Stock Dividends
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Barron's National Business and Financial Weekly (1942-Current file); Aug 3, 1953; 33, 31; ABI/INFORM Global
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Stock Dividends

They Can Save the Investor Many a Tax Dollar

By BENJAMIN GRAHAM

GIVEN an expanding company, which needs to add substantially to its equity capital, both the management and the stockholders face a dilemma in the matter of dividend policy. If the dividend is held down below a reasonable return on the fair value of the enterprise, the rank and file of the stockholders lose twice — first, by inadequate income, and second, by an unduly low market price for the shares.

On the other hand, if the company follows what used to be considered the preferable policy — namely, to pay a fully adequate dividend, but then to build up its equity capital by selling additional shares — the result makes no sense at all from the income-tax angle. For in that case the stockholders receive a good dividend, pay a high average personal tax thereon, and concurrently are called upon to put the same money, tax diminished, back into the business.

The simple solution of this dilemma lies in the use of *non-taxable stock dividends* to represent that part of the earnings which ordinarily would be paid out in cash, but are now required by the company for purposes of expansion. However, in the present state of investors' thinking on the matter of dividends, the stock-dividend solution is unattractive. A recent incident will illustrate this point.

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The Caterpillar Tractor Co. is a strong and successful enterprise which has paid dividends continuously since 1914. In June, 1953, it cut its quarterly cash dividend from 75 cents to 50 cents, but at the same time paid a stock dividend of 4%. In the accompanying statement the management explained that it needed to conserve cash for the building of a large additional plant. It added that the stockholders would be better off with a $2 annual rate in cash, plus a 4% stock dividend, than they were with the straight $3 cash disbursement, since those who wish to can realize more than the $1 difference by the sale of their stock dividends.

Apparently, the stockholders did not accept this reassurance at face value, however, for immediately following the announcement (in a generally weak market) the shares declined a full 10%. It would appear from this incident, and from others like it, that investors do not regard a stock dividend as a desirable substitute for a cash payment, even though the former may have a higher value taken at market. We believe the public is wrong in this matter. Under present conditions of taxation and corporate expansion needs, a stock-dividend policy *of the right kind* is in many cases more logical and more advantageous than

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a cash-dividend policy. It is not too difficult, we think, to demonstrate that this is true. But it will be much more difficult to change the thinking and the traditional reactions of the financial community in the matter of dividends.

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There are several factors that now make cash dividends less desirable than they used to be, and have enhanced the usefulness of systematic stock dividends. The first of these factors is the above-mentioned double taxation of distributed earnings, at heavy rates. The second is the continuous need for corporate expansion on a huge scale to support the full-employment principle to which both government and business are now committed. These same conditions give rise to a third factor, namely the sharpening of an inherent conflict of desire, re dividends, between the average or outside stockholder and controlling interests. Finally, we might assert that the cash dividend rate and dividend record are no longer, as once they were, the most convincing indication available of the success and the quality of a common stock investment.

Today's situation can be illustrated by almost any public utility company of the typical kind. It has satisfactory earnings; it pays a "normal" cash dividend; it is expanding at a rapid rate, and financing that expansion by the sale of bonds, preferred stock and also by offering subscription rights for new common stock to its shareholders, or directly to the public. If you examine what took place over the past seven years—the postwar period—you will find that the common stockholders as a class have given back to the company for new stock all or a large part of the cash dividends paid out to them. If you can trace the matter further you will find that the stockholders in the aggregate (other than corporations) lost in income taxes about 50% of the dividends received. This tax—piled on top of a 52% levy on the utility's net profits—was paid merely for the privilege of letting the dividend money pass into the stockholders' bank accounts and then out again in payment for the additional shares purchased.

Could the payment of this heavy dividend tax have been avoided, with the same results otherwise to both the company and its stockholders? Yes, by the use of periodic stock dividends to take the place of that part of the quarterly cash payment that is taken back by the sale of new shares. Those stockholders who in the past have not exercised their subscription rights could obtain the same overall cash result by selling their stock dividends as received. Those stockholders—the majority, no doubt—who subscribed to the new stock would obtain the same overall result by merely keeping their stock dividends. The latter group would have no income tax at all to pay on these transactions. The former group would pay very small income taxes, on a capital gains basis, as the stock dividends are sold.

