Corporate Finance, Module 15, “Payout Policy”

Corporate finance module 15: Readings for Eleventh Edition

(The attached PDF file has better formatting.)

The page numbers here are for the *eleventh* edition of Brealey and Myers. You may also use the seventh, eighth, ninth, or tenth editions of this text. The page numbers for earlier editions are in separate postings. The substantive changes in the textbook are slight among these editions, but the final exam problems are based on the eleventh edition.

{The Brealey and Myers textbook is excellent. We say to read certain sections and to skip others. This does not mean that certain sections are better; it means that the homework assignments and exam problems are based on the sections that you must read for this course. Some of the skipped sections are fascinating, but they are not tested.}

The terms *dividend policy* and *payout policy* are both used in corporate finance. Both terms are used in the online postings, practice problems, and final exam questions. The tenth and eleventh edition of the Brealey and Myers textbook uses the term payout policy; earlier editions used the term dividend policy.

Read the introduction on page 400. As Brealey and Myers say, the central question is “How does payout policy affect firm value?”

Read section 16.1, “Facts about Payout,” on pages 401-403. Focus on the sections “How firms pay dividends” on page 402 and “How firms repurchase stocks” on page 403. Even if you know how stocks are traded, the section on stock repurchase plans contains new information. Know the sequence in Figure 16.2 on page 402 and the terms for each date.

Read section 16.2, “The Information Content in Dividends and Repurchases,” on pages 403-405. You can skip the J. P. Morgan side-bar on page 405; it is a nice story, but it is not tested on the final exam. Many common dividend practices are hard to explain, and financial analysts presume that dividends send information to investors, not just money. There are more efficient ways of getting money to investors, but dividends may be a good source of information.

Read section 16.3, “Dividends or Repurchases: The Payout Controversy,” on pages 406-410, focusing on the sub-section “Dividend Policy Is Irrelevant in Perfect Capital Markets” on page 406. The illustrations on pages 410 and 411 helpful you understand the theory and answer final exam questions. Understanding this irrelevance theorem is important; the irrelevance theorem for capital structure is similar, so make sure you grasp the concept.

Skip section 16.4, “The Rightists,” on pages 411-413; skip section 16.5, “Taxes and the Radical Left,” on pages 413-417; and skip section 16.6, “Payout Policy and the Life Cycle of the Firm,” on pages 417-419. Brealey and Myers have a moderate view. But financial analysts differ so much in their views of dividends that Brealey and Myers present a range of opinion. If you trade common stocks, you may read these sections to better judge how dividends affect your stock values, but these sections are not tested on the final exam.

Read the first half of the summary on page 420, until the paragraph beginning “the most obvious and serious market imperfection …”; skip the rest of the summary. Taxes are critical, and the change in the tax rates beginning January 1, 2013, affect stock prices and payout policy. But these tax rates are nation-specific; they affect U.S. stocks, not Asian or European or Latin American stocks, and they are not tested on the final exam.

Dividend payouts highlight some unsolved problems. We have a hundred years of dividend payments by thousands of firms. But we still can’t explain what is happening, and we have widely divergent perspectives (left, right, and middle). This is not like a statistics course, where everything is mathematically proved; it is not like a social science class where it is hard to find hard data. Here we have data as hard as we would like, but we still can’t figure out why firms pay the dividends that they do. This is what make corporate finance so fascinating – and so promising for the student you can interpret the real world.

Review problems 1, 2, and 3 on page 421; problems 5 and 6 on page 422.

Problem 7 on page 422 is particularly relevant to actuaries, since insurance companies and pension funds have different tax rates (for dividends) than other firms. The tax rate on capital gains is now 20% for personal taxpayers and 35% for corporate taxpayers. Insurers have a proration provision that increases taxes on corporate dividends. The tax laws are complex, and they are not tested on this course. (The actual tax rate for personal taxpayers may be above 20% because of certain provisions in the new tax law.)

Review problem 9 on page 422. Would you expect life insurers and property-casualty insurers to pay out a high or low percentage of their earnings? Insurers (and especially life insurers) are a mature industry in the U.S. (though not in other parts of the world).

Review problem 10 on page 422 and problems 15, 17, 18, and 20 on page 423.