EQUITIES

Surprise! Higher Dividends = Higher Earnings Growth

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Marketwide dividend-payout ratios in the U.S. in he early 2000s were in the lowest historical decile, meaning that earnings-retention rates were at or near all-time highs. At the same time, price-to-earnings ratios and price-to-dividend ratios are high by historical standards.

At such levels, future long-term equity returns are likely to rival historical norms only if future earnings growth is considerably faster than normal. Some top Wall Street strategists do indeed forecast exceptional long-term growth. Among the reasons for this optimism: low dividend-payout ratios, which they see as evidence of a new paradigm in investing.

Unlike optimistic new-paradigm advocates, we found that low payout ratios (high retention rates) historically precede low earnings growth. This relationship is statistically strong and robust. We found that the empirical facts conform to a world in which managers pay a large share of earnings when they believe dividend cuts will not be necessary and pay out a small share when they are pessimistic, perhaps so that they can be confident of maintaining the dividend payouts.

Alternatively, the facts also fit a world in which low payout ratios lead to, or come with, inefficient empire building and the funding of less-than-ideal projects and investments, leading to poor subsequent growth, whereas high payout ratios lead to more carefully chosen projects. The empire-building story also fits the initial macroeconomic evidence quite well. At this point, these explanations are conjectures; more work on discriminating among competing stories is appropriate.

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