According to the Edison Electric Institute, about $4 billion is to be spent by the industry in 1953 and at least an additional $8 billion will be spent in 1954-56. Without question, utility stockholders will be called upon to purchase at least $1 of new stock for each $1 of cash dividends received. But to the extent that stock dividends are substituted for cash the sale of new stock would be correspondingly diminished—and at the same time the income tax burden on the equity owners would be reduced.

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The case for adopting this kind of policy can perhaps be dramatized by taking an extreme example—that of the American Telephone & Telegraph Co. In 1946-1952 A.T. & T. paid out $1,800 million in cash dividends at its traditional $9 rate. During the same seven years it received from its stockholders (and their transferees) nearly $2,700 million, paid in the first instance for convertible bonds and in the second as additional cash consideration (premiums) for the exchange of the bonds into stock. By the end of 1952 most of the bonds—as well as some previously existing—had been converted, so that the stock and premium accounts alone showed a growth of $2,600 million.

It is clear from these figures that in the past seven years American Telephone stockholders have effectively paid over to the company a good deal more money than they have received in dividends. To the extent that non-stockholders bought rights or convertible bonds, they were in the same position as if they had bought stock from existing owners. Had the shareholders received the new stock directly from the company in the form of stock dividends—instead of via the combination of cash dividends with con-

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vertible bond subscriptions and exchanges — *they would have been saved at least a half billion dollars in personal income taxes.*

The mechanism of a stock dividend policy by A.T. & T. is much simpler than one would imagine. The declarations would continue to fix a payment of $9 annually, but the medium of payment would be in stock valued at $150 per share. The same kind of dividend checks would be issued as now; but instead of calling for so many times $2.25 in cash it would call for that many times 3/200ths of a share. The owner could either hold these dividend checks, to add to his stock interest, or else he could cash them by depositing them with any broker or even his bank. The company would presumably set up an agency to cash in or round out stock fractions for its shareholders, at no cost to them.

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The cost of administering such a plan—covering the equivalent of over $90 million in cash dividends every three months—should be a good deal less than the present elaborate financial operations entail. Stock issued via the stock-dividend route would supersede the following series of steps: (a) Payment of cash dividends; (b) issuance of subscription rights for convertible bonds; (c) transferring such rights when sold; (d) issuing the new convertible bonds; (e) paying interest on and otherwise administering the convertible bonds; and (f) taking in the convertibles and the related cash premiums and issuing new stock in exchange — the same stock that would have been issued in the first place had a stock dividend policy been followed.

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The idea proposed for A. T. & T. is indeed a revolutionary one. In view of the almost sacred character of this company's quarterly dividend of $2.25 — a fixture since 1920 — a change might appear unthinkable. This may be true. Nevertheless, it makes better sense than the present enormously expensive shuttling back and forth of hundreds of millions of dollars annually. And if not applicable to A. T. & T., the idea would certainly fit a large number of utilities that are not bound by a particular dividend tradition. Citizens Utilities Co., a small but highly successful enterprise, has followed a combined cash and stock dividend policy with excellent results since 1946. The advantages of the policy have been fully explained to the shareholders.

The stock-dividend concept has a wider application, however, than the "subscription-right" cases we have been considering. Stock dividends should be used also, in a systematic fashion, to supplement a present low cash pay-out in relation to earnings. In the industrial and railroad fields most companies have met their need for more equity capital by holding down their cash dividend rates, rather than by paying full dividends and selling additional common stock. The overall situation in this respect is indicated by the following ratios covering the 200 stocks reported on by Moody's. In 1935-39 the pay-out averaged 81% of earnings; in 1945-49 the pay-out was only 51%. (For rails alone in 1948-1952 the pay-out rate was 37%.)

It is clear from these figures that a large number of companies have been paying out well under half of their earnings. Such a policy may be justified from the standpoint of corporate needs, but it has been unnecessarily hard upon the income and market position of the stockholders. A properly conceived and executed stock-dividend policy can conserve cash earnings for the company's requirements and at the same time give adequate recogntion to the stockholders' desire for liberal distributions.

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