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AHEAD OF THE TAPE

Fork It Over

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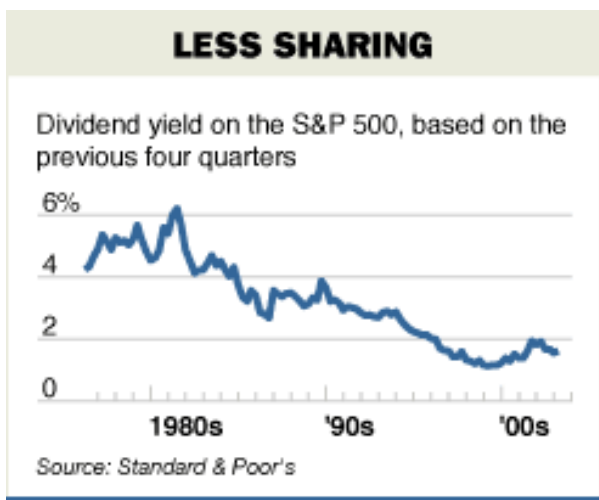
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Higher dividends mean slower growth? Says who?

OK, so a lot of people have been saying that ever since **Microsoft** announced Tuesday that it would boost its regular dividend and dole out a \$30 billion one-time payout. The move was a signal that the company sees few opportunities for growth, and so has nothing better to do with its cash hoard than giving it back to shareholders. Never mind that Microsoft's business doesn't entail large capital expenditures -- or that because it generates more than \$10 billion in cash a year, the dividend outlays will soon be absorbed.

And one needn't shake much dust off the history books to find a time when investors expected the stock market to throw off dividend yields much higher than today's 1.7%. Once upon a time, stock strategists even ran valuation models that would flash "sell" when the dividend yield dropped below that of the 10-year note. That worked like a charm until 1958, when dividend yields dropped below bond yields permanently.


"Most strategists turned bearish, and of course they were wrong," says Morgan Stanley senior investment strategist Byron Wien. "Their models were rendered ineffective and they were pushed out of their jobs."



What the strategists missed was that companies were reinvesting more of their cash -- a change that was given theoretical underpinnings when, in a seminal paper in 1961, Franco Modigliani and Merton Miller showed that dividend policy should have no effect on a company's value, all else being equal.

As time passed, the notion took hold that for companies with good growth prospects, reinvesting cash would actually serve shareholders better than paying out dividends. Since almost all companies believe their growth prospects are good, they reduced -- and in many cases eliminated -- dividends.

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But this may have been wrong. In a paper last year, AQR Capital Management managing principal Cliff Asness and First Quadrant Chairman Robert Arnott found that earnings are stronger following periods when dividend yields for U.S. stocks are high than when the yields are low. One explanation: Managers are more likely to give out dividends when they're confident future earnings will grow. Another possibility: When dividends are low, the mounting cash on balance sheets starts to burn holes in executives' pockets, and they spend more unwisely than when dividends are high and they must be careful with the cash that remains.

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