We were recently perusing a paper by Adam S. Koch and Amy X. Sun of Carnegie Mellon University in which they tested 6,395 dividend change announcements made by 1,682 publicly traded companies between 1983 and 1999 (compared to over 37,000 "no change" cases), in quest of several hypotheses regarding the meaning of dividend changes with respect to past and future earnings changes.

While most observers consider dividend changes to be an information cue about the future prospects of a company, Koch and Sun take a different tack, one which is quite timely in this age of a general culinary approach to corporate bookkeeping (most recently it has turned out that Fannie Mae was lying all along). Rather than focus on dividend increases as a message from management about the future (Healy and Palepu, 1988), they have determined that dividend changes are a kind of certification of previously reported earnings changes—just as valuable for investors, though the focus is more on the past than the future. Dividends become a tool for investors to determine the persistence of earnings changes, which is, said differently, all about the credibility of past reporting.

To quote their abstract, "We examine whether the market interprets changes in dividends as a signal about the persistence of past earnings changes. Prior to observing this signal, investors may believe that past earnings changes are not necessarily indicative of future earnings levels…Results confirm the hypothesis that changes in dividends cause investors to revise their expectations about the persistence of past earnings changes. This effect varies predictably with the magnitude of the dividend change and the sign of the past earnings change."

In other words, the authors are suggesting, and we agree, that investors are in a perpetual state of anxiety about the reliability of the information they've already received from management, and that when a dividend change confirms earlier reports investors are willing to reduce the necessary skepticism that is always a conscious or unconscious factor in their valuation equation.

To bring this down to earth, which we find necessary after parsing the authors' formulas (which often run a full two lines including much decoration with Greek letters in a simulacrum of algebra), if you're getting cash that means the company actually made the cash. Whether you as an investor look at it as a certification of the past or a message about the future isn't that important. What matters is that you've been given some proof of the "statements," and though there have been a few scam dividends in the past, handing out cash isn't usually the way crooked or self-serving managers operate. The end result is that an investor can mark up the valuation of the company that increases its dividend because in a world characterized by the everlasting tension between promise and certainty, at a minimum the certainty side of the equation has been strengthened.

"Dividends become a tool for investors to determine the persistence of earnings changes, which is, said differently, all about the credibility of past reporting."

In what we might call the Dividend Dark Ages covering 1990-2003, the armies of MBAs occupying the intermediary slots in the investment food chain insisted that dividends were foolish, that book entries are the same as money, and we should trust our corporate managers to wisely invest surplus earnings in ever greater growth, or, at worst, to buy back stock and kite the value of our holdings as well as their options.

As we know, this philosophy among investors has amounted to granting managers of publicly held corporations a license to kill, or at a minimum the license to manipulate share prices through devious accounting—which is perfectly understandable since the bulk of their

compensation is in shares.

Anti-dividend philosophies have been concocted by academically trained functionaries who forget that investing isn't about the numbers that are so easily melted in spreadsheets or "massaged" in investment strategy modeling software. Investing is about a human relationship between someone with capital and someone who needs that capital to make or sustain a business.

"Why do investors persist in accepting the projections of managers about the future without taking in some real return from the accomplishments of the past?"

Let's say your acquaintance wants to start a hip fashion boutique. You think he (or she) understands the business and can manage it, so you invest some money. A little soft on your manager and the pro-forma profits outlined in the business plan, you take stock in the venture, as a minority holder. A location is found, a lease is signed, the shelves are stocked and the sign goes up; before you know it there's a grand opening with colored flags and a full-page ad in the local paper. Ka-ching, Ka-ching, little skirts and hoop earrings are moving out the door to the seemingly constantly filled parking lot.

By and by it seems that the business is quite profitable, and you think you should share in the profits. But your manager says whoa, he's got a line on a great location for a second store. Business has been so good that he can open it from funds internally generated, no need for additional capital, so now you're going to own a piece of two stores, not just one, for no additional investment! The prospect of growth for your investment quiets you down, and any misgivings you might have had about the cost of your manager's new home and new Porsche seem to fade as you count on your fingers how much two stores might be worth.

Of course this calculation is significantly impacted by the future promise of value, rather than any present return. Of course boutiques do have a market value, roughly speaking, and you can determine what one store and two stores that are profitable might be worth to a buyer, but until there's a buyer you have only the promise. There is only theoretical value without a transaction.

You think maybe you'd like to have a nice new car, too, so you raise the issue of distributing profits once again. But once again your manager has a plan for expansion—this time for a mega-boutique in the new mall that's going up. Rents are premium there, but the retail traffic should be incredible. And so you wait, once again, while the investment you made has babies and more babies, and its babies have babies.

One can see where this is going, and we needn't reveal the ending by announcing the ultimate fate of the business. The simple fact is that an investor is always caught in the dialectic between the certainty of a cash return now and the promise of a greater return later. Why is it so difficult for investors to insist on some level of balance between the two?

Why do investors persist in accepting the projections of managers about the future without taking in some real return from the accomplishments of the past?

This is the human face of dividends, the true actuality of dividends: you invest money in a business and the business pays you back some of its profits in real time, while retaining enough for sustainable and reliable future growth. You receive confirmation of present success, you receive a return on your investment which is minimally a hedge against future failure of the business, you receive a share of profit which goes to the investor and not the manager (this is only fair), and you retain a position in the business which can bring you more of the same indefinitely.

What strange twist of the psyche would have it any other way? ❑

Lowell G. Miller is the founder, president, and chief investment officer for Miller/Howard Investments. He is the author of three acclaimed books on investing including the recently revised *The Single Best Investment* (Print Project 2006). This article represents our current opinion, which is subject to change without notice. Securities are mentioned for illustration purposes only. This is not a recommendation to buy, hold or sell.