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Business Review

Higher Payout?
... Dividends rise more slowly than other types of income, but new CID guidelines may help.

Western Consumer Budgets
... A moderate budget for the typical urban Western family probably now costs over $12,000.

RCPC's—Transitional Step
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Business Review is edited by William Burke, with the assistance of Karen Rusk (editorial) and Janis Wilson (graphics).
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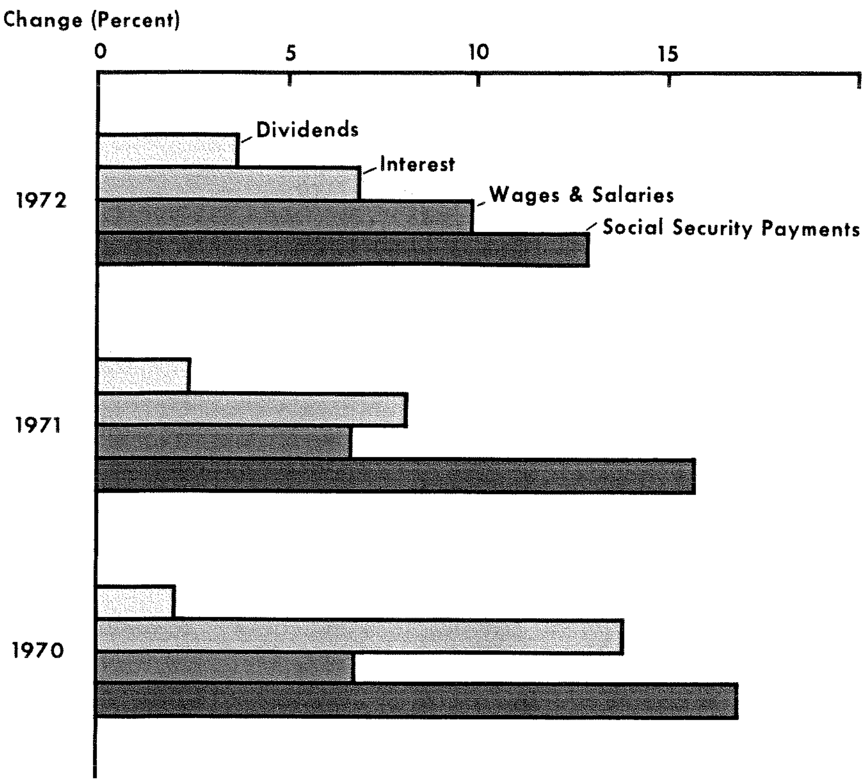
Widows and orphans (and other investors) got a lift recently when the Committee on Interest and Dividends (CID) eased its guidelines on corporate dividend payments. As a welcome side-effect, this ruling helped check temporarily the downward slide of the stock market, as stockholders came to realize that higher yields on their investments were at least possible, even if price appreciation should continue to be a mirage.

The new guidelines allow firms to continue operating under the old standard, which limits increases in payments to no more than 4 percent over the prior year, but they also provide a second option which bases current payments on historical payout ratios for the last five years. The new option provides that the aggregate cash payment per share in 1973, calculated as the percentage of per-share profits after taxes in the last completed fiscal year, cannot exceed the firm's average payout ratio for the 1968-72 period.

The Economic Stabilization Act of 1970 included no provisions regarding dividend or interest payments, but in the 1971 freeze, the Secretary of Commerce requested the 1300 largest corporations to forego dividend increases temporarily. As the freeze period ended, the CID set the 1972 guidelines, requesting firms to limit increases to 4 percent above the largest per-share dividend paid during calendar 1971 or the fiscal years 1969-71. The 4-percent guideline continued during Phase III, and that option is still available to corporate managers, along with the option to base their payments on historical payout ratios. The new option takes as the standard the same span of years as is used for monitoring profit-margin performance under the stabilization program.

Why dividends lag

Dividend payments in the aggregate have lagged considerably behind the growth of other types of income over the past several decades, especially in the most recent period. In recent years also, payouts have lagged far behind earlier dividend growth. These payouts were held down by the poor performance of profits during the sluggish 1969-71 period, and were also affected by the CID guidelines as the economy moved out of recession.



