Older investors a springboard for dividends, study says

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Debate has simmered for a half-century over why firms pay out cash dividends, siphoning money away from business-building investments and often creating an added tax burden for the shareholders who collect them.

New research has uncovered a surprising springboard for thousands of smaller companies and banks that share profits with investors instead of sinking everything back into the business.

A key trigger, according to findings that will appear in the Journal of Finance, is simply whether those firms are based in communities with large populations of older people, who are typically partial to the income-boosting benefits of dividends.

"Smaller firms are more reliant on local investors, so they have to be sensitive to the demands of those shareholders," said University of Illinois finance professor Scott Weisbenner, who co-wrote the study. "Microsoft will be fine even if no one in Seattle buys its stock. But if local people don't invest in smaller local companies, those firms could be in financial trouble."

The study, which analyzed Census and financial data, found that smaller companies are increasingly more likely to pay dividends as their nearby 65-and-older population rises - about 10 percentage points more likely for every 10 percent increase in the share of senior residents in the local community.

Further, firms that relocate to communities with older populations are 5 percent more likely to initiate dividends within two years - compared with staying put - and 10 percent more likely within five years, according to the study, co-written by Harvard Business School finance professor Bo Becker and Zoran Ivkovic, a finance professor at Michigan State University.

The study found that heavier concentrations of local seniors increase the likelihood of dividends for roughly the smaller half of the nation's approximately 8,500 publicly traded firms, with no impact on large corporations with global investment bases.

But smaller companies typically rely heavily on local investors, Weisbenner said, and the study shows those firms cater to seniors' preference for dividend-paying stocks when local demographics skew older.

"Older investors like dividends for a variety of reasons," he said. "Many still remember the Great Depression, so they want stocks that pay some cash. Plus, they're at an age where they like assets that return some money to live on without touching their principal."

Smaller companies also benefit from offering dividends to attract older investors, Weisbenner said. Local seniors are loyal shareholders, which reduces share turnover and thus provides stability to the stock. The study also found that local seniors value dividends highly, and are often willing to pay slightly higher prices for stock with cash returns.

"But it's not a complete win-win situation," he said. "On the down side, the money spent on dividends could be used instead for investment, research and development or other projects that would grow the company. But it's a tradeoff that many companies obviously think is worth making."

Weisbenner says the study is unique, combining two different areas of research - corporate finance and behavioral finance - to show that dividends are influenced not only by firm financial characteristics but by investor behavior as well.

"Local investment preferences are an important driver," he said. "It's not just a matter of firms setting whatever policy they want, with investors then scurrying to the one that matches their preferences."

"Indeed, the study finds that the presence of seniors in the community is more important than the firm's size, cash holdings and past stock returns in predicting which companies will decide to start paying dividends and which will not," Weisbenner said.

The study examined county-by-county senior ratios within states, rather than potentially misleading comparisons such as Florida's senior-leaning population vs. younger demographics in Alaska or Utah.

Weisbenner says the initial findings surprised even researchers, who suspected the results might have stemmed from factors other than an aging population.

A big question, he said, was whether a large older population also could mean that the community had a dying economy, dominated by old-guard firms that have limited growth potential and opt for dividends rather than investment.

But further study linked large senior populations only to dividends, not to share repurchases, net income and other common indicators of mature companies that have high cash flows but limited investment opportunities, Weisbenner said.

He says the findings could mean even more small companies will opt for dividends as the baby boomer generation reaches retirement age.

"Seniors typically like stocks that return some capital, but it remains to be seen whether the trend will continue," Weisbenner said. "Today's seniors remember the Great Depression. The seniors of 20 years from now won't have that experience and may not have the same preferences."

Provided by University of Illinois at Urbana-Champaign

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