

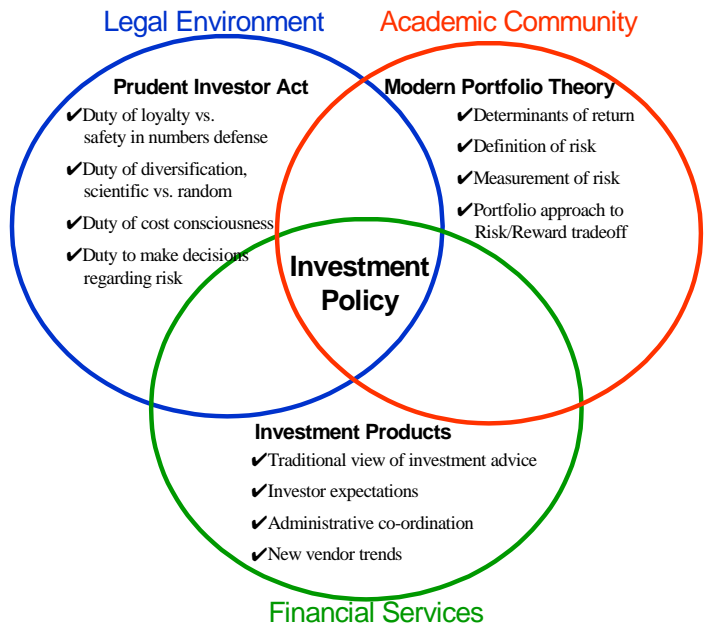
## INCOME FOR TRUST BENEFICIARIES: " A POTENTIALLY ELUSIVE PHENOMENON " IMPLICATIONS OF RECENT ACADEMIC RESEARCH

This article considers the extent and nature of the decades-long decline in stock dividend yields. We review a comprehensive study of corporate dividend policies over the period 1963 through 1999 recently authored by Professors Fama (University of Chicago) and French (Massachusetts Institute of Technology) [Gene Fama and Ken French, *Journal of Financial Economics* 60 (2001) pp. 3-43.] Fama and French conclude that fewer firms pay dividends, the proportion of income paid out as dividends is lower, and the proportion of income used for share repurchases is higher than in the past. These changes in corporate dividend policy conspire with high price-earnings ratios on stocks to drive down dividend yields. Despite the recent halving of share prices, dividend yields stand at a meager 1.87% as of 7/23/02, well below the twentieth century average of 4.56% and the postwar average of 3.86%.

### Income Trusts v. Total Return Trusts

Today's depressed bond interest rates and historically low stock dividend yields confront trustees of net income trusts with a dilemma. While prudent investing typically warrants a strategy of broad diversification, the legitimate budgetary needs and cash-flow expectations of income beneficiaries dictate a shift toward securities yielding higher-income. Trustees may respond to such demands by increasing the portfolio weighting of higher yield bonds (increasing duration or decreasing credit quality); by selling covered call options (thereby truncating upside equity returns); or by using other strategies to increase distributable accounting income. Revised asset allocations may restrict the portfolio's "Equity-Income" component (the segment of the US stock market consisting of firms paying higher than average dividends), leaving just the highest yielding stocks (typically bank and utility shares). In many cases, lower-yielding sectors of the domestic and international equity markets are abandoned completely. Such strategies carry a risk of surcharge for breach of the fiduciary duties to diversify and to remain impartial with respect to the interests of the income and remainder beneficiaries.

If the recent decline in the propensity of US corporations to pay dividends constitutes a fundamental change in dividend policy (what financial economists term a "regime shift"), then legislation allowing for unitrust conversions, principal and income adjustments, and other tools granting flexibility and discretion to trustees, has increased importance. Indeed, commercial trustees advertising asset management services may wish to delete phrases like "we utilize a sophisticated and proprietary dividend discount model to identify undervalued securities with significant growth potential" lest their marketing pitches seem increasingly irrelevant to customers and prospects.



