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## Revisiting the dividend puzzle Do all of the pieces now fit?

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#### Abstract

This paper revisits the dividend puzzle, described here as questions about the relevance of dividend policy and how managers should (and do) determine dividend policy. We examine theoretical and empirical research on dividends and share repurchases because they are the principal mechanisms by which corporations disburse cash to their shareholders. Despite a voluminous amount of study, researchers still do not have all the answers to the dividend puzzle. However, we are closer to its resolution. We also do not have definitive answers to why managers choose one method of cash distribution over the other. Solving the dividend puzzle may depend on understanding the effects of various market imperfections or frictions. Because various imperfections affect firms differently, dividend policy may vary substantially from one firm to another. Models that consider the competing frictions on a firm-specific basis offer promise for resolving the dividend puzzle.

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#### 1. Introduction

A main principle of corporate finance is that managers should make decisions that lead to maximizing the wealth of their shareholders as reflected in share price. Much debate exists about the role, if any, of dividend decisions on share prices. Both academics and corporate managers continue to disagree about whether the value of a firm is independent of its dividend policy. Despite exhaustive theoretical and empirical analysis to explain their pervasive presence, dividends remain one of the thorniest puzzles in corporate finance.

Miller and Modigliani (1961), hereafter called M&M, first posed this puzzle in their classic paper. They provide a compelling and widely accepted argument for dividend irrelevance if some well-defined conditions are met. M&M frame their analysis in the context of a perfect capital market with rational investors. Their premise is that valuation depends only upon the productivity of the firm's assets and not the form of payout. The irrelevance argument implies that no matter how much care managers take in choosing a dividend policy for their firm, the chosen policy has no beneficial impact on shareholder wealth. Thus, all dividend policies are equivalent. Early research by Black and Scholes (1974), Miller (1986), and Miller and Scholes (1978, 1982) support the dividend irrelevance argument.

Once we leave M&M's idealized world of economic theory and enter the real world, the issue of dividend irrelevance becomes more debatable. Such market imperfections as differential tax rates, information asymmetries between insiders and outsiders, conflicts of interest between managers and shareholders, transaction costs, flotation costs, and irrational investor behavior might make the dividend decision relevant.

Researchers responded to M&M's dividend policy's irrelevance conclusion by offering many competing hypotheses about why companies pay dividends and why investors pay attention to dividends—the "dividend puzzle." In assessing the contributions provided by researchers, Black (1976) concluded, "The harder we look at the dividend picture, the more it seems like a puzzle, with pieces that just don't fit together." Several years later, Feldstein and Green (1983, p. 17) echoed Black's sentiments by stating, "The nearly universal policy of paying substantial dividends is the primary puzzle in the economics of corporate finance." Miller (1986) also recognized that the observed preference for cash dividends is one of the "soft spots in the current body of theory." The profusion of theories led Ang (1987, p. 55) to observe, "Thus, we have moved from a position of not enough good reasons to explain why dividends are paid to one of too many." These observations suggest that solving the dividend puzzle has been neither simple nor obvious.

This paper revisits the dividend puzzle in order to determine whether all of the pieces now fit. Because the dividend literature is large, we limit our review to some salient theories and evidence.<sup>3</sup> We focus on dividends and share repurchases because they are the principal mechanisms by which corporations disburse cash to their shareholders. Because some people

<sup>&</sup>lt;sup>3</sup> See Allen and Michaely (1995) and Lease, John, Kalay, Loewenstein and Sarig (2000) for comprehensive reviews of the dividend literature.

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