Finance Research Letters 13 (2015) 66–73

Contents lists available at ScienceDirect

Finance Research Letters

journal homepage: www.elsevier.com/locate/frl

Net payout return: An alternative to the traditional returns approach based on dividends and share repurchases

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A R T I C L E   I N F O

Article history:
Received 6 March 2015
Accepted 23 March 2015
Available online 11 April 2015

JEL classification:
G10
G14
G20
G32
G35

Keywords:
Stock repurchase
Equity issuance
Dividends
Equity returns
Payout methods
Equity risk premium

A B S T R A C T

We examine two alternative measures of equity returns incorporating stock repurchases as well as dividends, the other incorporating new equity issuance. We compute stock returns for 30 S&P 500 firms using all three approaches and find that stock repurchases have on average increased average annual returns by almost 2% and geometric returns by +1.6% per annum, whilst new share issuance reduces average returns by 1.1% a year. We also find similar results at the aggregate portfolio level. We argue that investors should be concerned about total shareholder flows and not the amount of cash distributed through any particular channel.

1. Introduction

The proportion of US firms paying dividends has fallen significantly especially from the late 1970s to 1990s (Fama and French, 2001). The increased use of stock repurchases as a mechanism for returning value to shareholders has been a significant choice for many US firms since the start of this century

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http://dx.doi.org/10.1016/j.frl.2015.03.002
1544-6123/

(Jagannathan et al., 2000). DeAngelo et al. (2006) find that the declining propensity to pay is especially large among firms with high retained earnings. Almeida and Campello (2010) argue that such firms have low external financing costs, but have to hoard cash for investment purposes. DeAngelo et al. (2004) show that dividends have become increasingly concentrated among a small number of profitable firms. By way of example they illustrate that the top 25 dividend paying firms in the US account for more than 50% of aggregate dividends by dollar amounts.

Data from Standard & Poor's shows that more than $2 trillion worth of stock has been repurchased across all 10 major industry groupings over the last 5 years, ranging from a low of less than $10 billion for the Utilities sector to a high of $501 billion for Information Technology (S&P Quarterly Buyback Factsheet, 2014). Clearly industry sector is an important factor, but is beyond the scope of this paper. Dittmar and Dittmar (2008) analyse the time series behaviour of stock repurchases and equity issuance, highlighting the cyclical patterns in equity issuance as the supply of available equity financing and capital demand are both positively correlated with GDP growth, thus managers take advantage of high investor sentiment with the tendency of equity offerings to follow periods of high returns. Likewise Stephens and Weisbach (1998) also point to the procyclical patterns of stock repurchases. Ikenberry and Vermaelen (1996) identify the discretionary nature of open market repurchase programmes as well as the perception of it as a tax efficient alternative to paying cash dividends, whilst disagreeing that it is optimal from a signalling hypothesis perspective. They recognise the appeal of share repurchase to firms with excess debt capacity, excess cash, few growth opportunities, and as a tool for rectifying share valuation mispricing.

Baker and Wurgler (2000) find that new share issuance as a proportion of total new debt and equity is a strong predictor of US stock returns between 1928 and 1997 and that new equity share issuance typically occurs when market returns have been high and they find that firms issue relatively more equity just before years of low market returns. They also find that the equity share in new issues has more predictive power of one-year-ahead returns than the dividend-to-price ratio or the book-to-market ratio. Grullon et al. (2011) suggest that the real puzzle is disappearing yields not dividends when examined over time, as they find that net payout yields (conditional on firm characteristics) have been increasing despite the decline in dividends, as they find the propensity to payout has been relatively constant over the last three decades. Increasing market valuation multiples may be to blame. However, Grullon and Michaely (2002) show that regulatory shifts post-1983 are an important factor too promoting increased levels of share buyback activity.

We are concerned solely with a proof of concept, since share repurchases have exceeded aggregate dividends for the last few years with investors placing more emphasis on the dividends plus buyback yield, then it should follow that new share issuance ought to also be factored into the return equation, especially when considering long-run investment horizons. Grullon et al. (2011) argue that investors ought to be more concerned about net capital market flows than about the amount of cash distributed through any particular channel and find that, at any given time, a significant number of firms classified as non-dividend payers are positive net payers and a significant number of firms that are classified as dividend payers are actually negative net payers.

Some firms have paid out more in stock repurchases over the last four decades than cash distributed via dividends as Table 1 shows. This is the case for firms like Apple, Boeing, Exxon Mobil, Goldman Sachs, Home Depot, IBM, Pfizer and Wal-Mart. Due to the bailout of the financial sector following Lehman's collapse in 2008, several companies within this sector have had to issue a lot of new stock to repay TARP (Troubled Asset Relief Programme) money, stocks like AIG ($75 billion in January 2011), or to boost Tier 1 capital like JP Morgan Chase and Wells Fargo. Even troubled automaker Ford Motor has issued more than $18 billion worth of new stock since 2007, and total issuance since January 1973 has exceeded the aggregate value of all dividends paid during the same period. Consumer Goods firms feature high in the list of buyback sectors, yet Tobacco giant Altria Group has paid out more than a quarter of a trillion dollars in dividends since 1973. Up to 63% of this total or $163.5 billion was disbursed during 2008–2009 by way of two special dividends ($21.91/share in April 2007 after the divestiture of Kraft Foods and $51.06/share at the end of March 2008 when Philip Morris split domestic operations from international).

Dividends remain the core component of total return (Fama and French, 2001), however studies show that using various measures of pay-out yield other than dividends, particularly net payout yield,