Session 25: Post Class tests

1. Assume that you are looking at company that operates in a market where investors pay a 40% tax rate on dividends and only 20% in capital gains. The company’s stock trades at $20/share today and has an annual dividend of $1/share. If tomorrow is the ex-dividend day, what would you expect the stock price to be at the end of the day?
   a. $19/share
   b. $19.25/share
   c. $20/share
   d. $20.75/share
   e. $21/share
   f. None of the above

2. Dividends are more certain that capital gains and are hence more valuable.
   a. True
   b. False

3. There is evidence that companies acquire a dividend clientele that reflects their dividend policy. Thus, if you pay high dividends, you accumulate investors who like high dividends and if you pay no dividends, you get investors with that preference. If you do pay high dividends, which of the following groups of investors are you more likely to see holding your stock? (You can pick more than one)
   a. Wealthy & younger individuals
   b. Older & poorer individuals
   c. Growth-oriented mutual funds
   d. Income-oriented mutual funds
   e. Pension funds

4. Assume that you are the CEO of a large power company that has historically had a monopoly position in the market giving it stable earnings, thus allowing it to pay out 80% of its earnings as dividends. The government has just announced that it will be opening the power market to competition from both domestic and foreign companies. Which of the following actions would you take on dividends, given this announcement?
   a. Nothing. I will continue to pay out 80% of earnings
   b. Freeze absolute dividends, allowing the payout ratio to decrease over time (as earnings increase)
   c. Increase the dividend payout ratio, to signal confidence in your capacity to beat the competition.
   d. Eliminate dividends entirely
   e. Reduce your payout ratio to 60%
   f. Something else

5. Dividend changes can operate as signals to the market. Is an increase in dividends always a positive signal?
   a. Yes
   b. No
6. Assume that you are a firm that is considering suspending dividends, to redirect cash to much needed investment projects that potentially could generate significant profits for the company in future years. Which of the following market reactions would you most expect to see to your announcement of a dividend suspension (accompanied by an explanation of the investments that you plan to take with the cash)?
   a. Positive in both the short and the long term.
   b. No effect in the short term, positive in the long term
   c. Positive in the short term, Negative in the long term.
   d. Negative in the short term and long term
   e. Negative in the short term, Positive in the long term
   f. No effect in either the short or long term

7. Assume that you are a bondholder in a company that has just announced a large stock buyback. The stock price has jumped up sharply in response. What would you expect the bond price to do?
   a. Increase. If it is good news for stockholders, it has to be good news for bondholders.
   b. No change. Bondholders are unaffected by a special dividend,
   c. Decrease.
   Explain.
**Session 25: Post class test solutions**

1. **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:

   \[
   \text{Price drop as } \% = \frac{1-\text{tax rate on dividends}}{1-\text{tax rate on capital gains}} = \frac{1-.40}{1-.20} = .75 \text{ or } 75\%
   \]

   Since the dividend is $1.00, the price drop is $0.75.

2. **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.

3. **b, d & e. Older, poorer individual, income-oriented mutual funds, pension funds.** The first two groups value immediate cash flow more and care less about taxes. Pension funds don’t pay taxes and often need the cash flows to meet current claims.

4. **b. Freeze dividends and allow the payout ratio to decrease over time.**

   Though this may be cowardly, I would start by freezing the dollar dividends and watching how the competition affects my profits. If it looks like the competition is hurting my bottom line and making it more volatile, I would reduce dividends over time.

5. **c. No.** If you are a high-growth company, where investors thought you had great investment opportunities lined up, the payment of a dividend may send the signal that these investment opportunities are not as good or plentiful as assumed.

6. **e. Negative in the short term, Positive in the long term.** It is tough to predict how markets will behave, but I would not be surprised to see stock prices drop on the announcement (partly because investors might not believe me and partly because my clientele may not like a cut in dividends). Eventually, I would expect the stock price to reflect the positive effects of taking good investments but that may be a long time coming.

7. **c. Decrease.** The stock buyback takes cash out of the firm. Since that cash balance made the firm more credit-worthy, paying it out will make it less so and my bond prices will drop to reflect that.