

# [Bird in hand](https://assignbuster.com/bird-in-hand/)

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The essence of the bird-in-the-hand theory of dividend policy (advanced by John Litner in 1962 and Myron Gordon in 1963) is that shareholders are risk-averse and prefer to receive dividend payments rather than future capital gains. Shareholders consider dividend payments to be more certain that future capital gains – thus a “ bird in the hand is worth more than two in the bush”. Gorden contended that the payment of current dividends “ resolves investor uncertainty”. Investors have a preference for a certain level of income now rather that the prospect of a higher, but less certain, income at some time in the future. The key implication, as argued by Litner and Gordon, is that because of the less risky nature dividends, shareholders and investors will discount the firm’s dividend stream at a lower rate of return, “ r”, thus increasing the value of the firm’s shares. According to the constant growth dividend valuation (or Gordon’s growth) model, the value of an ordinary share, SV0 is given by: SV0 = D1/(r-g) Where the constant dividend growth rate is denoted by g, r is the investor’s required rate of return, and D1, represents the next dividend payments.

Thus the lower r is in relation to the value of the dividend payment D1, the greater the share’s value. In the investor’s view, according to Linter and Gordon, r, the return from the dividend, is less risky than the future growth rate g. M&M argued against this and referred to it as the bird-in-the-hand fallacy. In their irrelevancy model, M&M assume that the required rate of return or cost or capital, r, is independent of dividend policy. They maintain that a firm’s risk (which influences the investor’s required rate of return, r) is a function of its investment and financing decisions, not its dividend policy. M&M contend that investors are indifferent between dividends and capital gains – that is, they are indifferent between r and g is the dividend valuation model. The reason for this indifference, according to M&M, is that shareholders simply reinvest their dividends in share of the same or similar risk companies.

Dividend Signaling Theory In practice, change in a firm’s dividend policy can be observed to have an effect on its share price – an increase in dividend producing an increasing in share price and a reduction in dividends producing a decrease in share price. This pattern led many observers to conclude, contrary to M&M’s model, that shareholders do indeed prefer dividends to future capital gains. Needless to say M&M disagreed. The change in dividend payment is to be interpreted as a signal to shareholders and investors about the future earnings prospects of the firm. Generally a rise in dividend payment is viewed as a positive signal, conveying positive information about a firm’s future earning prospects resulting in an increase in share price. Conversely a reduction in dividend payment is viewed as negative signal about future earnings prospects, resulting in a decrease in share price. DIVIDEND AS A RESIDUAL There is school of thought which regards dividends as a residual payment.

They believe that the dividend pay-out is a function of its financing decision. The investment opportunities should be financed by retained earnings. Thus internal accrual forms the first line of financing growth and investment. If any surplus balance is left after meeting the financing needs, such amount may be distributed to the shareholders in the form of dividends. Thus, dividend policy is in the nature of passive residual. In case the firm has no investment opportunities during a particular time period, the dividend pay-out should be 100%. A firm may smooth out the fluctuations in the payment of dividends over a period of time.

The firm can establish dividend payments at a level at which the cumulative distribution over a period of time corresponds to cumulative residual funds over the same period. This policy smoothens out the fluctuations of dividend pay-out due to fluctuations in investment opportunities.