Discussion of “Monetary Policy and Reaching for Income”

Paper by
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Discussion by
David Solomon (Boston College)

Rodney White Conference
March 22nd, 2019
How an Investor SHOULD Think About Dividends

• Dividends are irrelevant without frictions (M&M)

• Adding costs can break the indifference:
  • Taxes on dividends or capital gains, transaction costs

• But investors still indifferent after taxes and costs
  – Don’t intrinsically care about dividends, just minimizing costs

• Positive versus normative
  – Is this how people actually think about dividends?
Curious things from consumer markets

**pay dividends** - definition and synonyms

to bring you a lot of benefit

*Thorough lesson planning always pays dividends.*

Synonyms and related words
Curious things from consumer markets

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Synonyms and related words
Curious things from consumer markets

Irrelevant Miles? Tax-Disadvantaged Miles? Signaling Miles?
Curious things from consumer markets

Extra perks for being Preferred

Special Dividends are extra benefits — above and beyond those you enjoy as a Preferred member. Earn Special Dividends when you fly with US or our partners. Now, benefits include coupons to save up to $300 on US Airways Vacations packages to destinations like Hawaii, Las Vegas and the Caribbean.*

All you have to do is log in to your account and claim your Special Dividends.
People LOVE dividends

- People talk as if they really like dividends. But why?

- Evidence of demand in financial markets as well
  - Companies increase dividends in response to proxies for dividend demand (Catering, Baker & Wurgler (2004))
  - Elderly investors more likely to purchase dividend-paying assets (Clienteles, Graham & Kumar (2006))
  - Price pressure around dividend-payment (Hartzmark & Solomon (2013))
Interim Returns for Dividend Payers

Hartzmark and Solomon (2013)
Interim Returns for Dividend Payers

Hartzmark and Solomon (2013)

Trading Days From Ex-Date

Significant

Not Significant
Interim Returns for Dividend Payers

Abnormal Return Occurring
After dividend announcement
• No uncertainty, risk, information...

Before ex-day
• No tax consequences

-> Price pressure from dividend-seeking investors
Theories of Dividend Demand


- **Free Dividends Fallacy**: Investors think dividends are free money
  - Hartzmark & Solomon (2017)

- **Commitment Against Overconsumption**
  - Shefrin & Statman (1984), this paper

- **Hedonic Editing**: Increased prospect theory value by sometimes combining Div + CapGain, sometimes separating them
  - Shefrin & Statman (1984)

- **Resolve uncertainty in how much to consume**
  - View dividends as an annuity
Findings

• Demand for dividend-paying assets is higher when interest rates are low
  – Buy more high-dividend stocks when fed funds rate is low
  – Buy more when local deposit rate is low
  – Buy more income mutual funds when fed funds rate is low
  – High returns on dividend-paying stocks when fed funds rate is low

• Demand is higher among retirees with greater needs for income

• These actions may be driven by investors following a rule of “live off your income”, including for reasons micro-founded by commitment against overconsumption
  – Consume dividends more when retired
Findings

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• These actions may be driven by investors following a rule of “live off your income”, including for reasons micro-founded by commitment against overconsumption
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Demand for Dividends & Interest Rates

• Are investors buying and holding dividend-paying assets? Or buying the dividends directly?

• Big predictable time-series effect in returns of dividend-paying stocks
  – High returns *only* in the month the dividend is paid
Demand for Dividends & Interest Rates

Hartzmark & Solomon (2013) Abnormal Returns & Months Since Dividend Payment

Quarterly–Significant
Not Quarterly–Significant
Quarterly–Not Significant
Not Quarterly–Not Significant

Quarterly means the month lag is a multiple of 3.
## Table V - Daily Abnormal Returns, Economic Uncertainty and Dividend Yield

