more liberal dividend policy of Union Pacific produced the opposite result.

This anomaly of the stock market is explained in good part by the underlying conflict of the two prevailing ideas regarding dividends which we have discussed in this chapter. In the following brief summary of the situation we endeavor to indicate the relation between the theoretical and the practical aspects of the dividend question.

### Summary

1. In some cases the stockholders derive positive benefits from an ultraconservative dividend policy, i.e., through much larger eventual earnings and dividends. In such instances the market's judgment proves to be wrong in penalizing the shares because of their small dividend. The price of these shares should be higher rather than lower on account of the fact that profits have been added to surplus instead of having been paid out in dividends.
2. Far more frequently, however, the stockholders derive much greater benefits from dividend payments than from additions to surplus. This happens because either: (a) the reinvested profits fail to add proportionately to the earning power or (b) they are not true "profits" at all but reserves that had to be retained merely to protect the business. In this majority of cases the market's disposition to emphasize the dividend and to ignore the additions to surplus turns out to be sound.
3. The confusion of thought arises from the fact that the stockholder votes in accordance with the first premise and invests on the basis of the second. If the stockholders asserted themselves intelligently, this paradox would tend to disappear. For in that case the withholding of a large percentage of the earnings would become an exceptional practice, subject to close scrutiny by the stockholders and presumably approved by them from a considered conviction that such retention would be beneficial to the owners of the shares. Such a ceremonious endorsement of a low dividend rate would probably and properly dispel the stock market's skepticism on this point and permit the price to reflect the earnings that are accumulating as well as those which were paid out. The foregoing discussion may appear to conflict with the suggestion, advanced in the previous chapter, that long-term increases in common stock values are often due to the reinvestment of undistributed profits.

We must distinguish here between the two lines of argument. Taking our standard case of a company earning \$10 per share and paying dividends of \$7, we have pointed out that the repeated annual additions of \$3 per share to surplus should serve to increase the value of the stock over a period of years. This may very well be true, and at the same time the rate of increase in value may be substantially less than \$3 per annum compounded. If we take the reverse case, viz., \$3 paid in dividends and \$7 added to surplus, the distinction is clearer. Undoubtedly the large addition to surplus will expand the value of the stock, but quite probably also this value will fail to increase at the annual rate of \$7 compounded. Hence the argument against reinvesting large proportions of the yearly earnings would remain perfectly valid. Our criticism is advanced against the latter type of policy, e.g., the retention of 70% of the earnings, and not against the normal reinvestment of some 30% of the profits.

*The key is that for every \$1 retained in the business \$1 of shareholder value should be created or the marginal ROIC should exceed the cost of the firm's capital.*

### **Dividend Policies since 1934.**

If the dividend practice of American corporations were to be judged solely by the record during 1934–1939, the criticism expressed in this chapter would have to be softened considerably.

In these recent years there has been a definite tendency towards greater liberality in dividend payments, particularly by companies that do not have clearly defined opportunities for profitable expansion. Retention of earnings by rapidly growing enterprises, e.g., airplane manufacturers, is hardly open to objection. Since the end of 1932, on the other hand, General Motors Corporation has disbursed about 80% of earnings to common-stock holders, with no wide deviation in any year through 1939. In 1939 the Treasury Department announced that it would use 70% as a rough or preliminary test to decide whether or not a company is subject to the penalty taxes for improper accumulation of surplus.

As far as stock prices are concerned, it can hardly be said that they have been unduly influenced by arbitrary dividend policies in these recent years. For not only have the policies themselves been far less arbitrary than in former times, but there has been a definite tendency in the stock market to subordinate the dividend factor to the reported and prospective earnings.

### **The Undistributed-profits Tax.**

The more liberal dividends of recent years have been due in part to the highly controversial tax on undistributed profits. This was imposed by Congress in 1936, on a graduated scale running from 7 to 27%. Following violent criticism, the tax was reduced to a vestigial 21/2% in 1938 and repealed entirely the following year. Its main object was to compel companies to distribute their earnings, so that they might be subject to personal income taxes levied against the stockholders.

A secondary objective appears to have been to restrict the accumulation of corporate surpluses, which were thought by some to be injurious, either because they withheld purchasing power from individuals or because they were conducive to unwise expansion. But the tax was widely and violently condemned, chiefly on the ground that it prevented the creation of surplus or reserve funds essential to meet future losses or emergencies or expansion needs. It was said to lay a heavy penalty on corporate thrift and prudence and to bear with particular severity on small or new corporations which must rely largely on retained profits for their growth.

### **Law Objectionable but Criticized on Wrong Grounds.**

In our own opinion the law was a very bad one, but it has been criticized largely on the wrong grounds. Its objective, as first announced, was to tax corporations exactly as if they were partnerships and hence to equalize the taxation basis of corporate and unincorporated businesses. Much could be said in favor of this aim. But as the bill was finally passed it effectively superposed partnership taxation on top of corporate taxation, thus heavily discriminating against the corporate form and especially against small stockholders. Nor was it a practicable tax as far as wealthy holders were concerned, because the extremely high personal tax rates, combined with the corporation taxes (state and federal), created an over-all burden undoubtedly hostile to individual initiative. Fully as bad were the technical details of the tax law, which compelled distributions in excess of actual accounting profits, disregarded very real capital losses and allowed no flexibility in the treatment of inventory values.

Despite the almost universal opinion to the contrary, we do not believe that the undistributed profits tax really prevented the reinvestment of earnings, except to the extent that these were diminished by personal income taxes—as they would be in an unincorporated business.

Corporations had available a number of methods for retaining or recovering these earnings, without subjecting them to the penalty tax. These devices included (1) declaration of taxable stock dividends (e.g., in preferred stock); (2) payment of “optional” dividends, so contrived as to impel the stockholders to take stock rather than cash; (3) offering of additional stock on attractive terms at the time of payment of cash dividends. Critics of the tax have asserted that these methods are inconvenient or impracticable. Our own observation is that they were quite practicable and were resorted to by a fair number of corporations in 1936 and 1937,<sup>19</sup> but that they were avoided by the majority, either from unfamiliarity or from a desire to throw as harsh a light as possible upon the law.

### **Proper Dividend Policy.**

In view of the skepticism that we have expressed as to whether or not stockholders are really benefited by dividend-withholding policies, we may be thought sympathetic to the idea of preventing reinvestment of profits by imposing penalty taxes thereon. This is far from true. Dividend and reinvestment policies should be controlled not by law but by the intelligent decision of stockholders.

Individual cases may well justify retention of earnings to an extent far greater than is ordinarily desirable. The practice should vary with the circumstances; the policy should be determined and proposed in the first instance by the management; but it should be subject to independent consideration and appraisal by stockholders in their own interest, as distinguished from that of the corporation as a separate entity or the management as a special group.

### **Note [392] SECURITY ANALYSIS**

End Security Analysis, 1940.

