

13-5. (*Flotation costs and issue size*) D. Butler Inc. needs to raise \$14 million. Assuming that the market price of the firm's stock is \$95, and flotation costs are 10 percent of the market price, how many shares would have to be issued? What is the dollar size of the issue?

## Mini Case

The following article appeared in the July 2, 1995, issue of the *Dallas Morning News*. In the article, Scott Burns, the author, makes the case for the importance of dividends.

Let us now praise the lowly dividend.

Insignificant to some. Small potatoes to others. An irksome sign of tax liability to many. However characterized, dividends are experiencing yet another round of defamation on Wall Street. Why pay out dividends, the current argument goes, when a dollar of dividend can be retained as a dollar of book value that the market will value at two, three, or four dollars? With the average stock now selling at more than three times book value, investors should prefer companies that retain earnings rather than pay them out, even if they do nothing more with the money than repurchase shares.

### The New Wisdom

Instead, the New Wisdom says, the investor should go for companies that retain earnings, reinvest them, and try to maximize shareholder value. Dividends should be avoided in the pursuit of long-term capital gains.

The only problem with this reasoning is that we've heard it before. And always at market tops.

- We heard it in the late 1960s as stock prices soared and dividend yields fell.
- We heard it again in the early 1970s as investors fixated on the "Nifty Fifty" and analysts calmly projected that with growth companies yielding 1 percent or less, the most important part of the return was the certainty of 20 percent annual earnings growth.
- And we're hearing it now, with stock prices hitting new highs each day. The Standard Poor's 500 Index, for instance, is up 19.7 percent since December 31, the equivalent of more than 7 years of dividends at the current yield of 2.6 percent.

### Tilting the Yield

Significantly, we didn't hear that dividends were irrelevant in the late 1970s, as stock valuations moved to new lows. At that time, portfolio managers talked about "yield tilt"—running a portfolio with a bias toward dividend return to offset some of the risk of continuing stock market decline. Indeed, many of the best performing funds in the late 1970s were equity-income funds, the funds that seek above-average dividend income.

You can understand how much dividends contribute to long-term returns by taking a look at the performance of a major index, with and without dividend reinvestment. If you had invested \$10,000 in the S&P's 500 Index in January 1982 and taken all dividends in cash, your original investment would have grown to \$37,475 by the end of 1994.

It doesn't get much better than that.

The gain clocks a compound annual return of 10.7 percent, and a total gain of \$27,475. During the same period you would have collected an additional \$14,244 in dividends.

Not a trivial sum, either.

In other words, during one of the biggest bull markets in history, unreinvested dividend income accounted for more than one-third of your total return.

If you had reinvested those dividends in additional stock, the final score would be even better: \$60,303. The appreciation of your original investment would have been \$27,475, and the growth from reinvested dividends would have been \$22,828. Nearly half—45 percent—of your total return came from reinvested dividends. And this happened during a stellar period of rising stock prices.

Now consider the same investment during a period of misery. If you had invested \$10,000 in the S&P's 500 Index stocks in January 1968, your investment would have grown to only \$14,073 over the next 13 years, a gain of only \$4,073. During much of that time, the value of your original investment would have been less than \$10,000. Dividends during the period would have totaled \$7,088—substantially more than stock appreciation. Reinvested, the

same dividends would have grown to \$9,705, helping your original investment grow to \$23,778.

In a period of major ups and downs that many investors don't like to remember, dividends accounted for 70 percent of total return (see the accompanying table).

We could fiddle with these figures any number of ways. We could reduce the value of dividends by calculating income taxes. We could raise it by starting with the Dow Jones industrial average stocks, which tend to have higher dividends. But the point here is very simple: Whether you spend them or reinvest them, dividends are always an important part of the return on common stock.

Source: Scott Burns, "Those Lowly Dividends," *Dallas Morning News*, July 2, 1995, p. 1H. Reprinted with permission of the *Dallas Morning Star*.

#### A Close Look at Dividends in Two Markets

ANATOMY OF THE BULL MARKET, 1982 TO 1994		
Original investment		\$ 10,000
Gain on original investment		\$ 27,475
Total dividends		
Gain on reinvested dividends	\$14,244	
Total gain from dividends	\$ 8,584	
Total		<u>\$22,828</u>
Compound annualized return equals 14.8%; 45% from dividends.		\$60,303

ANATOMY OF A BEAR MARKET, 1968 TO 1980		
Original investment		\$10,000
Gain on original investment		\$ 4,073
Total dividends		
Gain on reinvested dividends	\$ 7,088	
Total gain from dividends	<u>\$ 2,617</u>	
Total		<u>\$ 9,705</u>
Compound annualized return equals 6.9%; 70% from dividends		\$23,778

Source: Franklin/Templeton Group Hypothetical Illustration Program.

Based on your reading of this chapter, evaluate what Burns is saying. Do you agree or disagree with him? Why?