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STRATEGIES

In a Twist, High Dividends Are Now a Predictor of Growth

By MARK HULBERT

It may seem too good to be true, but companies that pay the highest dividends are also likely to grow the fastest.

For years, many finance professors have taught just the opposite. Reinvesting current earnings back into a company is supposed to promote earnings growth. Higher payout ratios are supposed to be followed by lower earnings growth. But research conducted by Robert D. Arnott of First Quadrant and Clifford S. Asness of AQR Capital Management reveals a very different picture. For the overall stock market between 1871 and 2001, corporate profits grew fastest in the 10 years following the calendar years in which companies had the highest average dividend payout ratio. In contrast, the 10-year real earnings growth rate was the lowest following years with the lowest average payout ratios.

Mr. Arnott and Mr. Asness, who both work for quantitative research firms, began circulating early versions of their study in academic circles earlier this year. In their latest version, which will be published in the January/February issue of The Financial Analysts Journal, they respond to several arguments posed by critics who have read their work.

Critics say that while the researchers' conclusion may accurately describe the behavior of the overall market, it may not apply to individual companies. Mr. Arnott and Mr. Asness concede that this is possible.

But based on the preliminary results of additional research being conducted by Mr. Arnott, he believes it is likely that the pattern that he and Mr. Asness found at the level of the overall market applies to the individual firm as well. He notes in this regard another study that appeared in last December's Journal of Finance by two Columbia Business School accounting professors, Doron Nissim and Amir Ziv ("Dividend Changes and Future Profitability"). This other research found that between 1963 and 1997, earnings per share grew for two years at an above-market rate for the average company that increased its dividends.

Other critics worried that the research by Mr. Arnott and Mr. Asness may have been skewed by firms' share repurchases. Mr. Arnott and Mr. Asness reject that objection. They found that the period since 1980 fit the same pattern as did the prior period back to 1871, during which share repurchase programs were relatively rare.

Mr. Arnott and Ms. Asness believe that the primary cause of their surprising result is the poor job that the average company does when investing the cash that it would pay out as dividends. Therefore it is better for the company to distribute its earnings to shareholders.

With less cash on hand, a company interested in building its empire is forced to resort to the debt or equity markets to secure needed financing. That directly subjects its business to market discipline, reducing the likelihood that management will pursue unprofitable ventures.

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Their research provides strong evidence in favor of theory first advanced in 1986 by Michael C. Jensen, currently an emeritus professor of business administration at Harvard Business School. Writing in The American Economic Review, Professor Jensen speculated that the more cash that companies have now (beyond what is needed for current projects) the less efficient they will be in the future.

Professor Jensen said managers had incentives to use this excess cash to expand their firms beyond what was most profitable because "growth increases managers' power by increasing the resources under their control." So shareholders need to determine "how to motivate managers to disgorge the cash," he said.

The common theme that emerges from these various studies is a very unflattering portrait of corporate management: give executives lots of rope and they too often end up hanging themselves. It would appear that a high dividend payout ratio is an effective way to reduce the length of that rope.