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The Intelligent Investor, Revised Edition by Benjamin Graham

### **Shareholders and Dividend Policy page 489**

In the past the dividend policy was a fairly frequent subject of argument between public, or “minority,” shareholders and managements. In general these shareholders wanted more liberal dividends, while the managements preferred to keep the earnings in the business “to strengthen the company.” They asked the shareholders to sacrifice their present interests for the good of the enterprise and for their own future long-term benefit. But in recent years the attitude of investors toward

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<sup>19</sup> See Rolbein, David L., “Noncash Dividends and Stock Rights as Methods for Avoidance of the Undistributed Profits Tax,” XII The Journal of Business of the University of Chicago 221–264, July, 1939. For more comprehensive surveys of this tax see Alfred G. Buehler, *The Undistributed Profits Tax*, New York, 1937 (an adverse appraisal), and Graham, Benjamin, “The Undistributed Profits Tax and the Investor,” LXVI Yale Law Journal 1–18, November, 1936, elaborating the views expressed above.

dividends has been undergoing a gradual but significant change. The basic argument now for paying small rather than liberal dividends is not that the company “needs” the money, but rather that it can use it to the shareholders’ direct and immediate advantage by retaining the funds for profitable expansion. Years ago it was typically the weak company that was more or less forced to hold on to its profits, instead of paying out the usual 60% to 75% of them in dividends. The effect was almost always adverse to the market price of the shares. Nowadays it is quite likely to be a strong and growing enterprise that deliberately keeps down its dividend payments, with the approval investors and speculators alike.<sup>20</sup>

There was always a strong theoretical case for reinvesting profitability in the business where such retention could be counted on to produce a goodly increase in earnings. But there were several strong counter-arguments, such as: The profits “belong” to the shareholders, and they are entitled to have them paid out within the limits of prudent management; many of the shareholders need their dividend income to live on; the earnings they receive in dividends are “real money,” while those retained in the company may or may not show up later as tangible values for the shareholders. These counter-arguments were so compelling, in fact, that the stock market showed a persistent bias in favor of the liberal dividend payers as against the companies that paid no dividends or relatively small ones.<sup>21</sup>

In the last 20 years the “profitable reinvestment” theory has been gaining ground. The better the past record of growth, the readier investors and speculators have become to accept a low payout policy. So much is this true that in many cases off growth favorites the dividend rate—or even the absence of any dividend—has seemed to have virtually no effect on the market price.

A striking example of this development is found in the history of *Texas Instruments, Incorporated*. The price of its common stock rose from \$5 in 1953 to \$256 in 1960, while earnings were advancing from 43 cents to \$3.91 per share and while no dividend of any kind was paid. (In 1962 cash dividends were initiated, but by that year the earnings had fallen to \$2.14 and the price had shown a spectacular drop to a low of 49.)

Another extreme illustration is provided by *Superior Oil*. In 1948 the company reported earnings of \$35.26 per share, paid \$3 in dividends, and sold as high as 235. In 1953 the dividend was reduced to \$1, but the high price was 660. In 1957 it paid no dividend at all, and sold at 2,000! This unusual issue later declined to \$795 in 1962, when it earned \$49.50 and paid \$7.50.<sup>22</sup>

The market’s appraisal of cash dividend policy appears to be developing in the following direction: Where prime emphasis is not placed on growth the stock is rated as an “income issue,” and the dividend rate retains its long-held importance as the prime determinant of market price. At the other extreme, stocks clearly recognized to be in the rapid-growth category are valued primarily in terms of the expected growth rate over, say, the next decade, and the cash-dividend rate is more or less left out of the reckoning.

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<sup>20</sup> (Zweig) The irony that Graham describes here grew even stronger in the 1990s, when it almost seemed that the stronger the company was, the less likely it was to pay a dividend—or for its shareholders to want one. The “payout ratio” (or the percentage of their net income that companies paid out as dividends) dropped from “60% to 75% in Graham’s day to 35% to 40% by the end of the 1990s.

<sup>21</sup> In the late 1990s, technology companies were particularly strong advocates of the view that all of their earnings should be “plowed back into the business,” where they could earn higher returns than any outside shareholder possibly could by reinvesting the same cash if it were paid out to him or her in dividends. Incredibly, investors never questioned the truth of this patronizing Daddy-Knows-Best principle—or even realized that a company’s cash belongs to the shareholders, not its managers.

<sup>22</sup> Superior Oil’s stock price peaked at \$2,165 per share in 1959, when it paid a \$4 dividend. For many years, Superior was the highest-priced stock listed on the NYSE. Superior, controlled by the Keck family of Houston, was acquired by Mobil corp. in 1984.

While the above statement may properly describe present tendencies, it is by no means a clear-cut guide to the situation in all common stocks, and perhaps not in the majority of them. For one thing, many companies occupy an intermediate position between growth and no growth enterprise. It is hard to say how much importance should be ascribed to the growth factor in such cases, and the market's view thereof may change radically from year-to-year. Secondly, there seems to be something paradoxical about requiring the companies showing slower growth to be more liberal with their cash dividends. For these are generally the less prosperous concerns, and in the past the more prosperous the company the greater was the expectation of both liberal and increasing payments.

It is our belief that shareholders should demand of their managements either a normal payout of earnings—on the order, say of two-thirds—**or else a clear cut demonstration that the reinvested profits have produced a satisfactory increase in per-share earnings.** Such a demonstration could ordinarily be made in the case of a recognized growth company. But in many other cases a low payout is clearly the cause of an average market price that is below fair value, and here the shareholders have every right to inquire and probably to complain.

A niggardly policy has often been imposed on a company because its financial position is relatively weak, and it has needed all or most of its earnings (plus depreciation charges) to pay debts and bolster its working capital position. When this is so there is not much the shareholders can say about it—except perhaps to criticize the management for permitting the company to fall into such an unsatisfactory financial position. However, dividends are sometimes held down by relatively unprosperous companies for the declared purpose of expanding the business. We feel that such a policy is illogical on its face, and should require both a complete explanation and a convincing defense before the shareholders should accept it. In terms of the past record there is no reason a priori to believe that the owners will benefit from expansion moves undertaken with their money by a business showing mediocre results and continuing its old management.

**END**

**For beginners:**

The *dividend payout ratio* equals total common dividends divided by net income available to common shareholders. We can better understand the company's financial situation by analyzing the payout ratio in relation to its cash flow reinvestment ratio. The reinvestment ratio compares gross cash flow and gross investment by dividing gross investment by gross cash flow. The faster the company is growing, the higher the ratio will be. If the ratio is rising without a corresponding increase in growth, examine whether the company's investments are taking longer to blossom than expected, or whether the company is adding capital inefficiently. See page 180, *Copeland*.

On the one hand, if the company has a high dividend payout ratio and a reinvestment ratio greater than 1, then it must be borrowing money to fund negative free cash flow, to pay interest, or to pay dividends. But is this sustainable? On the other hand, a company with positive free cash flow and low dividend payout is probably paying down debt (or aggregating excess cash). In this situation is the company passing up the valuable tax benefits of debt or hoarding cash unnecessarily?

Payout ratio = Dividends per share/Earnings per share =  $\$5.50/\$33.27 = 16.53\%$

Then you can calculate the expected growth rate = retention ratio x ROE =

$(1 - \text{dividend payout ratio}) \times (\text{net income/equity}) = (1 - 0.1653) \times 23.22\% = 19.4\%$ .

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### **What It Is:**

The dividend payout ratio measures the percentage of a company's net income that is returned to shareholders in the form of dividends. (In the United Kingdom, this concept is referred to as Dividend Cover.)

### **How It Works/Example:**

The dividend payout ratio is a relatively simple calculation:

Total Annual Dividends per Share / Diluted Earnings per Share

For example, let's assume that Company XYZ distributed four regular quarterly dividend payments of \$0.25 each, for a total annual dividend payment of \$1.00 per share. Over the same period, XYZ reported net earnings of \$10 per share. Using the formula above, Company XYZ's dividend payout ratio is:

$$\$1 / \$10 = 10\%$$

In other words, Company XYZ distributed 10% of its net income as dividends last year and retained the remaining 90% for other operating needs.

### **Why It Matters:**

While some investors prefer that a company reinvest its earnings back into the business to fuel future growth, many appreciate a generous cash dividend payment -- particularly since tax legislation enacted in 2003 has given dividends a tax-advantaged status. For income-oriented investors, the dividend payout ratio is a closely-watched financial measure.

Dividend payout ratios provide valuable insight into a company's dividend policy and can also reveal whether those payments appear "safe" or are in jeopardy of possibly being reduced. In the example of XYZ above, a ratio of 10% means that shareholders are only receiving a dime for every dollar the company is earning. In this case, the company is generating ample profits to support this relatively modest payment. In fact, if management considered it in the best interests of the company, it could probably afford to raise its dividend payment significantly.

