Argumentative essay on afin53: dividend discount model

Business, Company

Indeed, according to the previously celebrated bird in hand theory, firms were considered to suffice for purposes of paying dividends. The bird in hand theory advances the concept that shareholders would prefer payment of dividends rather than reinvestment of profits to be paid later. In that respect, the higher the dividends a firm paid, the better its standing in the market. It is on that premise that the dividend discount model operates. Accordingly, the value of the firm is equal to the present value of the expected dividend payment. The position now is way different especially with the Modigliani and Miller's seminal paper on dividend irrelevancy theory. According to the two, the value of the firm is independent of the dividend policy. The firm's stock prices and the cost of capital are not affected by the dividend policy. In that context, ultimately, the value of the shareholders' wealth is left unaltered despite the dividend payment models. It is these developments that have occasioned situations where firms remain progressive and profitable without necessarily paying dividends. This paper advances the position that firms that do not pay dividends are not necessarily worthless.

Foremost, the bird in hand theory needs to be appreciated for its short sightedness. It seeks to satisfy the shareholders' immediate interest. In addition, it merely places decision making on one factor, that is, the dividend payment. The dividend discount model essentially expands the bird in hand theory. In the dividend discount model, the basis is placed upon the net present value of all the expected dividend payments. This is minus other external and internal factors. In that vein, the dividend discount model needs to be appreciated for its limited consideration. It assumes that shareholders' interests are invested in the amount of dividends paid only. Nothing could be

further from the truth.

The position now has shifted fundamentally. In typical firms, the shareholders and the management are motivated by different and diverse factors. This has effectively reduced the dividend discount model to mere theory from practical application. Indeed, the industry is replete with numerous examples of firms which are worth billions yet have hardly patted with a coin in dividends. Exactly what drives such firms is the subject of the ensuing discourse.

The modern firm together with its shareholders is influenced by two essential determinants. This is the cost of capital and the firm’s stock prices at the stock market. This two are essential for their economic consequences on the wealth of the shareholders. In brief, the cost of capital refers to the interest paid in employing the use of various sources of capital. Ideally, the firm would rather employ the use of cheap and risk free capital which will in turn commute to lower capital costs in terms of interest payable and lower risks of illiquidity due to the risk free capital sources. In that strain, it is in the interest of the firm and indeed the shareholders that the cost of capital is balanced and weighted in a manner that minimizes the costs. This is a typical function that management, in their stewardship role, play in the firm. Additionally, the financial statements and reports have been radically tailored and standardized with the view of reflecting the general trajectory in the firm in terms of cost of capital and the attendant interests and illiquidity consequences. These details inform the decision of the shareholder to invest in the firm or offload his shares in the firm.

On the other hand, the stock prices of the firm determine the actual value of

the shareholder’s shares at any given time. For this reason, investors are often keen to invest only in firms whose shares trade highly or have the potential of trading at high amounts. The stock prices of the firm’s shares are often dynamic and no one factor can be pointed out as the cause and or the only determinant. However, stocks respond to demand and supply in a way that the higher the demand, the higher the price and the converse holds for lower demand. It is this that actually influences the overall value of the firm. In financial statements and reports the trends in the behavior in stock prices over different periods are often shown. It is upon these statistics and information that the decisions of shareholders to invest in a particular firm or not are based.

In the same strain, the clientele theory advances for dividend irrelevancy. It is based on the premise that some investors are well endowed financially and therefore prefer capital gains rather than earn dividends from their investments. This approach contrasts sharply with the dividend discount theory. Firms that use these approaches would remain worthy despite not paying any dividends.

In conclusion, it is imperative to appreciate the role dividends play in the short term. By paying dividends, firms satisfy the immediate demands of the shareholders hence the bird in hand theory. However, most modern shareholders have sufficient short term sources of finances in turn reducing their appetites for short term funding. They, therefore, often opt for long term investments. In that strain, the shareholders would be attracted to options that can grow their overall shareholder wealth in the firm. Such an approach is insensitive and inconsistent to the dividend discount model.

Instead, these approaches find consistency and concurrence with the Modigliani and Miller school of thought which seeks to maximize the shareholder’s wealth by operating with the cheapest capital in terms of costs and risks of illiquidity.

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