<table>
<thead>
<tr>
<th></th>
<th>Recessions</th>
<th></th>
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<tbody>
<tr>
<td></td>
<td>Declaration Day</td>
<td>Interim Period</td>
<td>Ex-Day</td>
<td>Declaration to Ex-Day</td>
<td>40 Days After Ex-Day</td>
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<tr>
<td>Constant</td>
<td>0.118 ***</td>
<td>0.150 ***</td>
<td>0.249 ***</td>
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<td>-0.673 ***</td>
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<td></td>
<td>(21.75)</td>
<td>(8.87)</td>
<td>(37.82)</td>
<td>(27.09)</td>
<td>(-21.07)</td>
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<tr>
<td>Recessions</td>
<td>-0.013</td>
<td>0.096 **</td>
<td>0.081 ***</td>
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<td></td>
<td>(-0.80)</td>
<td>(2.08)</td>
<td>(5.51)</td>
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<tr>
<td>R²</td>
<td>0.000</td>
<td>0.000</td>
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<tr>
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<td>-0.372 ***</td>
<td>0.146 ***</td>
<td>-0.153 *</td>
<td>0.000</td>
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<tr>
<td></td>
<td>(2.65)</td>
<td>(-4.72)</td>
<td>(5.26)</td>
<td>(-1.79)</td>
<td>(-0.39)</td>
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<tr>
<td>VIX(/10)</td>
<td>0.012</td>
<td>0.228 ***</td>
<td>0.044 ***</td>
<td>0.274 ***</td>
<td>-0.004 ***</td>
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<tr>
<td></td>
<td>(0.93)</td>
<td>(5.60)</td>
<td>(3.11)</td>
<td>(6.27)</td>
<td>(-5.84)</td>
</tr>
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<td>N</td>
<td>136,045</td>
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<td>136,647</td>
<td>136,647</td>
<td>136,632</td>
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Demand for Dividends & Interest Rates

- Are investors buying and holding dividend-paying assets? Or buying the dividends directly?

- Big predictable time-series effect in returns of dividend-paying stocks
  - High returns only in the month the dividend is paid

- $64,000 Question: Do you define dividend yields as being positive in all months of the year, or only the months with a dividend ex-day?
  - Consumption theory predicts general demand in all months
  - Thinking that dividends are free predicts demand only for the dividend month itself
  - If purchases in all months, shouldn’t expected returns at some point be low?

- Would love to know what long horizon returns are for a constant portfolio of dividend-paying stocks
When are dividends perceived as more valuable?

But bond yields today are unusually low...

Another strategy would be to substitute a portfolio of blue-chip stocks with generous dividends for an equivalent high-quality U.S. bond portfolio.

Many excellent U.S. common stocks have dividend yields that compare very favorably with the bonds issued by the same companies.

*at&t* Dividend Yield: 6%
Bond Yield: <3%

Burton Malkiel

THE WALL STREET JOURNAL
COMMENTSARY
The Bond Buyer’s Dilemma
“The humble dividend is reclaiming its rightful place as the arbiter of stock-market value... To investors desperate for income, the argument for buying equities is, well, duh. Who wouldn't want a higher income? Shares might swing around, but corporate managers go out of their way to preserve the dividend.”
“The humble dividend is reclaiming its rightful place as the arbiter of stock-market value... To investors desperate for income, the argument for buying equities is, well, duh. Who wouldn't want a higher income? Shares might swing around, but corporate managers go out of their way to preserve the dividend.”
Does any of this even make sense???

- Comparison between dividends and bond interest isn’t comparing the same quantities!
  - High interest rates at the bank pay you from someone else’s pocket
  - High dividend yields pay you from your own pocket

- If investors want to commit to just consume a certain amount, why not just buy an annuity?
  - They don’t! There’s a whole puzzle about this

- If they’re just planning consumption, why buy mutual funds who artificially juice their dividend yield by trading in and out of dividend-paying stocks?
  - 28% of dividend-paying funds are doing this!
    (Harris, Hartzmark & Solomon (2015))
Even more curious things from financial markets
Even more curious things from financial markets

First Trust Dividend and Income Fund (FAV)

Investment Objective/Strategy - The First Trust Dividend and Income Fund is a diversified, closed-end management investment company. The Fund's primary investment objective is to seek a high level of current income. Its secondary objective is capital appreciation. The Fund will seek to achieve its investment objectives by investing at least 80% of its managed assets in a diversified portfolio of dividend-paying multi-cap equity securities, debt securities and senior secured floating rate loans that offer the potential for attractive income and/or capital appreciation.