On the other hand, an excessively high payout ratio suggests that the company might be paying out more than it can comfortably afford. Not only does this leave just a small percentage of profits to plow back into the business, but it also leaves the firm highly susceptible to a decline in future dividend payments. In some cases, a company will even pay out more than it earns, thus yielding a dividend payout ratio in excess of 100%. Such extremely high payouts are rarely sustainable and should warn investors that a dividend cut may be on the horizon. Because the act of reducing dividends is usually interpreted as a sign of weakness, when a dividend cut announcement is made, it also usually triggers a decline in the share price. Even if management finds a way to maintain an extremely high dividend payout ratio for an extended period of time, this strategy usually results in either a dwindling cash position or a rising debt load.

It should be noted, also, that dividend payout ratios can be impacted by a number of factors. For example, different accounting methods yield different earnings per share figures, which in turn influence the ratio. Furthermore, businesses in different growth stages can be expected to have different dividend policies. Young, fast-growing companies are typically focused on reinvesting earnings in order to grow the business. As such, they generally sport low (or even zero) dividend payout ratios. At the same time, larger, more-established companies can usually afford to return a larger percentage of earnings to stockholders.

When comparing dividend payout ratios, you should also remember that they will vary widely according to industry. For example, where many high-tech sectors often distribute small or non-existent dividends, banks and utilities typically pay out a healthy chunk of their gains each year. Also, companies operating in some industries - such as real estate investment trusts (REITs) -- are required by law to distribute a certain percentage of earnings (this figure now sits at 90% for REITs). For this reason, it can be misleading to compare the ratios of companies operating in different industries. When applied correctly, though, dividend payout ratios can be a powerful analytical tool.

### **Should a company retain its earnings? *Buffett* uses the example of the One-Dollar Premise<sup>23</sup>**

*Buffett's* goal is to select companies in which each dollar of retained earnings is translated into at least one dollar of market value. This test can quickly identify companies whose managers, over time, have been able to optimally invest their company's capital. If retained earnings are invested in the company and produce above average return, the proof will be a proportionally greater rise in the company's market value.

In time, that is. Although the stock market will track business value reasonably well over long periods, in any one year, prices can gyrate widely for reasons other than value. The same is true for retained earnings, *Buffett* explains. If a company uses retained earnings unproductively over an extended period, eventually the market, justifiably, will price its shares disappointingly. Conversely, if a company has been able to achieve above average returns on augmented capital, the increased stock price will reflect that success.

*Buffett* believes that if he has selected a company with favorable long term economic prospects run by able and shareholder-oriented managers, the proof will be reflected in the increased market value of the company. And he uses a quick test: **The increased market value should at the very least match the amount of retained earnings, dollar for dollar. If the value goes higher than the retained earnings, so much the better.** All in all, explains *Buffett*, "within this gigantic auction arena, it is our job to select a business with economic characteristics allowing each dollar of retained earnings to be translated into at least a dollar of market value." (1990 *Berkshire* Annual Report).

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### **Retained Earnings Method**

A simpler approach to assess management's progress is to view a company's growth in the context of retained earnings, the excess profits management has at its disposal each year after paying dividends. Share price increases, theoretically, should be linked to retained earnings. A stock should rise, at a minimum, by the increase in retained earnings during the year. If DuPont earned \$4 per share, paid \$2.50 in dividends, and retained \$1.50. The \$1.50 became an asset and should have

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<sup>23</sup> *The Warren Buffett Way*, Second Edition by Robert G. Hagstrom pages 117-118

increased shareholders' equity, or book value, by at least \$1.50 per share during the year, it made poor use of the money it retained and should have raised the dividend.

## **GROWTH IN RETAINED EARNINGS AS A MANAGEMENT CHECK**

Nothing measures the value of management better than its track record of investing money. Management's role, you recall, is to increase the value of the firm. It can do so by creating profits from its sales and by successfully reinvesting those profits to maximize shareholders' returns. Management sometime has no choice but to return its earnings as dividends, for only by doing so can the company maximize value to shareholders. In other instances, even profit opportunities abound, the company must retain all of its profits.

In his 1924 book, Common Stocks as Long-Term Investments, *Edgar Lawrence Smith* first postulated that common stocks should rise in value if the company does not apply out all its earnings as dividends. Every dollar retained by the company, Smith argued, increases shareholders' equity, which increased net worth and should cause identical upward movements in the market value of the company. If Company X earns \$5 million in profits, pays out \$2 million as dividends, and retains \$3 million, the "book value" of the company has increased by \$3 million. A company with 10 million shares outstanding should see a \$3.33 rise in the stock.

It did not take long for Wall Street to exploit Smith's breakthrough. In the late 1920s, speculators exploited Smith's theories to support their frenzied thirst for equities. In the public's mind, as long as a company was retaining money—any money—it was increasing its intrinsic value, and, therefore, the company could keep increasing in value. It did not matter whether the underlying assets supporting the stock were worth the present price. Nor did it matter whether the company could maintain its growth rates in earnings or retained earnings. The market rewarded growth companies with ever higher valuations and overlooked slow growth companies that were adding just as much value to their retained earnings each year.

Benjamin Graham wrote that by 1929, investors were so fixated on future earnings they ignored the historical records of companies and bid up stocks based on what retained earnings might be years down the road. Nevertheless, Smith's notion that business value rises with retained earnings is credible. If a company earns \$1 per share and retains it all, the value of the company should rise by at least \$1. If it doesn't, then value has been destroyed somewhere. That is where a careful analysis of financial statements can help.

The line item "retained earnings" is nearly an accounting adjustment on the balance sheet. It is the sum of all accumulated profits since the time the company was formed minus the dividends paid. If a company's net income over the past 50 years was \$20 billion and it paid \$10 billion in dividends, retained earnings would be \$10 billion. That doesn't mean that the company is sitting on \$10 billion in cash. Rather, it means management has had at its disposal over the past 50 years \$10 billion in excess profits to reinvest. Most of the money likely was spent building new plants, hiring workers, research and development, expanding into new markets, or buying other companies.

Though retained earnings exist as a paper account, the line item is nevertheless important, for it tells you the source of the company's increase in net assets. To explain this concept, let's take the hypothetical example of an individual who saves \$20,000 over three years. (Page 82, The Warren Buffett Way by Robert Hagstrom. Paperback)

Over the years, BH has earned very high returns from its capital and has retained all of its earnings. With such high returns, shareholders would have been ill served if they were paid a dividend. Not surprisingly, *Berkshire* does not pay a dividend.

And that is just fine with the shareholders. *Berkshire* Hathaway (Brk.a) has outperformed most stock indices by a wide margin. Go to <http://www.Berkshirehathaway.com/letters/letters.html> and read the letters to shareholders.



**Has Buffett been wise to retain capital and not pay out any dividends to shareholders?**

***Berkshire's* Corporate Performance vs. the S&P 500**

Annual Percentage Change  
Year

|  | in Per-Share<br>Book Value of Brk.a | In S&P 500<br>with Dividends | Difference |
|--|-------------------------------------|------------------------------|------------|
| 2008 .....                               | (9.6)                               | (37.0)                       | 27.4       |
| Compounded Annual Gain – 1965-2008 ..... | 20.3%                               | 8.9%                         | 11.4       |
| Overall Gain – 1964-2008 .....           | 362,319%                            | 4,276%                       |            |

**Notes:** Data are for calendar years with these exceptions: 1965 and 1966, year ended 9/30; 1967, 15 months ended 12/31.

Starting in 1979, accounting rules required insurance companies to value the equity securities they hold at market rather than at the lower of cost or market, which was previously the requirement. In this table, *Berkshire's* results through 1978 have been restated to conform to the changed rules. In all other respects, the results are calculated using the numbers originally reported.

