EQUITIES

Does Dividend Policy Foretell Earnings Growth?

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Working Paper

Many market observers believe that a high level of retained earnings (or low dividend payout ratio) among companies is a sign that future earnings growth will be well above historical norms. The thinking behind this view is that low market-wide dividend payout ratios suggest that companies are reinvesting more earnings, which should lead to faster future aggregate growth.

However, in the real world, many complications exist that could confound the expected inverse relationship between current payouts and future earnings growth. For instance, dividends might signal managers' private information about future earnings prospects, with low payout ratios indicating fear that the current earnings may not be sustainable. Alternatively, earnings might be retained for the purpose of "empire-building," which itself can negatively impact future earnings growth.

Our evidence supports the latter view. It is consistent with anecdotal tales about managers signaling their earnings expectations through dividends, or engaging in inefficient empire building, at times; either of these phenomena will conform to a positive link between payout ratios and subsequent earnings growth.

Our findings offer a challenge to optimistic market observers who see low dividend payouts as a sign of high future earnings growth to come. These observers may prove to be correct, but history provides scant support for their thesis. This challenge is potentially all the more serious, as stock prices (relative to earnings, dividends and book values) can at times rely heavily on this expectation of superior future real earnings growth.

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