Slash and burn

Stockmarkets grapple with savage reductions in companies' dividends.

Illustration by Claudio Munoz

It felt like death by a thousand cuts. Already this month has seen plenty to rattle stockmarkets, from dreadful economic news to the continuing bloodshed at American International Group, an insurer. Commodity firms were given a reprieve on March 4th by hopes of a big stimulus package in China—though all they got was reaffirmation of the country's 8% growth target. Meanwhile, a new fear haunts the markets: the mounting number of firms slashing their dividends.

That banks and insurance companies will chop their payments is now understood, but the pain has spread. General Electric (GE) has cut its dividend for the first time in 71 years, Dow Chemical for the first time since 1912. In Europe previously reliable payers like Telecom Italia and Anglo-American, a mining firm, have reduced their payouts, and even BP has said it cannot increase its dividend at today's oil prices. Income investors were left to ponder Eurotunnel, the operator of the rail link between France and Britain, which will pay the first dividend since its creation in 1986. Its $9m may buy a few tissues for those mourning the loss of $9 billion of annual payouts from GE alone.

Based on experience since the second world war, investors had cause to be more optimistic. Although stock prices and earnings move up and down violently, dividends have been more reliable, typically falling from the peak of a cycle to its trough by only one-tenth in real terms. Furthermore, the share of American earnings paid out as dividends has declined from a post-war peak of almost two-thirds to about one-third in 2007, with many firms preferring stock buybacks (which have now ground to a halt). That should have given companies a bigger buffer.

Unfortunately other structural trends worked against income-lovers. Firms' debt levels rose, increasing the volatility of earnings. And the quality of the profits fell. Financial companies contributed about one-third of the $736 billion of dividends paid globally by quoted firms in 2007. Standard & Poor's, a rating agency, reckons that dividends in America could fall by about a quarter this year—the steepest drop since 1938. Even this may understate the decline. Financial firms' payouts will collapse—even relatively well capitalised banks like JPMorgan

Chase have reduced their dividends. And more of the industrial firms that make up the other two-thirds of total dividends will cut too. Pessimists point to 1931-35, when dividends per share in America fell by 45% from peak to trough.

For many firms dividend cuts are an unpleasant task that should not be shirked. There is no point in starving a business and endangering a firm's balance-sheet in order to meet macho dividend commitments. The counter-argument, that cuts remove an important discipline on managers, hardly holds true today, when all firms are counting the pennies. That being so, when firms announced cuts why did their share prices slump? The reason has a lot to do with signalling.

A share's value must be the present value of all future dividends—otherwise stockmarkets would be a giant Ponzi scheme. But in theory shareholders should not care whether dividends are paid out today or later. Just as taking money out of a cash machine does not make you richer, nor does extracting cash from a firm you own. Investors who need income to meet pension payments, for example, can raise it just as well by selling a small part of their holdings instead of receiving dividends. It is true that dividends, rather than capital appreciation, have provided a big chunk of long-term equity returns. But this partly reflects the choice of firms to pay out a big chunk of their earnings. Had they paid out less, capital appreciation would, in theory, have been commensurately higher.

The main reason why investors are worried is that dividends are a guide to managers' views of when earnings might reach their trough: they do not want to pay the dividend out of borrowing, or worse, cut it again. Occasionally this floor is breached—in 1933 American earnings per share dropped below dividends. Today, GE has cut its quarterly dividend from 31 cents per share to ten cents. That is partly to reduce gearing, but also suggests managers' low confidence in analysts' forecasts for earnings of about 30 cents. Likewise if American dividends fall by a third from their recent peak, then—assuming they set a floor for profits—earnings would bottom out at about two-thirds below the level of 2007. That would be a drop on a par with the 1930s and far below most forecasts. An overblown scenario perhaps, but the scare over dividends suggest that many investors are still too optimistic.

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