The S&P 500 numbers are **pre-tax** whereas the *Berkshire* numbers are **after-tax**. If a corporation such as *Berkshire* were simply to have owned the S&P 500 and accrued the appropriate taxes, its results would have lagged the S&P 500 in years when that index showed a positive return, but would have exceeded the S&P 500 in years when the index showed a negative return. Over the years, the tax costs would have caused the aggregate lag to be substantial.

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### **Reinvest All Dividends**

One of the most amazing track records in investing belonged to John Neff, who piloted the Windsor Fund for 31 years before retiring in December 1995. Neff as a “value investor;” that is, he waited until stock prices dropped sharply before buying and emphasized dividend-paying stocks to maximize his returns.

Over that great 31 year period, Neff beat the S&P 500 21 times and sported an annual compounded return of 13.9 percent versus 10.6 percent for the index. A \$10,000 investment with Neff in 1964 turned into \$565,200 by the end of 1995, By comparison, a \$10,000 investment in the S&P 500 returned \$227,200. Astonishingly, dividends accounted for about 40 percent of the yearly gains investors received from owning the fund during Neff’s tenure. Neff realized, rightly, that if he could find stocks sporting dividend yields of 4% to 5%, then half his work was done. After all, if you want your stocks to provide 10 percent average annual gains and if 5 percent comes from dividends, you need only a f percent rise in the share price to attain your goal.

That was Neff’s great discovery. The share price of the Windsor fund merely doubled over those 31 years, from \$7.75 to \$15.55. The net asset value hardly budged through the years because Windsor Fund derived such a high percentage of its gains from stock dividends, pounding did the rest. Had individuals reinvested all the dividends Neff’s fund returned to them each year, their \$7.75 initial investment would have turned into \$437.59 dividends reinvested from the fund’s first year of existence compounded over the next 30 years. Second year dividends compounded over the next 30 years. Second year dividends compounded for 20 years, and so on adding layer upon layer of gains for investors.

### **THE GROWTH FACTOR OF DIVIDENDS**

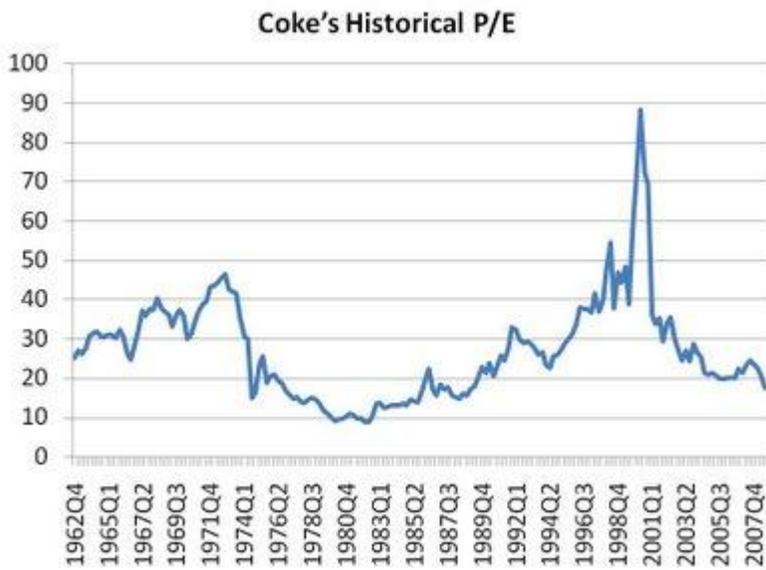
As John Neff’s investing illustrates, dividends and dividend growth is an important part of equity returns.

As a refresher, equity returns can only come from one or a combination of three factors:

- Earnings growth (*second most stable part of equity returns*)
- +dividend yield (*2/3 thirds of return with reinvestment and the most stable*)

- Change (expansion or contraction) of Price Earnings multiples (*The most volatile component of returns*).<sup>24</sup>
  - = **Total returns**
  - Minus inflation or plus deflation
  - = **Real Returns.**

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Stocks paying high dividends tend to decline less in poor markets. A company that continually improves its earnings and dividends offers compelling short-term returns that can beat bond yields. Over the long term, a growth company offers stock price returns that can bear the market as a whole.<sup>25</sup>

Take a look at two dividend-paying growth companies, *Merck & Co.* and *Philip Morris (MO)*, to see how dividends can benefit investors over long periods. Assume an investor bought *Philip Morris* and *Merck* in 1980 at split-adjusted prices of \$1.90 and \$3.90, respectively, and held the shares. By 1997, the yearly dividends for both companies constituted a share. By 1997, the yearly dividends for both companies constituted a huge return on the original investment (see next page). Likewise, yearly earnings for Philip Morris and Merck provided astounding inflation-beating returns.

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*Philip Morris* (bought at \$1.90) and *Merck* (bought at \$3.90)

|      | <b>Philip<br/>Morris</b> | Div.   | EPS<br>Yield | Div.<br>Return | <b>MERCK</b> | DIV. | EPS<br>Yield | Div.<br>Return |  |
|------|--------------------------|--------|--------------|----------------|--------------|------|--------------|----------------|--|
|      | EPS                      |        |              |                | EPS          |      |              |                |  |
| 1980 | \$0.20                   | \$0.06 | 10.5%        | 3.2%           | \$0.28       |      |              |                |  |
| 1981 | \$0.22                   | \$0.08 | 11.6%        | 4.2%           |              |      |              |                |  |
| 1982 | \$0.26                   | \$0.10 | 13.7%        | 5.3%           |              |      |              |                |  |
| 1983 | \$0.30                   | \$0.12 | 15.8%        | 6.3%           |              |      |              |                |  |
| 1984 | \$0.35                   | \$0.14 | 18.4%        | 7.4%           |              |      |              |                |  |
| 1985 | \$0.42                   | \$0.17 | 22.1%        | 8.9%           |              |      |              |                |  |
| 1986 | \$0.52                   | \$0.21 | 27.4%        | 11.1%          |              |      |              |                |  |
| 1987 | \$0.65                   | \$0.26 | 34.2%        | 13.7%          |              |      |              |                |  |
| 1988 | \$0.74                   | \$0.34 | 38.9%        | 17.9%          |              |      |              |                |  |
| 1989 | \$1.01                   | \$0.42 | 53.2%        | 22.1%          |              |      |              |                |  |
| 1990 | \$1.28                   | \$0.52 | 67.4%        | 27.4%          |              |      |              |                |  |
| 1991 | \$1.51                   | \$0.64 | 79.5%        | 33.7%          |              |      |              |                |  |
| 1992 | \$1.82                   | \$0.78 | 95.8%        | 41.1%          |              |      |              |                |  |

<sup>25</sup> *Wall Street on Sale: How to Beat the Market as a Value Investor* by Timothy P. Vick pages 146-147

|      |        |        |        |       |
|------|--------|--------|--------|-------|
| 1993 | \$1.35 | \$0.87 | 71.1%  | 45.8% |
| 1994 | \$1.82 | \$1.01 | 95.8%  | 53.2% |
| 1995 | \$2.17 | \$1.22 | 114.2% | 64.2% |
| 1996 | \$2.56 | \$1.47 | 134.7% | 77.4% |
| 1997 | \$3.00 | \$1.60 | 157.9% | 84.2% |

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These companies have been particularly generous, returning 40 percent to 50 percent of their yearly earnings to investors, while reinvesting the rest to increase the equity account. Because both companies grew consistently, they were able to raise their dividends nearly every years. By 1997, Philip Morris’s dividends alone provided an 84.2 percent return on an investor’s 1980 investment. Merck’s dividends provided a 43.3 percent return on an investor’s 1980 investment. Their dividends have provided returns that beat inflation by a wide margin.

