

61.2 An exercise on dividend policy

According to the dividend irrelevance theory, investors should be indifferent as to whether or not a company pays a dividend. How would the system work if NO companies ever paid a dividend?

Suggested Elements of a Response

The dividend irrelevance theory is the idea that investors are unconcerned whether a company pays a dividend, or whether it keeps the relevant funds and reinvests them. If the company keeps the relevant funds and reinvests them, shareholders will benefit from an increase in the value of their shares. Those shareholders who need such extra value in the form of money, and who might therefore require a dividend, will be able to get it by selling a portion of their shares. Thus if my shares double in value over a year but the company does not pay a dividend, I may sell half of my shares and spend the money, and still hold an investment at the end of the year which is equal in value to my investment at the beginning of the year.

If no companies ever paid a dividend, the only way in which existing investors could realize any extra value in the form of money would be by selling a portion of their investments to new investors. The stock market as a whole would therefore come to bear a close resemblance to a Ponzi scheme. The difference is that companies in the stock market are supposed to engage in some real profit-making enterprise, and to prove it with audited financial reports.