There can be no assurance that the Fund's investment objectives will be achieved.

Current Fund Data (as of 9/8/2014)

<table>
<thead>
<tr>
<th>Metric</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Closing NAV¹</td>
<td>$10.35</td>
</tr>
<tr>
<td>Closing Share Price²</td>
<td>$9.30</td>
</tr>
<tr>
<td>Discount to NAV</td>
<td>10.14%</td>
</tr>
<tr>
<td>Total Managed Assets</td>
<td>$109,498,265</td>
</tr>
<tr>
<td>Common Shares Outstanding</td>
<td>8,259,517</td>
</tr>
<tr>
<td>Dividend Frequency</td>
<td>Quarterly</td>
</tr>
<tr>
<td>Dividend Per Share Amt³</td>
<td>$0.1700</td>
</tr>
<tr>
<td>Distribution Rate⁴</td>
<td>7.31%</td>
</tr>
<tr>
<td>Daily Volume</td>
<td>44,882</td>
</tr>
<tr>
<td>Average 30-Day Daily Volume</td>
<td>37,489</td>
</tr>
<tr>
<td>Closing Share Price 52-Week High/Low</td>
<td>$9.57 / $8.16</td>
</tr>
<tr>
<td>Closing NAV 52-Week High/Low</td>
<td>$10.56 / $9.25</td>
</tr>
</tbody>
</table>

Share Price and NAV History (Since Inception)

Past performance is not indicative of future results.
First Trust Active Dividend Income Fund
Financial Highlights
For a Common Share outstanding throughout each period

<table>
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<tr>
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<tr>
<td>Net assets, end of period (in 000's) ..................</td>
<td>76,196</td>
<td>76,456</td>
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<td>2,030%</td>
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http://www.sec.gov/Archives/edgar/data/1403275/000144554609000266/0001445546-09-000266.txt
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![First Trust Dividend and Income Fund (FAV)](http://www.sec.gov/Archives/edgar/data/1403275/000144554609000266/0001445546-09-000266.txt)

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Descends down the rabbit hole

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- How do you get a dividend yield of 19.31%?!?!
Huntington Dividend Capture Fund

PORTFOLIO PROFILE
As of 8/31/2014

Inception: 03/01/2001
Ticker: HDCAX
CUSIP: 446327660
Net Assets (millions): $67.39

Fund Goal And Strategy

To seek total return on investment, with dividend income as an important component of that return. The Fund is appropriate for investors seeking capital appreciation with the potential for higher current income than the average stock fund.
Huntington Dividend Capture Fund

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Strategic Timing of Purchases and Sells to Capture Dividends.
Because stocks generally pay dividends on a regular quarterly schedule, the Fund's management seeks to buy stocks prior to their dividend payments and sell stocks after their dividend payments. This strategy may increase portfolio turnover, but provides the opportunity to increase income for shareholders.
**Huntington Dividend Capture Fund**

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“May increase portfolio turnover”
• Surely nobody is actually buying this fund, right?
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- Surely nobody is actually buying this fund, right?

Did you muppets not learn anything?

All this rolling in my grave is making me nauseous
Conclusion

• Interesting evidence that demand for dividends is higher in low interest rate environments

• Consistent with financing consumption streams, but also consistent with other mistakes too

• Best evidence: Retirees demanding high dividend stocks, Retirees consuming dividends

• Probably both explanations. Hard to tell apart, and other papers don’t do a much better job