But to achieve these types of annual returns, you had to have been discriminating. You had to buy both stocks at relatively cheap prices. *Philip Morris* was priced at an average of 10 times earnings in 1980; Merck at 14 times earnings. Second, you had to choose companies capable of improving their earnings consistently over long periods, which in turn permitted strong dividend growth. And, most importantly, you had to hold these investments long enough to allow the earnings and dividend yields to surpass the rate of inflation. A long holding period also enabled you to optimize the stocks’ appreciation potential through the power of compounding. By the end of 1997, *Philip Morris* traded at \$45, a 2,268 percent return on your original investment. Over the same period, *Philip Morris* ‘s earning grew 1,400 percent.

The presence of dividends is a by-product of a firm’s success since dividends are distributed from earnings and hence growth in dividends comes from a growth in earnings.

**The above discussion illustrates why growing companies are very dependent upon good capital allocation.** More money needs to be deployed in the business rather than paid out to shareholders to fund growth, but growth—to be profitable—must generate returns above the firms cost of capital to be profitable. As *Buffett*, *Lowenstein* and *Graham* discussed, every dollar reinvested in the company should add one dollar to the company’s net worth and at least one dollar to its intrinsic value. Investors should praise companies that retain capital by not paying dividends if the deployment of retained earnings is at high enough rates. And conversely, shareholders should require managements to explain retention of capital in low-return or non-competitive businesses.

As a check on whether a company is retaining excess capital properly, look at the growth in retained earnings compared to the growth in market value over time (3 to 5 to 10 years) of the company. A good management assessment is to view a company’s growth in the context of retained earnings, the excess profits management has at its disposal each year after paying dividends. Share price increases should be linked to the growth in retained earnings. A stock should rise, at a minimum, by the increase in retained earnings during the year.

If Company ABC earned \$4 per share, paid \$2.50 in dividends, and retained \$1.50 per share, you should expect ABC’s stock to rise by at least \$1.50. The \$1.50 will have increased the book value by that amount and if the stock price does not reflect proportionately at least the same increase in book value then capital is being retained unwisely. Of course, “Mr. Market” causes prices to rise and fall in the short term without reason to the underlying fundamentals at times, so view this comparison with at least 5 years of data, preferably more. Fifteen years of data should give you a linear comparison between growth in retained earnings and the company’s share price. A good visual way to see the linkage is to look at charts and see

their long term charts on various companies. Go to <http://www.srcstockcharts.com/> to see these companies 35 year charts of prices, earnings, and dividends.

### Case Study #1:

WD-40 (WFC)

Does WFC have an appropriate dividend policy? For every dollar retained, is there more than \$1 dollar created in market value over time? What is the company doing with its cash? Does management discuss its dividend policy with shareholders explicitly?



Hint: you will need to go to [www.edgar.com](http://www.edgar.com) and download a few years of financials and track the change in retained earnings. You should read the shareholder letters and management's discussion of the company's operations, investments and capital needs, etc.

Good luck.

**Case Study #2: Microsoft (MSFT)** Microsoft considers dividend (Source: Financial Times 4 July 2003)

Microsoft is considering paying its shareholders a special dividend of significantly more than \$10 billion according to a person close to the discussion. This would be the largest corporate payout ever, and help reduce its \$46 billion cash pile....

The software giant has come under increasing pressure from shareholders to release some of its cash pile which has grown as its shares have lagged. A decision made to begin paying a dividend, which will amount to nearly \$900 million this year, will make little impact as it continues to generate \$3 billion of cash each quarter....

The company said when it originally announced its 8 cents per share dividend—the first paid in its 28-year history—that it would consider raising the pay-out. One option would involve distributing more than \$1 per share at a cost of more than \$10 billion. End of article.



Assignment: Should MSFT pay out more to shareholders? Is the business profitable, earning more than its cost of capital or what shareholders could earn? Is the company's MROIC or marginal returns on capital higher, lower or the same as its core business? What would you advise MSFT's board. Would you invest?

As a review

### **Finance Just in Time by Hugh Dixon**

Dividends are the actual cash paid out to shareholders. Indeed, in an earlier era (1930s-1960's), dividends used to be the main yardstick for judging companies. But, although dividends are important, they are not the whole story. Shareholders also care about what companies do with the cash they hold back and reinvest. After all, the more cash that is invested today—provided, of course, that it is invested profitably—the more cash that will be available tomorrow. Many high tech companies, for example, go for years without paying dividends. Investors, instead, expect to benefit from capital growth. Moreover, companies have discretion over what dividends they pay. It is not just that they can cut back investment to pay

dividends; they can also borrow the money. Some US companies have reduced or eliminated their dividend payout to distribute excess cash by buying back shares.

**Lesson for Beginners:**

When a company returns most of its earnings in the form of dividends (like with a Public Utility Company), the company doesn't have much in the way of reinvestment possibilities, and management is properly returning capital to shareholders. Therefore, an investor would be foolish to plow money back into the very same company through an automatic dividend reinvestment plan! Think like a business person.

**Appendices**

Go here to find the latest on dividends, dividend payout ratios, and other financial data.

[http://pages.stern.nyu.edu/~adamodar/New\\_Home\\_Page/data.html](http://pages.stern.nyu.edu/~adamodar/New_Home_Page/data.html)

**For the year-End 2007**

| <i>Industry Name</i>     | <i>Number of Firms</i> | <i>Dividend Yield</i> | <i>Dividend Payout</i> |
|--------------------------|------------------------|-----------------------|------------------------|
| Advertising              | 40                     | 0.13%                 | 10.28%                 |
| Aerospace/Defense        | 69                     | 0.19%                 | 14.17%                 |
| Air Transport            | 49                     | 0.09%                 | 10.48%                 |
| Apparel                  | 57                     | 0.66%                 | 9.15%                  |
| Auto & Truck             | 28                     | 1.32%                 | 11.49%                 |
| Auto Parts               | 56                     | 0.70%                 | NA                     |
| Bank                     | 504                    | 1.51%                 | 48.34%                 |
| Bank (Canadian)          | 8                      | 3.24%                 | 51.49%                 |
| Bank (Midwest)           | 38                     | 3.63%                 | 55.69%                 |
| Beverage                 | 44                     | 0.51%                 | 26.24%                 |
| Biotechnology            | 103                    | 0.00%                 | 0.00%                  |
| Building Materials       | 49                     | 0.62%                 | 10.39%                 |
| Cable TV                 | 23                     | 0.63%                 | 3.03%                  |
| Canadian Energy          | 13                     | 3.99%                 | 12.88%                 |
| Chemical (Basic)         | 19                     | 1.22%                 | 22.99%                 |
| Chemical (Diversified)   | 37                     | 0.98%                 | 17.70%                 |
| Chemical (Specialty)     | 90                     | 0.84%                 | 18.40%                 |
| Coal                     | 18                     | 1.17%                 | 15.07%                 |
| Computer Software/Svcs   | 376                    | 0.14%                 | 11.00%                 |
| Computers/Peripherals    | 144                    | 0.11%                 | 7.27%                  |
| Diversified Co.          | 107                    | 0.56%                 | 11.32%                 |
| Drug                     | 368                    | 0.16%                 | 26.34%                 |
| E-Commerce               | 56                     | 0.17%                 | 1.53%                  |
| Educational Services     | 39                     | 0.09%                 | 2.19%                  |
| Electric Util. (Central) | 25                     | 2.98%                 | 32.61%                 |
| Electric Utility (East)  | 27                     | 2.94%                 | 32.15%                 |
| Electric Utility (West)  | 17                     | 2.88%                 | 22.84%                 |
| Electrical Equipment     | 86                     | 0.38%                 | 26.92%                 |