### A Lower Propensity to Pay Dividends

Fama and French consider a number of aspects of the shift away from dividend payments. Indeed, they characterize dividend payments as a "potentially elusive phenomenon". The proportion of dividend paying firms fell from a high of 66.5% in 1978 to 20.8% in 1999. Not only have existing firms decreased or terminated dividends, but new firms tend to eschew dividend payments altogether. Consequently, the flood of new listings on the New York, American, and NASDAQ exchanges has reduced the overall proportion of publicly traded firms that pay dividends to shareholders. Newly listed firms tend to be high growth, low profitability companies that deploy their cash flow to fund investment projects rather than make shareholder distributions. Fama and French focus more closely on the issue of whether and which U.S. companies exhibit a propensity to decrease or terminate dividends. Specifically, they ask three questions:

- 1) Are large, low growth / high profit firms (the group of companies that have traditionally paid dividends) less likely to pay dividends in the future?
- 2) Are firms that have terminated dividend payments less likely to resume such payments? and,

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3) Are firms that have never paid dividends less likely to initiate them?

The Fama-French study suggests that, unlike the swallows that return periodically to Capistrano, shareholders waiting for dividends to reappear may be disappointed.

#### Dividends, Legal Lists, and Current Investor Demands

Before reviewing the study, we should note that the Fama-French findings illustrate how modern economic reality may conflict with the historical conservatism that characterizes fiduciary investing. At one time, abandoning the Harvard College v. Amory standard, some state courts declared that any investment in stocks was per se speculative and, hence, imprudent. As certain legislatures evolved legal-list standards, equity investments became permissible in some jurisdictions if a firm demonstrated a long and consistent dividend payment track record. For many years following the Great Depression, investors demanded higher dividend yields from stocks than coupon rates on bonds, because stocks were inherently more risky. When, in the 1960's, the dividend yield on stocks slipped below bonds, many market prognosticators advised shareholders to sell because they believed the stock market to be grossly overvalued and therefore dangerously speculative. Investors heeding the advice to retreat from the market until the relative stock/bond yields reverted to 'normal' are still waiting for the buy signal. Given the historical economic and regulatory environment governing trust investments, trustees wishing to purchase equities tend to gravitate towards the "less risky" Equity-Income portion of the stock market. This is the world of the safe, blue chip firm with an excellent track record with respect to both share price stability and dividend payout.

Investors do not now demand dividends as they had in the past. The first half of the twentieth century witnessed zero real capital gains on equities; in inflation-adjusted terms, all of the returns to stock investors from 1900-1950 came in the form of dividends. Whereas dividends were once viewed as a legitimate reward to investors who entrusted their capital to corporate management, they are now seen as a sign of management weakness. Firms that pay dividends may, in fact, be signaling that internal investment/growth opportunities are no longer readily available (earnings cannot be employed to fund projects yielding a positive net present value). Dividends thus may be construed, in the modern world, as a signal from management that shareholders should deploy their capital elsewhere. Indeed, if earnings can be invested in growth-oriented projects that have higher

expected returns than the firm's cost of capital (i.e. the firm can invest its cash internally to enrich shareholders), why would the firm want to return cash to its investors?

Furthermore, the differential tax rates on ordinary income and long-term capital gains make receiving cash dividends relatively disadvantageous. The tax-free compounding of long-term capital gains extends further the advantage of capital gains over dividends. Consequently, some modern shareholders view dividends as the worst of all possible worlds, because they transform lightly taxed capital gains into fully taxed income; and, because they evidence a lack of future profitable corporate investment opportunities.

#### Empirical Evidence

The Fama/French study focuses on non-financial, non-utility firms traded on the New York, American and NASDAQ exchanges. Fama and French begin by noting that, prior to 1978, newly listed firms on stock exchanges ("new lists"), are more profitable (i.e. net earnings produce a greater return on the book value of equity) than established firms. During the 1973 through 1978 period, return on equity for new lists equals 17.79%, as opposed to 13.68% for all firms. During the 1993-1998 period, however, the earnings of new lists average only 2.07% of book equity as opposed to 11.26% for all firms. Additionally, while one third of the new lists paid dividends during the 1973-1978 period, just 3.7% of new lists paid dividends by 1999. The declines follow a steady trend throughout the entire period. Both the number and character of new lists have changed dramatically. During 1973-1977, the number of new lists equals 103. For the period 1993-1998 the number of new lists jumps to 584 and 322 new lists appear in 1999 alone. Furthermore, recent new lists tend to be small firms that exhibit high asset growth rates. Since these firms frequently use revenues to finance asset growth, they tend to exhibit low profitability.

