Funding the Future

New research shows that FTSE companies are over paying ...

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The report that I have worked on for some time with colleagues Prof Adam Leaver of Sheffield University and Prof Colin Hassan and Dr Nick Tsitsianis from Queen Mary, University of London, has now been published. Our academic blog on the report is here, and the report here. The purpose of this blog is to offer my interpretation of that work.

The object of this work was to find out whether the phenomenon we had already identified in the USA of companies paying out more to their members by way of dividend or share buybacks over extended periods of time was also to be found in the UK. We then sought to determine whether this had any apparent consequences in underlying corporate performance, such as real growth, productivity and investment rates.

The findings of the work are quite shocking, in my opinion. Within the limitations of the databases that research of this sort necessarily relies on (because we tested a large number of variables in 182 companies for a decade), we found that maybe 20% of the FTSE 350 companies that were persistently listed on that exchange from 2009 to 2019 paid out well over 100% of their earnings due to their members to those shareholders by way of dividend or share buyback. They over distributed profit in other words A further 20% paid out an average of 88% of their earnings.

By market value these two groups represented 60% of the companies surveyed although they were only 40% of the sample by number. In other words, it was very likely that this heavy distribution policy was having a significant impact on their share price, and so market value. There was a bias towards the biggest companies partaking in this activity.

What we found was that this policy was very directly associated with the increase in the level of borrowing in these companies. Those companies that paid out the most in dividends increased their borrowings the most. And since increased borrowing is associated with risk, high dividend distribution came at the price of risk. That’s unsurprising. Many of these companies would appear to be borrowing in order to pay dividends.

But, that was not where the story stopped. As our research showed, the companies that paid out the most in dividends behaved markedly differently to the rest of the sample of companies. Their growth rates were worse than companies that paid out less. They did not add significant value over the period. Their investment in new capital equipment was weak. And when they did invest they bought risky assets, such as goodwill. As we found, many were extremely vulnerable to any reappraisal of the value of the goodwill that they hold on their balance sheets. And, because in many cases the value of groups as a whole were much lower than the value of parent company balance sheets that reflect that goodwill, there was often good reason for wondering whether that reappraisal of goodwill valuation was required.

What the research showed, by corollary, was that the companies with the second-lowest distribution policies (i.e., those paying relatively modest dividends or doing few share buy backs) performed very well when it came to underlying economic performance, whether that be measured by real growth, increase in value-added per employee, investment per employee or other criteria that suggest investment in the real business activity that a company supposedly exists to promote. They may not be well-rewarded for this diligence on their part, but this is where real value is to be found. The smallest companies were not too far behind this group in many cases.

What does this mean? I think a number of obvious conclusions can be drawn.

The first is that financialisation is far advanced in many stock exchange companies. The data suggests that in many there is now an apparent disconnect between the underlying economic performance of the group of companies that they supposedly manage and the manufacture of dividend payments by way of financial engineering that may well be primarily motivated by the desire to deliver rising share prices. This engineering is little understood, yet not that hard to deliver. It will be the subject of another blog. The important point is that the idea that many of these entities exist to really pursue a trade is open to doubt. The possibility exists that the trades that they undertake are mere mechanisms for translating largely borrowed funds into dividend payments to shareholders almost irrespective of profits earned.

Second, worryingly, stock markets now reward this financial engineering much more than they do the effective management of trade undertaken in pursuit of profit. That is very clear from the data, as noted above. In other words, stock markets are actively encouraging companies to ignore real economic performance in the activities they supposedly exist to manage by more greatly rewarding those who undertake financial engineering instead.

Third, the possibility very obviously exists that current accounting disclosure does not encourage or even readily permit these two very different approaches to corporate management to be readily identified. That is worrying, because the risk profile of the over-distributing firms is very different to that of the more normal forms distributing dividends that are well within their capacity to pay. Whether accounting is fit for purpose has to be questioned in that case.

Fourth, this has major social implications, most especially in a society that seeks to base its pension provision policy largely upon saving in the shares issued by stock exchange quoted companies. The pressure on fund managers to match the FTSE indices is high. That means they will weight their portfolios to the best-rewarded companies, and in that case they will be both exposing those they present to the highest possible risk and the lowest possible underlying potential for improved performance. You literally could not make such a severe consequence up. This behaviour is seriously distorting capital allocation in the UK away from those who might use it best, towards those who use it for financial engineering.

Last, this has underlying implications. Quite simply the message is sent out that trying to actually make a profit is a waste of time: engineering results is where the money is to be made. No wonder we have such poor underlying economic p0erfirmance in the UK. Now we have the evidence to prove that.

The findings are stark, but are for the index as a whole. We have begun to develop thinking on how to apply this to individual companies, but at present suggest that may be pushing the boundaries of the research a little far. We hope to do more to make that possible. We think that important: people's futures are at risk as a result of current stock market and investment behaviour. And that matters.