|                         |     |       |        |
|-------------------------|-----|-------|--------|
| Electronics             | 179 | 0.21% | 4.43%  |
| Entertainment           | 93  | 0.93% | 12.07% |
| Entertainment Tech      | 38  | 0.01% | NA     |
| Environmental           | 89  | 0.17% | 18.93% |
| Financial Svcs. (Div.)  | 294 | 1.01% | 25.82% |
| Food Processing         | 123 | 0.86% | 24.79% |
| Food Wholesalers        | 19  | 0.99% | 26.52% |
| Foreign Electronics     | 10  | 0.80% | 18.02% |
| Furn/Home Furnishings   | 39  | 2.14% | 16.41% |
| Grocery                 | 15  | 1.10% | 11.65% |
| Healthcare Information  | 38  | 0.26% | 4.08%  |
| Heavy Construction      | 12  | 0.20% | 4.84%  |
| Home Appliance          | 11  | 0.69% | 12.00% |
| Homebuilding            | 36  | 0.98% | 5.64%  |
| Hotel/Gaming            | 75  | 0.57% | 14.63% |
| Household Products      | 28  | 1.04% | 22.64% |
| Human Resources         | 35  | 0.52% | 8.90%  |
| Industrial Services     | 196 | 0.27% | 8.44%  |
| Information Services    | 38  | 0.33% | 15.61% |
| Insurance (Life)        | 40  | 1.21% | 29.95% |
| Insurance (Prop/Cas.)   | 87  | 1.48% | 15.69% |
| Internet                | 266 | 0.06% | 0.52%  |
| Investment Co.          | 18  | 0.00% | NA     |
| Investment Co.(Foreign) | 15  | 0.00% | 0.00%  |
| Machinery               | 126 | 0.59% | 11.09% |
| Manuf. Housing/RV       | 18  | 0.96% | 16.26% |
| Maritime                | 52  | 1.86% | 18.33% |
| Medical Services        | 178 | 0.09% | 1.32%  |
| Medical Supplies        | 274 | 0.12% | 16.28% |
| Metal Fabricating       | 37  | 0.49% | 10.28% |
| Metals & Mining (Div.)  | 78  | 0.36% | 14.45% |
| Natural Gas (Div.)      | 31  | 2.19% | 12.38% |
| Natural Gas Utility     | 26  | 2.78% | 30.29% |
| Newspaper               | 18  | 2.66% | 18.24% |
| Office Equip/Supplies   | 25  | 1.30% | 8.68%  |
| Oil/Gas Distribution    | 15  | 3.86% | 43.13% |
| Oilfield Svcs/Equip.    | 113 | 0.45% | 5.16%  |
| Packaging & Container   | 35  | 0.82% | 16.30% |
| Paper/Forest Products   | 39  | 1.30% | 25.39% |
| Petroleum (Integrated)  | 26  | 1.24% | 12.53% |
| Petroleum (Producing)   | 186 | 0.32% | 4.09%  |
| Pharmacy Services       | 19  | 0.17% | 5.78%  |
| Power                   | 58  | 0.05% | 1.24%  |
| Precious Metals         | 84  | 0.09% | 13.08% |
| Precision Instrument    | 103 | 0.18% | 6.86%  |
| Property Management     | 12  | 1.02% | 12.98% |
| Publishing              | 40  | 0.65% | 13.81% |

|                        |             |              |               |
|------------------------|-------------|--------------|---------------|
| R.E.I.T.               | 147         | 1.73%        | 86.18%        |
| Railroad               | 16          | 0.73%        | 13.03%        |
| Recreation             | 73          | 0.83%        | 22.24%        |
| Reinsurance            | 11          | 0.82%        | 12.64%        |
| Restaurant             | 75          | 0.67%        | 19.79%        |
| Retail (Special Lines) | 164         | 0.49%        | 8.79%         |
| Retail Automotive      | 16          | 0.63%        | 2.72%         |
| Retail Building Supply | 9           | 3.26%        | 12.84%        |
| Retail Store           | 42          | 0.77%        | 11.51%        |
| Securities Brokerage   | 31          | 0.75%        | 12.82%        |
| Semiconductor          | 138         | 0.20%        | 19.60%        |
| Semiconductor Equip    | 16          | 0.09%        | 5.29%         |
| Shoe                   | 20          | 0.57%        | 11.98%        |
| Steel (General)        | 26          | 0.89%        | 7.60%         |
| Steel (Integrated)     | 14          | 0.36%        | 7.61%         |
| Telecom. Equipment     | 124         | 0.11%        | 11.47%        |
| Telecom. Services      | 152         | 1.01%        | 55.16%        |
| Thrift                 | 234         | 1.83%        | 58.41%        |
| Tobacco                | 11          | 2.82%        | 67.86%        |
| Toiletries/Cosmetics   | 21          | 0.77%        | 22.22%        |
| Trucking               | 32          | 0.77%        | 6.14%         |
| Utility (Foreign)      | 6           | 0.00%        | 0.00%         |
| Water Utility          | 16          | 1.77%        | 22.25%        |
| Wireless Networking    | 74          | 0.29%        | 10.55%        |
| <b>Market</b>          | <b>7364</b> | <b>0.67%</b> | <b>18.73%</b> |

The examples and *Buffett's* discussion about **Economic Goodwill** will give you insights into the different investment characteristics of capital intensive vs. capital light businesses.

| <i>Capital Intensity Example</i>                        | <b>Company A</b> | <b>Company B</b> |
|---|------------------|------------------|
| <b>Current Assets</b>                                   | 3                | 3                |
| <b>Fixed Assets</b>                                     | 2                | 7                |
| <b>Goodwill*</b> <i>see discussion below by Buffett</i> | 5                | 0                |
| <b>Current Liabilities</b>                              | 1                | 1                |
| <b>Book Value</b>                                       | \$9              | \$9              |

|  |     |     |
|--|-----|-----|
| <b>Earnings \$2.00 per share in cash</b> |     |     |
| <b>Return on Tangible Capital</b>        | 50% | 22% |

From the 1983 Annual Report of *Berkshire Hathaway*, Chairman's Letter to Shareholders.

### Corporate Performance

During 1983 our book value increased from \$737.43 per share to \$975.83 per share, or by 32%. We never take the one-year figure very seriously. After all, why should the time required for a planet to circle the sun synchronize precisely with the time required for business actions to pay off? Instead, we recommend not less than a five-year test as a rough yardstick of economic performance. Red lights should start flashing if the five-year average annual gain falls much below the return on equity earned over the period by American industry in aggregate. (Watch out for our explanation if that occurs as Goethe observed, "When ideas fail, words come in very handy.")

During the 19-year tenure of present management, book value has grown from \$19.46 per share to \$975.83, or 22.6% compounded annually. Considering our present size, nothing close to this rate of return can be sustained. Those who believe otherwise should pursue a career in sales, but avoid one in mathematics.

We report our progress in terms of book value because in our case (though not, by any means, in all cases) it is a conservative but reasonably adequate proxy for growth in intrinsic business value - *the measurement that really counts*. Book value's virtue as a score-keeping measure is that it is easy to calculate and doesn't involve the subjective (but important) judgments employed in calculation of intrinsic business value. It is important to understand, however, that the two terms - book value and intrinsic business value - have very different meanings.

**Book value** is an accounting concept, recording the accumulated financial input from both contributed capital and retained earnings. Intrinsic business value is an economic concept, estimating future cash output discounted to present value. Book value tells you what has been put in; intrinsic business value estimates what can be taken out.

An analogy will suggest the difference. Assume you spend identical amounts putting each of two children through college. The book value (measured by financial input) of each child's education would be the same. But the present value of the future payoff (the intrinsic business value) might vary enormously - from zero to many times the cost of the education. So, also, do businesses having equal financial input end up with wide variations in value.

