

Dividends Part 1

When a company makes a profit, it can do one or a combination of three things: it can reinvest the profits for further growth and expansion, it can buyback shares from the public or it can distribute some of these profits as dividends. The second and third option are seen as most desirable by shareholders since each has the effect of increasing shareholder wealth in the short term. How? Well, a share buyback means less outstanding shares which translates to a higher Earnings Per Share and this is eventually reflected in a higher share price for the company and thus the shareholder sees rise in the value of their shares. In the case of dividend payments, the shareholder receives cash in hand which can be re-invested or spent as desired. Thus, in the end the shareholder's real wealth is increased as opposed to the company reinvesting the profits, the rewards of which would be seen in the longer term. Some may argue this point, however from my experience dividends or anything that may show value now is looked upon more favorably than longer term visions, especially in the recent bear market conditions.

In this article, I would like to focus on Dividends since I have noticed a recent interest in this area. Many investors look forward to their dividend payments but may not necessarily understand the fundamental process or implications of such payments. However, due to word limit restrictions this week's article will only cover the fundamental process involved in making dividend payments. Once this framework is established we can then move on to the more complicated issues which I will talk about in my next article.

Essentially, by choosing to pay a dividend a company is signaling to its shareholders that these profits are better off being distributed to its owners than being reinvested in the company. In other words, the management of the company believes the return that shareholders receive from the dividend is higher than the future growth potential of the same profits ploughed back into the company. Thus, dividends are usually paid by mature and profitable companies, but this does not mean that companies that do not pay dividends are without profits. Also, some companies that may not be profitable may still pay dividends through loans and short term debt financing, as they believe that this is better than the dreaded dividend cut! However, investors need to be wary of such companies as they may be sinking themselves into a deeper and deeper hole. A general rule of thumb is to watch out for companies with debt to equity ratios greater than 60 per cent.

A company can pay dividends in three ways: cash dividends, stock dividends or property dividends. A cash dividend is the most common form of dividend and as the name implies, is paid in cash; a stock dividend is a pro-rata distribution of additional shares of a company's stock to existing common shareholders; while a property dividend is when a company distributes property, for example, pencils, books, gold, silver or any item with a tangible value. Property dividends are the least common of all three types of payments. For the purpose of simplicity, in this article we will focus on the most common type of dividend- cash!

Dividends must be declared by the Board of Directors of a company each time they are paid. They may be declared quarterly, half yearly or yearly depending on the company and the company's objectives. To understand the process in which dividends are paid, there are four important dates to be cognizant of: Declaration Date, Ex-Dividend Date, Date of Record and Payment Date.

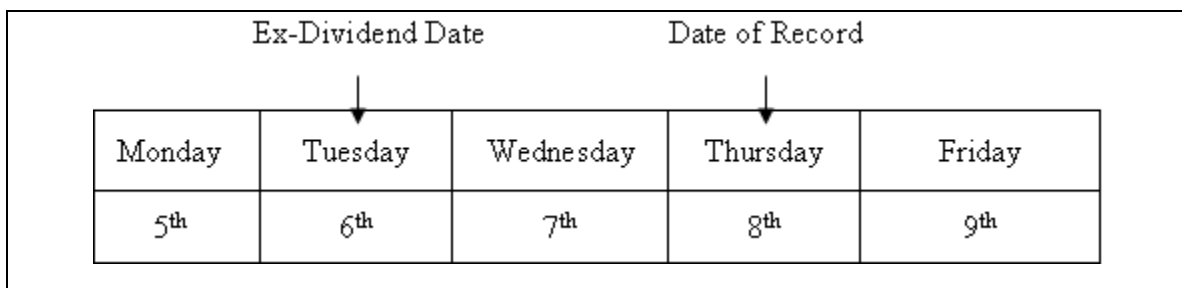
The Declaration Date is the date the Board of Directors announces their intention to pay a dividend. On this day the company will create a liability in its books called Dividends Payable and this liability is removed when the company actually makes the payment to the shareholders. Additionally, on this date the Board will also announce the Ex-Dividend Date and the Payment Date.

The Ex-dividend date is the date the share trades without its dividend. In other words, if you purchase the dividend paying stock one day before the ex-dividend date you will get the dividend, but if you buy the on or after the ex-dividend date then the seller is entitled to the dividend. The ex-date is the second business day before the date of record.

The Date of Record is the date on which the company looks at its records to determine who are the shareholders of the company. Thus, only those on record or holders of record on this date are entitled to a dividend payout.

The Ex- Dividend Date and the Date of Record are used to ensure that the right people receive the dividend cheque. This is because the settlement period for stocks is T+3, which means that when you buy a stock it takes three days from the transaction date (T) for the change in ownership to be recorded in the books. Thus, as mentioned above you need to purchase the stock at least three days before the Date of Record (or the day before the Ex-div date) if you are to receive the dividend. This is further illustrated in **Diagram 1** (source: www.investopedia.com)

Diagram 1



Finally, the Date of Payment, the date that we are mostly interested in, is the date that the company mails out the dividend to the holder of record. This date is generally a week or more after the date of record so that the company has sufficient time to ensure that it accurately pays all those who are entitled.

Now you have an idea of the process of a dividend payout from the date it is declared by the Board of Directors to the day it is in your mailbox. Also, you can understand the reasons for all the dates and the time lag in between them. While it is important to note these days when purchasing a dividend paying stock, it is more crucial to think about the quality of your investment rather than just the date on which you buy. The significance of this will be highlighted in my next article, where I will reveal the implications associated with dividend payments.