Fama and French proceed to examine the entire universe of publicly traded, non-financial, non-utility firms. By 1999 the great majority of all publicly traded companies no longer pay dividends. The table at the top of the following page indicates the magnitude of the change in the percentage of dividend paying companies over 5 year periods from 1963 through 1998.

Only 20.8% of companies pay dividends in 1999. This phenomenon cuts across all stock exchanges and is not merely an artifact of the

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*...some modern shareholders view dividends as the worst of all possible worlds, because they transform lightly taxed capital gains into fully taxed income; and, because they evidence a lack of future profitable corporate investment opportunities.*

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	1963-1967	1968-1972	1973-1977	1978-1982	1983-1987	1988-1992	1993-1998
<b>Payers</b>	71.6%	64.6%	60.3%	58.2%	36.1%	29.4%	23.5%
<b>Non Payers</b>	28.4%	35.4%	39.7%	41.8%	63.9%	70.6%	76.5%

*The population of dividend paying firms shrinks at average annual rate of 9.8% over the period under evaluation. The number of firms that initiate dividend payments is nowhere near sufficient to overcome the number terminating dividends.*

surge of new listings on the NASDAQ. A trustee of net income trusts (especially trustees lacking powers of invasion either under ascertainable standards or under trustee discretion) find that the opportunity set of equity investments producing distributable accounting income is greatly restricted. In 1978, 2,419 firms paid dividends. This number declines to 1,063 firms by 1999. The population of dividend paying firms shrinks at average annual rate of 9.8% over the period under evaluation. The number of firms that initiate dividend payments is nowhere near sufficient to overcome the number terminating dividends. The dividend initiation rate for firms that did not previously pay dividends shrinks from an average rate of 7.1% of first-time payers in the 1963-1977 period to just 0.7% in 1999.

**Statistical Evidence**

If the Fama/French study merely confirms the fact that a lower percentage of firms currently pay dividends, this conclusion would be, in the main, unremarkable. Of greater significance, however, are their findings for the subpopulation of firms that exhibit size and accounting characteristics common to dividend payers. Fama and French address this issue from two perspectives. They study both the characteristics of firms likely to pay dividends, and the decreased tendency over time for firms exhibiting such characteristics to pay dividends. Specifically, they show that the propensity to pay dividends is positively associated with firm size and profitability and negatively associated with asset growth and investment opportunities. For example, during the 1993-1998 period, dividend-paying firms were, on average, more than thirteen times as large as non-paying firms.

Fama and French also show that similar groups of firms are much less likely to pay dividends now than in the past. The authors marshal both qualitative and quantitative evidence in support of the hypothesis that modern firms, irrespective of size, or financial accounting trends exhibit a propensity to avoid payment of dividends. Qualitative evidence flows from the fact that firms with particular characteristics (i.e. large, profitable, low growth firms) are less likely to pay dividends now than in the past. A full 72.4% of firms with positive earnings available to common stock pay dividends in 1978,

while just 30% of firms with comparable profitability pay dividends in 1998. Similarly, although dividend payments were never prevalent within the population of unprofitable firms, prior to 1983 approximately 20% of such firms pay a dividend despite negative earnings while just 7.2% of such firms pay a dividend in 1998.