At *Berkshire*, at the beginning of fiscal 1965 when the present management took over, the \$19.46 per share book value considerably *overstated* intrinsic business value. All of that book value consisted of textile assets that could not earn, on average, anything close to an appropriate rate of return. In the terms of our analogy, the investment in textile assets resembled investment in a largely-wasted education.

Now, however, our intrinsic business value considerably exceeds book value. There are two major reasons:

- (1) Standard accounting principles require that common stocks held by our insurance subsidiaries be stated on our books at market value, but that other stocks we own be carried at the lower of aggregate cost or market. At the end of 1983, the market value of this latter group exceeded carrying value by \$70 million pre-tax, or about \$50 million after tax. This excess belongs in our intrinsic business value, but is not included in the calculation of book value;
- (2) More important, we own several businesses that possess economic **Goodwill** (which is properly includable in intrinsic business value) far larger than the accounting Goodwill that is carried on our balance sheet and reflected in book value.

Goodwill, both economic and accounting, is an arcane subject and requires more explanation than is appropriate here. The appendix that follows this letter - "Goodwill and its Amortization: The Rules and The Realities" - explains why economic and accounting Goodwill can, and usually do, differ enormously.

You can live a full and rewarding life without ever thinking about Goodwill and its amortization. But students of investment and management should understand the nuances of the subject. My own thinking has changed drastically from 35 years ago when I was taught to favor tangible assets and to shun businesses whose value depended largely upon economic Goodwill.

### Appendix

#### **BERKSHIRE HATHAWAY INC.**

##### **Goodwill and its Amortization: The Rules and The Realities**

This appendix deals only with economic and accounting Goodwill – not the goodwill of everyday usage. For example, a business may be well liked, even loved, by most of its customers but possess no economic goodwill. (AT&T, before the breakup, was generally well thought of, but possessed not a dime of economic Goodwill.) And, regrettably, a business may be disliked by its customers but possess substantial, and growing, economic Goodwill. So, just for the moment, forget emotions and focus only on economics and accounting.

When a business is purchased, accounting principles require that the purchase price first be assigned to the fair value of the identifiable assets that are acquired. Frequently the sum of the fair values put on the assets (after the deduction of liabilities) is less than the total purchase price of the business. In that case, the difference is assigned to an asset account entitled "excess of cost over equity in net assets acquired". To avoid constant repetition of this mouthful, we will substitute "Goodwill".

Accounting Goodwill arising from businesses purchased before November 1970 has a special standing. Except under rare circumstances, it can remain an asset on the balance sheet as long as the business bought is retained. That means no amortization charges to gradually extinguish that asset need be made against earnings.

The case is different, however, with purchases made from November 1970 on. When these create Goodwill, it must be amortized over not more than 40 years through charges – of equal amount in every year – to the earnings account. Since 40 years is the maximum period allowed, 40 years is what managements (including us) usually elect. This annual charge to earnings is not allowed as a tax deduction and, thus, has an effect on after-tax income that is roughly double that of most other expenses.

That's how accounting Goodwill works. To see how it differs from economic reality, let's look at an example close at hand. We'll round some figures, and greatly oversimplify, to make the example easier to follow. We'll also mention some implications for investors and managers.

*Blue Chip* Stamps bought *See's* early in 1972 for \$25 million, at which time *See's* had about \$8 million of net tangible assets. (Throughout this discussion, accounts receivable will be classified as tangible assets, a definition proper for business analysis.) This level of tangible assets was adequate to conduct the business without use of debt, except for short periods seasonally. *See's* was earning about \$2 million after tax at the time, and such earnings seemed conservatively representative of future earning power in constant 1972 dollars.

Thus our first lesson: businesses logically are worth far more than net tangible assets when they can be expected to produce earnings on such assets considerably in excess of market rates of return. The capitalized value of this excess return is economic Goodwill.

In 1972 (and now) relatively few businesses could be expected to consistently earn the 25% after tax on net tangible assets that was earned by *See's* – doing it, furthermore, with conservative accounting and no financial leverage. It was not the fair market value of the inventories, receivables or fixed assets that produced the premium rates of return. Rather it was a combination of intangible assets, particularly a pervasive favorable reputation with consumers based upon countless pleasant experiences they have had with both product and personnel.

Such a reputation creates a consumer franchise that allows the value of the product to the purchaser, rather than its production cost, to be the major determinant of selling price. Consumer franchises are a prime source of economic Goodwill. Other sources include governmental franchises not subject to profit regulation, such as television stations, and an enduring position as the low cost producer in an industry.

Let's return to the accounting in the *See's* example. *Blue Chip's* purchase of *See's* at \$17 million over net tangible assets required that a Goodwill account of this amount be established as an asset on *Blue Chip's* books and that \$425,000 be charged to income annually for 40 years to amortize that asset. By 1983, after 11 years of such charges, the \$17 million had been reduced to about \$12.5 million. *Berkshire*, meanwhile, owned 60% of *Blue Chip* and, therefore, also 60% of *See's*. This ownership meant that *Berkshire's* balance sheet reflected 60% of *See's* Goodwill, or about \$7.5 million.

In 1983 *Berkshire* acquired the rest of *Blue Chip* in a merger that required purchase accounting as contrasted to the "pooling" treatment allowed for some mergers. Under purchase accounting, the "fair value" of the shares we gave to (or "paid") *Blue Chip* holders had to be spread over the net assets acquired from *Blue Chip*. This "fair value" was measured, as it almost always is when public companies use their shares to make acquisitions, by the market value of the shares given up.

The assets "purchased" consisted of 40% of everything owned by *Blue Chip* (as noted, *Berkshire* already owned the other 60%). What *Berkshire* "paid" was more than the net identifiable assets we received by \$51.7 million, and was assigned to two pieces of Goodwill: \$28.4 million to *See's* and \$23.3 million to *Buffalo Evening News*.

After the merger, therefore, *Berkshire* was left with a Goodwill asset for *See's* that had two components: the \$7.5 million remaining from the 1971 purchase, and \$28.4 million newly created by the 40% "purchased" in 1983. Our amortization charge now will be about \$1.0 million for the next 28 years, and \$.7 million for the following 12 years, 2002 through 2013.

In other words, different purchase dates and prices have given us vastly different asset values and amortization charges for two pieces of the same asset. (We repeat our usual disclaimer: we have no better accounting system to suggest. The problems to be dealt with are mind boggling and require arbitrary rules.)

But what are the economic realities? One reality is that the amortization charges that have been deducted as costs in the earnings statement each year since acquisition of *See's* were not true economic costs. We know that because *See's* last year earned \$13 million after taxes on about \$20 million of net tangible assets – a performance indicating the existence of economic Goodwill far larger than the total original cost of our accounting Goodwill. In other words, while accounting Goodwill regularly decreased from the moment of purchase, economic Goodwill increased in irregular but very substantial fashion.

Another reality is that annual amortization charges in the future will not correspond to economic costs. It is possible, of course, that *See's* economic Goodwill will disappear. But it won't shrink in even decrements or anything remotely resembling them. What is more likely is that the Goodwill will *increase* – in current, if not in constant, dollars – because of inflation.

That probability exists because true economic Goodwill tends to rise in nominal value proportionally with inflation. To illustrate how this works, let's contrast a *See's* kind of business with a more mundane business. When we purchased *See's* in 1972, it will be recalled, it was earning about \$2 million on \$8 million of net tangible assets. Let us assume that our hypothetical mundane business then had \$2 million of earnings also, but needed \$18 million in net tangible assets for normal operations. Earning only 11% on required tangible assets, that mundane business would possess little or no economic Goodwill.

A business like that, therefore, might well have sold for the value of its net tangible assets, or for \$18 million. In contrast, we paid \$25 million for *See's*, even though it had no more in earnings and less than half as much in "honest-to-God" assets. Could less really have been more, as our purchase price implied? The answer is "yes" – *even if both businesses were expected to have flat unit volume* – as long as you anticipated, as we did in 1972, a world of continuous inflation.

