

Corporate Finance, Module 15, "Payout Policy"

Required reading, Eighth Edition:

(The attached PDF file has better formatting.)

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{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 term *dividend policy* in the seventh edition has been changed to *payout policy* in the eighth edition. Both terms are used in the online postings, the practice problems, and the final exam questions.

Read the introduction on page 415. As Brealey and Myers say, the central question is "How does payout policy affect firm value?"

Read section 16.1, "Choice of Payout Policy," on pages 415-416. This is an introduction.

Read section 16.2, "Dividend Payment and Stock Repurchase," on pages 416-418. These are facts about dividends; even if you know how stocks are traded, the section on stock repurchase plans contains much new information.

Skip section 16.3, "How Do Companies Decide on Dividend Payments," on pages 418-419. We don't need Lintner's model for the financial theory in this textbook. The model is reasonable, but it is not used elsewhere in this course.

Read section 16.4, "The Information in Dividends and Stock Repurchases," on pages 419-421, skipping "The Dividend Cut Heard Round the World" on page 421. 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 16.5, "The Payout Controversy," on pages 422-427, focusing on the subsection "Dividend Policy Is Irrelevant in Perfect Capital Markets" on page 422. You will find the illustration on page 424 helpful for understanding the theory and answering final exam questions. Understanding this irrelevance theorem is important; the irrelevance theorem for capital structure is similar, so spend time to make sure you grasp the concept.

Skip section 16.6, "The Rightists," on pages 427-429; skip section 16.7, "Taxes and the Radical Left," on pages 429-433; and skip section 16.8, "the Middle-of-the-Roaders," on pages 433-435. Brealey and Myers are middle-of-the-roaders. But financial analysts differ so much in their views of dividends that Brealey and Myers present the full range of current

opinion. If you trade common stocks, you may want to read these sections to better judge how dividends affect your stock values, but these sections are not tested on the final exam.

Read the summary on page 436, stopping at the line: "... to run a tighter ship"; skip the rest of the summary.

The payout (dividend) issue highlights the corporate finance problems facing us, and the eighth edition of the textbook shows these issues more clearly. We have many facts: 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.