The authors base their conclusions on the result of rigorous statistical examination. Forming portfolios based on key characteristics derived from regression analysis, they estimate, for the base period 1963-1977, the likelihood (cumulative probability distribution function) that a large, profitable, low-growth firm will pay (or not pay) a dividend. By observing samples of firms with similar characteristics in later years, the authors compare the fraction of firms expected to pay to the fraction that actually pays dividends. If the number of actual payers is less than expected, the amount of the shortfall quantifies the reduced propensity to pay. The statistical analysis covers numbers of subpopulations (large firms with positive earnings available to pay dividends to common stock owners, firms that have never paid, firms that have suspended payments, etc.). The aggregate evidence strongly suggests that, irrespective of key characteristics, firms from every group are less likely to pay a dividend. For example, in 1998, 58.3% of firms are expected to pay dividends. However, only 21.3% do, in fact, pay. The lower propensity to pay cuts across every type of firm—both large and small, high growth and low growth, profitable or unprofitable. As the twenty first century emerges, U.S. corporations no longer feel compelled to compensate investors with dividends.

**Share Repurchases—Proxy Dividends?**

Of particular interest to trustees is the extent to which corporate share repurchases have replaced dividends as a method of distributing cash to stockholders. Share repurchases may reflect several motives. Neither repurchases to fund ESOP/management compensation agreements nor repurchases to finance merger and acquisition activities represent a transformation of earnings into capital value for shareholders. However, if share repurchase reflects a new corporate policy in

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*Traditional fiduciary accounting principles seem to coexist poorly with modern corporate policies for shareholder compensation. As long as there exists a differential tax rate between dividend and capital gain income, U.S. corporations have a structural incentive to continue to repackage distributions in a more tax-effective fashion because the lower tax liability to shareholders decreases the firm's cost of capital.*

which the repurchase programs substitute lower-taxed capital gains distributions for highly-taxed dividend distributions, the implications are profound. Indeed, by 1999, the Fama/French study concludes that dividend paying companies use share repurchase programs rather than dividends for approximately 25% of cash payments to shareholders. Additionally, the proportion of earnings used to fund share repurchases has increased significantly throughout the period under study:

⇒ Trustees of family trusts retaining undiversified positions in inherited stock because of high dividend “benefits” to beneficiaries fail to realize that high dividends raise a corporation’s cost of capital. This means that shareholder value leaks out of both the tax door and the stock price valuation door because hurdle rates for profitable company projects are higher.

	1973-1977	1978-1982	1983-1987	1988-1992	1993-1998
<b>% Corporate earnings used for share repurchase</b>	3.37%	5.12%	27.98%	30.02%	35.46%

Consider, for example, a legislature’s decision not to adopt the Uniform Principal and Income Act’s provisions allowing for adjustment between income and principal accounts to foster equitable treatment for both beneficiary classes. Under most unreformed fiduciary accounting statutes, the proceeds of such transactions are credited to principal because they are considered realized capital gains from the sale of trust property. Traditional fiduciary accounting principles seem to coexist poorly with modern corporate policies for shareholder compensation. As long as there exists a differential tax rate between dividend and capital gain income, U.S. corporations have a structural incentive to continue to repackage distributions in a more tax-effective fashion because the lower tax liability to shareholders decreases the firm’s cost of capital.

⇒ The opportunity set of investments is more limited. Portfolios constructed wholly from high-yielding stocks may be imprudently concentrated. The safe, blue-chip portfolio becomes precariously susceptible to dramatic decline when economic conditions change.

If income opportunities are not reasonably available in the bond markets, a more viable alternative is a unitrust/discretionary trust structure. Legislation permitting trustees of income trusts to convert to total return unitrusts will allow for critical investment flexibility. Conversely, due to the long-term regime shift in the dividend policy of U.S. corporations, adherence to outmoded (doctrinaire) investment strategies may increase the risk of fiduciary breach actions from disgruntled beneficiaries.

**Conclusion**

Trustees, looking for accounting income in the equity markets find a shrinking population of companies from which to build a portfolio. Of potentially greater importance, however, is the fact that the new sources of distributions to shareholders that lie outside the equity income segment of the market may be unavailable to trustees simply because of the constraints imposed by fiduciary accounting rules. The future of growth investing may involve capital-gain income to shareholders—a paradox not contemplated by the framers of either the 1931 or 1962 Principal and Income Acts.

Recent academic research has several implications for trustees of net income trusts:

⇒ The equity-income portion of the market may no longer remain a viable place in which to generate sufficient accounting income to meet a beneficiary’s needs.

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