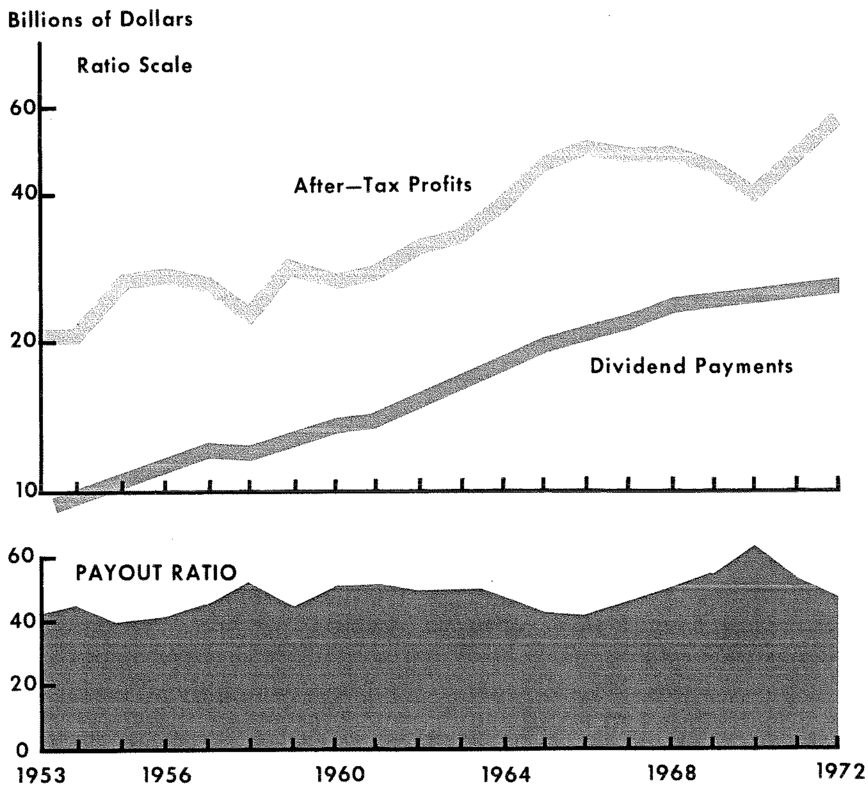
Dividend payments increase at slower pace than other forms of income, such as wages, interest and social security

Between 1967 and 1972, dividends increased only 22 percent, to $26.0 billion last year, as against gains of 50 percent or more in employee compensation and personal interest payments. Meanwhile, social-security and other transfer payments actually doubled. Except in 1968, increases of dividends were relatively small throughout this period. After several years' sluggishness, dividends rose by 3½ percent in 1972, roughly in line with the guideline increase, but in contrast, interest payments last year increased about 7 percent, employee compensation 10 percent, and social-security payments 13 percent.

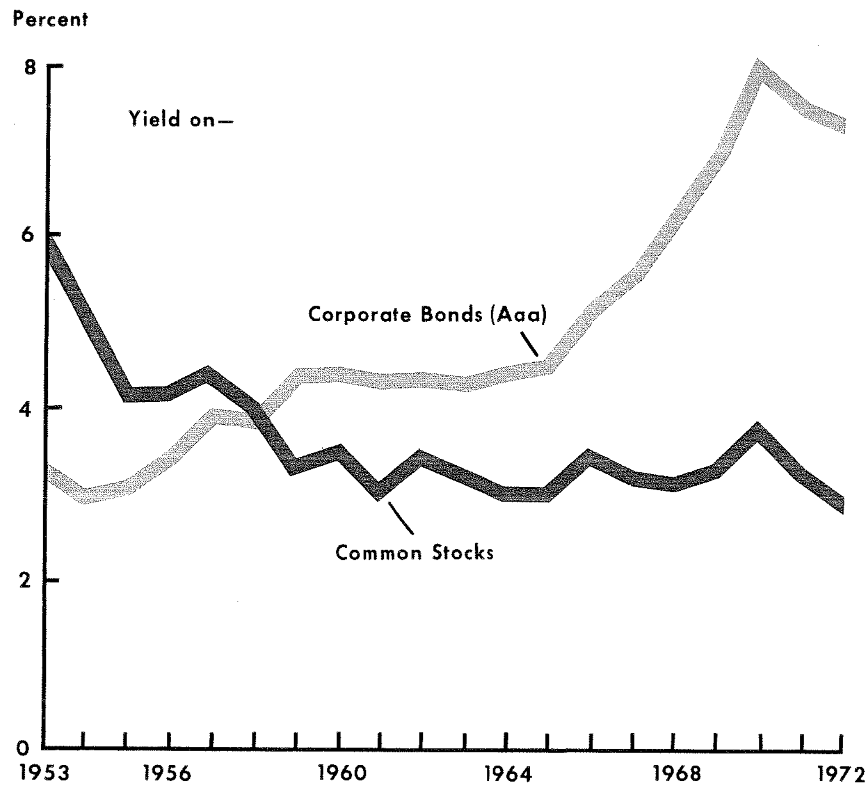
Dividend payments have closely paralleled corporate profits over time. (Both tripled in size over the past two decades). Consequently, with profits rising only 19 percent between 1967 and 1972, dividend payments not surprisingly were held to a 22-percent increase.

