Assumptions of M&M dividend irrelevancy theory

M&M made a number of simplifying assumptions:

(a) **No taxes exist** (corporate or personal).

(b) **Capital markets are perfectly efficient**: for example, funds will always be made available to finance attractive (i.e. + net present value) investments.

(c) There are **no transactions costs**: for example, in issuing new shares, or taking out a bank loan, or selling shares.

(d) All **information is fully and freely available** to shareholders.

Criticism of M&M dividend irrelevancy theory

There are strong arguments **against** M&M's view that dividend policy is irrelevant as a means of affecting shareholders' wealth. These reflect the unrealistic nature of the assumptions in M&M dividend irrelevancy theory.

(a) **Impact of taxation**

Differing rates of **taxation** on **dividends** and **capital gains** can create a **preference** for either a **high dividend** or **high earnings retention**. This is one of the key reasons why different clientele are attracted by different dividend policies.

(b) **Capital markets are not perfectly efficient**

Companies may find that funds are **not** always available to finance attractive investments. Where capital rationing is an issue, **dividend retention** may be **preferred** by companies.

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(c) Impact of **transaction costs**

Because of **transaction costs** on the sale of shares, investors who want some cash from their investments will prefer to receive dividends rather than to sell some of their shares to get the cash they want.

(d) **Imperfect information**

Shareholders are often not fully aware of the **future investment plans** and **expected profits** of their company. Even if management were to provide them with profit forecasts, these forecasts would not necessarily be accurate or believable unless backed up with a signal of confidence in the form of a rising dividend. So, shareholders may **prefer a current dividend** to future capital gains (or deferred dividends) because the future is more uncertain. This is known as the **bird-in-the-hand** theory.

Young companies
Young companies (or any companies with volatile cash flows) often follow a residual policy.
- Zero/low dividend
- Investment offer high returns
- Often prefer to avoid debt finance

Mature companies
Mature companies often follow a stabe growth or constant payout policy.
- High, stable dividend
- Investments offer lower returns
- More likely to use debt finance