To understand why, imagine the effect that a doubling of the price level would subsequently have on the two businesses. Both would need to double their nominal earnings to \$4 million to keep themselves even with inflation. This would seem to be no great trick: just sell the same number of units at double earlier prices and, assuming profit margins remain unchanged, profits also must double.

But, crucially, to bring that about, both businesses probably would have to double their nominal investment in net tangible assets, since that is the kind of economic requirement that inflation usually imposes on businesses, both good and bad. A doubling of dollar sales means correspondingly more dollars must be employed immediately in receivables and inventories. Dollars employed in fixed assets will respond more slowly to inflation, but probably just as surely. And all of this inflation-required investment will produce no improvement in rate of return. The motivation for this investment is the survival of the business, not the prosperity of the owner.

Remember, however, that *See's* had net tangible assets of only \$8 million. So it would only have had to commit an additional \$8 million to finance the capital needs imposed by inflation. The mundane business, meanwhile, had a burden over twice as large – a need for \$18 million of additional capital.

After the dust had settled, the mundane business, now earning \$4 million annually, might still be worth the value of its tangible assets, or \$36 million. That means its owners would have gained only a dollar of nominal value for every new dollar invested. (This is the same dollar-for-dollar result they would have achieved if they had added money to a savings account.)

*See's*, however, also earning \$4 million, might be worth \$50 million if valued (as it logically would be) on the same basis as it was at the time of our purchase. So it would have gained \$25 million in nominal value while the owners were putting up only \$8 million in additional capital – over \$3 of nominal value gained for each \$1 invested.

Remember, even so, that the owners of the *See's* kind of business were forced by inflation to ante up \$8 million in additional capital just to stay even in real profits. Any unleveraged business that requires some net tangible assets to operate (and almost all do) is hurt by inflation. Businesses needing little in the way of tangible assets simply are hurt the least.

And that fact, of course, has been hard for many people to grasp. For years the traditional wisdom – long on tradition, short on wisdom – held that inflation protection was best provided by businesses laden with natural resources, plants and machinery, or other tangible assets ("In Goods We Trust"). It doesn't work that way. Asset-heavy businesses generally earn low rates of return – rates that often barely provide enough capital to fund the inflationary needs of the existing business, with nothing left over for real growth, for distribution to owners, or for acquisition of new businesses.

In contrast, a disproportionate number of the great business fortunes built up during the inflationary years arose from ownership of operations that combined intangibles of lasting value with relatively minor requirements for tangible assets. In such cases earnings have bounded upward in nominal dollars, and these dollars have been largely available for the acquisition of additional businesses. This phenomenon has been particularly evident in the communications business. That

business has required little in the way of tangible investment – yet its franchises have endured. During inflation, Goodwill is the gift that keeps giving.

But that statement applies, naturally, only to true economic Goodwill. Spurious accounting Goodwill – and there is plenty of it around – is another matter. When an overexcited management purchases a business at a silly price, the same accounting niceties described earlier are observed. Because it can't go anywhere else, the silliness ends up in the Goodwill account. Considering the lack of managerial discipline that created the account, under such circumstances it might better be labeled "No-Will". Whatever the term, the 40-year ritual typically is observed and the adrenalin so capitalized remains on the books as an "asset" just as if the acquisition had been a sensible one.

\* \* \* \* \*

If you cling to any belief that accounting treatment of Goodwill is the best measure of economic reality, I suggest one final item to ponder.

Assume a company with \$20 per share of net worth, all tangible assets. Further assume the company has internally developed some magnificent consumer franchise, or that it was fortunate enough to obtain some important television stations by original FCC grant. Therefore, it earns a great deal on tangible assets, say \$5 per share, or 25%.

With such economics, it might sell for \$100 per share or more, and it might well also bring that price in a negotiated sale of the entire business.

Assume an investor buys the stock at \$100 per share, paying in effect \$80 per share for Goodwill (just as would a corporate purchaser buying the whole company). Should the investor impute a \$2 per share amortization charge annually (\$80 divided by 40 years) to calculate "true" earnings per share? And, if so, should the new "true" earnings of \$3 per share cause him to rethink his purchase price?

\* \* \* \* \*

## VALUATION

We believe managers and investors alike should view **intangible assets** from two perspectives:

1. In analysis of operating results – that is, in evaluating the underlying economics of a business unit – amortization charges should be ignored. What a business can be expected to earn on unleveraged net tangible assets, excluding any charges against earnings for amortization of Goodwill, is the best guide to the economic attractiveness of the operation. It is also the best guide to the current value of the operation's economic Goodwill.
1. In evaluating the wisdom of business acquisitions, amortization charges should be ignored also. They should be deducted neither from earnings nor from the cost of the business. This means forever viewing purchased Goodwill at its full cost, before any amortization. Furthermore, cost should be defined as including the full intrinsic business value – not just the recorded accounting value – of all consideration given, irrespective of market prices of the securities involved at the time of merger and irrespective of whether pooling treatment was allowed. For example, what we truly paid in the *Blue Chip* merger for 40% of the Goodwill of *See's* and the News was considerably more than the \$51.7 million entered on our books. This disparity exists because the market value of the *Berkshire* shares given up in the merger was less than their intrinsic business value, which is the value that defines the true cost to us.

Operations that appear to be winners based upon perspective (1) may pale when viewed from perspective (2). A good business is not always a good purchase – although it's a good place to look for one.

We will try to acquire businesses that have excellent operating economics measured by (1) and that provide reasonable returns measured by (2). Accounting consequences will be totally ignored.

At yearend 1983, net Goodwill on our accounting books totaled \$62 million, consisting of the \$79 million you see stated on the asset side of our balance sheet, and \$17 million of negative Goodwill that is offset against the carrying value of our interest in Mutual Savings and Loan.

We believe net economic Goodwill far exceeds the \$62 million accounting number.

This bias caused me to make many important business mistakes of omission, although relatively few of commission.

Keynes identified my problem: "The difficulty lies not in the new ideas but in escaping from the old ones." My escape was long delayed, in part because most of what I had been taught by the same teacher had been (and continues to be) so extraordinarily useful.

### **Buffett's experience in paying out cash dividends**

*Buffett* was talked into paying out a 10 cents dividend to shareholders of *Berkshire* Hathaway early in his ownership.

### **Page 297 of Snowball:**

Feeling flush during what would turn out to be a brief moment of financial success—" we were selling out of rayon windings for a few months and making a lot of money"-- *Buffett* had let himself get talked into a \$.10 share dividend. The firm's lawyers had argued that *Berkshire* was doing so well that it might be accused of unjustifiably retaining earning. Either while day dreaming or simply in a moment of weakness, *Buffett* went along with the distribution a dime a share sounded measly somehow took them 24 hours to realize that doubtless see if their argument. By then it was too late and his uncharacteristic agreeableness had showered on the partners and shareholders 101, 733 that he used he could've turned into millions someday. He would never make that mistake again

Eight months later, *Buffett* offered *Berkshire* shareholders a swap. Anyone who wanted an income producing security could have a 7.5% the bench or in exchange for stock. A total of 32,000 shares returned in. With this move *Buffett* washed out of a mix a group of shareholders wanted income, ensuring that the rest more likely to care about growth instead of dividends."It was brilliant, says *Vernon McKenzie*. End, course, with fewer shares outstanding, he was able to tighten his grip on *Berkshire* that much more. --"

Curiously, even as the magnitude of his original error in buying the place was clear, *Ken Chase* stoically followed *Buffett's* orders to shrink the business. Rather than perceptive take a hateful backlash like that Dempster, *Buffett* listened to Chase's recommendations that the unions be treated well, and decided to tolerate losses some reminiscent of the company operational a new Bedford tent.