The payout ratio meanwhile has fluctuated considerably, reflecting the tendency for corporate directors to adjust dividend policy to profits performance with a certain lag. In 1967, corporations paid out 46 cents for every profit dollar, but the ratio later rose as a consequence of modest increases in dividends and sharp declines in profits. In the 1970 recession year, the ratio jumped to 63 percent—the highest level of the past generation—but then fell off again in line with the recent recovery in profits. In the first quarter of 1973, the ratio fell to 40 percent, partly because of the lag in adjustment to that profits upsurge, but also because of the payout limitation enforced by the old CID guidelines.

Several different considerations affect the dividend decisions of corporate managers. According to a recent Conference Board study, most managers look first at corporate earnings records, present and prospective, when deciding on the size of payout. This involves an analysis of the firm's cash flow and anticipated need for funds. Also, corporations frequently are influenced in their decisions by past dividend practices, and this shows up in attempts to maintain the continuity or regularity of dividend payments, or to maintain a stable rate of dividends per share. Seven out of ten surveyed firms targeted their payout at somewhere between 40 and 60 percent of after-tax profits each year. With profits now rising and CID guidelines easing, all these policy considerations would suggest a substantial expansion of dividend payments as time goes on.



Dividend payments closely parallel growth of corporate profits, but payout ratio shows substantial fluctuations



Dividend yield on stocks falls considerably below bond yield over past several decades . . . gap widens in recent years

Bonds favored

Nonetheless, for several decades now, investors have been turning to bonds rather than to stocks as a source of current income. In 1953 dividend payments totaled $8.9 billion, as against $11.8 billion in interest payments. But in the second quarter of 1973, dividends were $27.3 billion (at an annual rate) compared with $85.7 billion in interest payments.

One reason for the relative disenchantment may be the weakness of stock prices, at least over the last half-decade. (After rising almost 50 percent between 1962 and 1967, the Standard and Poor stock index increased only 19 percent over the past half-decade). Related to this is the fact that bond yields far outstripped dividend yields during that period, making stocks even less desirable.

It was not always thus. In 1953 dividends provided a 5.80 percent yield for the S&P stock index, while the corporate-bond yield averaged no more than 3.20 percent. By 1967 these figures were almost exactly reversed, and since then the spread has widened even more in favor of bonds. By the first quarter of 1973, the dividend yield was only 2.78 percent, compared with a 7.22-percent bond yield.

Dividends slighted
During the market upsurge of the past several decades, dividend payouts seemed far less important to Wall Street money managers than potential increases in earnings per share. In those days, the securities that seemed most attractive often paid nominal dividends or none at all; according to one analysis covering the period 1960-70, the most profitable firms paid out on the average only 25 percent of their net income, while the least profitable paid out 60 percent in dividends. Because of this emphasis on profits growth, investors and corporate managers preferred to see earnings piled back into expansion or diversification that would produce further increases in earnings per share. But then, as the "gunslingers" era on Wall Street came to an end, investors began to adopt a more traditional approach and showed renewed interest in yields.

One stock-market study conducted at the University of Chicago indicates that dividends have always comprised a large part of the total return to investors. Over the 1926-65 period, the average annual return amounted to 9.3 percent, and over one-half of this return came from dividends rather than price appreciation.

Higher payout?
The recent CID action may stimulate corporate directors to boost dividend payments. In fact, the Committee noted that "it was guided primarily by considerations of equity" in easing payout restraints—in other words, that it was attempting to provide parallel treatment for different types of income. At the same time, the continuation of the basic guidelines indicates that an upper limit will be maintained on the size of payout. Under the old 4-percent guideline, total dividend payments this year could rise to about $27.0 billion, whereas under the new option, the upper limit may be around $29.2 billion.

Executives might be tempted for reasons of their own to set a limit on dividend increases. They realize that external funds could dry up in the developing atmosphere of financial stringency—despite that fact that the corporate sector is usually the last to be hit by tight money—and they know also that many other uses besides dividends exist for corporate cash, such as heavy capital-spending programs.

With Phase 4 controls now set in place, industries generally may have trouble maintaining profit margins, because of the switch from a percentage mark-up to a dollar-for-dollar passthrough of cost increases. Moreover, some industries (such as transportation) that have considerable leeway under the new formula for boosting dividends are in no position to do so because of their lack of profitability. In any case, the percentage of after-tax profits paid out in 1973 is almost certain to fall somewhat below 1972's 47-percent ratio, simply because the new formula applies to 1972 earnings instead of the much higher projected 1973 profits.

However, considerably more leeway for higher dividends would exist next year, if the new formula were then applied to 1973 profits—and if the overall profits trend were to remain favorable in the face of Phase 4 controls and perhaps also a decelerating economy. After-tax profits jumped 26 percent, and cash flow 20 percent, between the first quarter of 1972 and the first quarter of 1973. In view of those increases, as well as the usual tendency for dividend payouts to follow profits trends, dividends quite possibly may begin to grow apace with other types of income.

William Burke