Session 22: Post class test solutions

1. **b. Companies are reluctant to change dividends per share.** Companies try to maintain their dividends per share over time. They change dividends infrequently, and when they do, it is more likely to be an increase than a decrease.
2. **d. Companies feel much less secure or certain about future earnings.** The tax disadvantage associated with dividends has actually decreased over the last three decades and the link between transactions costs or short termism with dividend policy is not clearly established.
3. **c. Dividend increases lag earnings increases**. Companies tend to wait to make sure that earnings increases are sustainable before paying dividends.
4. **d. All of the above**. Declining firms can sell assets and use the proceeds to pay more than their earnings as dividends. Cyclical firms tend to pay dividends based on average earnings over a cycle, which implies that dividends can be higher than earnings during the down cycle. Special dividends may represent cash accumulated in prior years and thus can push the dividend payout ratio over 100%.
5. **b. $19.25**. The stock price will drop on the ex dividend day. The magnitude of the drop can be computed by taking the following ratio:
   Price drop as % = (1- tax rate on dividends)/ (1- tax rate on capital gains)
   = (1-.40) / (1-.20) = .75 or 75%
   Since the dividend is $1.00, the price drop is $0.75.
6. **False.** The comparison should not be between dividends today and capital gains in the future but capital gains today, since the stock price drops when the dividend is paid. Thus, if the company did not pay a dividend, I could sell the stock today at the higher price but if it does, I receive the dividend and a lower price today.