



Trading and Investing for Beginners

What are dividends?

By Eric LeRiche

Dividends are payments made by a corporation to its shareholders. When a corporation makes a profit, that money can be put to two uses: it can either be re-invested in the business or it can be paid to the shareholders of the company as a dividend, or a combination of both

Usually, a dividend is allocated as a fixed amount per share. Therefore, a shareholder receives a dividend in proportion to the number of shares they have in their possession. . Paying dividends is not an expense; rather, it is the division of an asset among shareholders. Public companies usually pay dividends on a fixed schedule, but may declare a dividend at any time, sometimes called a special dividend to distinguish it from a regular one.

The most popular forms of payment are Cash and stocks:

Cash dividends (most common) are those paid out in the form of a cheque.

Stock are paid out in form of additional stock shares. They are usually issued in proportion to shares owned (e.g., for every 100 shares of stock owned, 5% stock dividend will yield 5 extra shares).

Some companies have dividend reinvestment plans. These plans allow shareholders to use dividends to systematically buy small amounts of stock, usually with no commission and sometimes at a slight discount. In some cases the shareholder might not need to pay taxes on these re-invested dividends, but in most cases they do.

On the declaration date a liability is created and the company records that liability on its books; it now owes the money to the stockholders.

The ex-dividend date is important because it is the day on which all shares bought and sold no longer come attached with the right to be paid the most recently declared dividend.

Prior to this date, the stock is said to be *cum* dividend ('with dividend'): existing holders of the stock and anyone who buys it will receive the dividend, whereas any holders selling the stock lose their right to the dividend. On and after this date the stock becomes *ex* dividend: existing holders of the stock will receive the dividend even if they now sell the stock, whereas anyone who now buys the stock now will not receive the dividend.

It is relatively common for a stock's price to decrease on the *ex*-dividend date by an amount roughly equal to the dividend paid. This reflects the decrease in the company's assets resulting from the declaration of the dividend. The company does not take any explicit action to adjust its stock price; in an efficient market, buyers and sellers will automatically price this in. This obviously is important to keep in mind when doing your Due Diligence

One note about the record date: Shareholders who properly registered their ownership on or before the date of record will receive the dividend. Shareholders who are not registered as of this date will not receive the dividend. Registration in most countries is essentially automatic for shares purchased before the *ex*-dividend date.

PRO`s

"Shareholders have their own personal cash needs and self-select the companies whose dividends satisfy these.

"Preferred shareholders like common share dividends because it creates a cushion that must be cut before their own dividends are.

"The perceived risk of dividends today is less than a promised increase in dividends at a later date. In other words "Dividends are better than retained earnings because the latter might never materialize as future. Some suggest that retaining earnings is, in effect, management dictating to owners how to invest their money. Others prefer retained earnings to dividends because of the less punitive tax regime that they are subject to.

CON`s

"Management and the board may believe that the money is best re-invested into the company: research and development, capital investment, expansion, etc. Proponents suggest that a management eager to return profits to shareholders may have run out of good ideas for the future of the company. Some studies have demonstrated that companies that pay dividends have higher earnings growth, however, suggesting that dividend payments may be evidence of confidence in earnings growth and sufficient profitability to fund future expansion.

"When dividends are paid, individual shareholders in many countries suffer from double taxation of those dividends: the company pays income tax to the government when it earns any income, and then when the dividend is paid, the individual shareholder pays income tax on the dividend payment; in many countries, the tax rate on dividend income

is lower than for other forms of income to compensate for tax paid at the corporate level. Taxation of dividends is often used as justification for retaining earnings, or for performing a stock buyback, in which the company buys back stock, thereby increasing the value of the stock left outstanding. In contrast, corporate shareholders often do not pay tax on dividends because the tax regime is designed to tax corporate income (as opposed to individual income) only once. The shareholder will pay a tax on capital gains (which is often taxed at a lower rate than ordinary income) only when the shareholder chooses to sell the stock. If a holder of the stock chooses to not participate in the buyback, the price of the holder's shares should rise, but the tax on these gains is delayed until the actual sale of the shares. Certain types of specialized investment companies (such as a REIT in the U.S.) allow the shareholder to partially or fully avoid double taxation of dividends.

"Shareholders in companies which pay little or no cash dividends can reap the benefit of the company's profits when they sell their shareholding, or when a company is wound down and all assets liquidated and distributed amongst shareholders.

Measurements:

If you are a value investor or looking for dividend income then there are a couple of measurements that are specific to you. For dividend investors, one of the telling metrics is Dividend Yield.

This measurement tells you what percentage return a company pays out to shareholders in the form of dividends. Older, well-established companies tend to payout a higher percentage than do younger companies and their dividend history can be more consistent.

You calculate the Dividend Yield by taking the annual dividend per share and divide by the stock's price.

Dividend Yield = annual dividend per share / stock's price per share

For example, if a company's annual dividend is \$1.50 and the stock trades at \$25, the Dividend Yield is 6%. ($\$1.50 / \$25 = 0.06$)

What is the dividend payout ratio?

There are some metrics used in fundamental analysis that fall into what I call the "ho-hum" category.

The Dividend Payout Ratio (DPR) is one of those numbers. It almost seems like a measurement invented because it looked like it was important, but nobody can really agree on why.

The DPR (it usually doesn't even warrant a capitalized abbreviation) measures what a company's pays out to investors in the form of dividends.

You calculate the DPR by dividing the annual dividends per share by the Earnings Per Share.

$DPR = \text{Dividends Per Share} / \text{EPS}$

For example, if a company paid out \$1 per share in annual dividends and had \$3 in EPS, the DPR would be 33%. ($\$1 / \$3 = 33\%$)

The real question is whether 33% is good or bad and that is subject to interpretation.

Growing companies will typically retain more profits to fund growth and pay lower or no dividends.

Companies that pay higher dividends may be in mature industries where there is little room for growth and paying higher dividends is the best use of profits (utilities used to fall into this group, although in recent years many of them have been diversifying).

Either way, you must view the whole DPR issue in the context of the company and its industry. By itself, it tells you very little.

As you can see there is a lot to know when it comes to dividends and I could go on for ever but let me just go on to say that not all of the tools of fundamental analysis work for every investor on every stock. If you are looking for high growth technology stocks, they are unlikely to turn up in any stock screens you run looking for dividend paying characteristics.

Choose your tools wisely and don't base your decisions on a single tool, ever!

Sincerely

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