Briefly Noted

Take RMDs Early or Late in the Year?

The Internal Revenue Service mandates distributions be taken from tax-deferred accounts, such as traditional individual retirement accounts (IRAs), by December 31 of each calendar year for those subject to the required minimum distribution (RMD) rules. The IRS does not, however, state at what point during the calendar year those distributions must be taken. (A special one-time April 1 deadline exists for those who turn age 70½ during the previous calendar year and have yet to begin taking their RMDs.)

This raises the question: When is the best time to take the RMDs? Christine Benz of Morningstar categorized the options as being at year-end, at the beginning of the year and at regular intervals throughout the year. Each option has advantages and disadvantages.

Postponing until near the end of the year allows investments to maximize returns and income. Any capital gains and income payments are tax free. Combined, delaying can increase the portfolio's compounded returns by allowing a greater sum of money to work for a longer period of time. Waiting until December does incur the risk of negative returns, but—as Benz points out—stocks and bonds tend to have positive returns on an annual basis far more often than negative returns. Delaying too long can put a retiree dangerously close to the December 31 deadline, potentially leaving not enough time to complete a Roth IRA conversion, if desired. (Benz suggests early December for this reason.) Delaying too late in year also leads to the possibility of dying before the current year's RMD is taken.

Taking the distribution early in the year ensures the deadline is met. It also alleviates the potential of dying before the year's RMD is taken (which could cause problems for heirs) and leaves ample time to conduct a Roth IRA conversion. Potential positive returns for the current calendar year are forfeited, but potential losses are also avoided.

Spacing withdrawals throughout the year eliminates the timing decision of when to take withdrawals. It also provides a stream of regular cash flows. Benz notes that many financial providers can calculate and disburse withdrawals on a monthly, quarterly or semiannual basis. These automated payments eliminate the chance of accidently missing a planned withdrawal.

Source: "When's the Right Time to Take RMDs?," Christine Benz, Morningstar.com, August 10, 2017.

Equity Allocations in 401(k) Plans Exceed Pre-Financial Crisis Levels

Exposure to stocks among 401(k) participants exceeded pre-financial crisis levels at the end of 2015 (the most recent year data is available for). Ninety-one percent of workers had exposure to equities, compared to 87% in 2007. Furthermore, equities accounted for more than 80% of portfolio allocations for 48% of plan participants. In comparison, 44% of plan participants had equity allocations in excess of 80% at year-end 2007.

Stock funds comprised 43% of account balances in 2015. The allocation to equity funds was highest among workers in their 40s (48.1%) and 50s (43.9%).

Participants in their 20s were more likely to use target date funds (46.6%) and other balanced funds (7.5%). Overall, target date funds are included in 65% of 401(k) plans. They are commonly the default option in plans with an auto-allocation feature. As such, it is not surprising to see that 67% of workers who were offered target date funds allocate to them. Workers in their 60s had the largest allocations to bond funds (10.1%), money funds (5.7%) and guaranteed investment contracts/stable value funds (9.8%). These allocations are to be expected, given the participants' proximity to retirement.

Participants' account balances averaged $73,357 in 2015, slightly down from 2014. The median balance was $16,732, the lowest since at least 2012. The decline in the average balance is attributed to workers and plans entering and leaving an Employee Benefit Research Institute (EBRI)/Investment Company Institute (ICI) database. The average account balance among workers who were in the database during both 2014 and 2015 rose 3.1% to $85,729.

Behind the numbers is a wide variance in account balances. At the lower end, 41.3% of plan participants had account balances of less than $10,000. At the higher end, 19.3% of workers had balances in excess of $100,000. Age, tenure and salary all have a significant influence on the size of an individual's account.

The database used for this analysis is a collaboration between the EBRI and the ICI. The database covers nearly half of all 401(k) plan participants and 43% of 401(k) plan assets.

Source: "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2015," Jack VanDerhei, Sarah Holden, Luis Alonso and Steven Bass, EBRI Issue Brief, August 3, 2017.

The Factors Driving Dividend Policy

An analysis of global dividend policies attributed the rationale for companies to pay and raise their dividends to many factors, including communicating information, so-called "agency costs," tax policy and a company's maturation.

Companies can use dividends to convey, or "signal," information about their financial strength and prospects. For instance, a common perception is to view dividend-paying companies as having more financial stability or otherwise being less risky.

Reaction to changes in the dividend is long-standing evidence of signaling. Stocks of companies that raise or initiate dividends outperform over time, in aggregate. Conversely, stocks of companies that cut or suspend their dividends underperform. Such actions are viewed by investors as conveying strength (weakness) and optimism (pessimism).

In common law countries, such as the United States, shareholders have no legal right to dividend payments. Rather, dividends are paid solely at the discretion of the board of directors. This structure creates an "arms-length" separation between shareholders and corporate executives. It also creates what is known as an agency cost, by forcing a company to choose between holding onto its free cash and distributing it out to investors as an incentive to invest in the company. From the standpoint of shareholders, dividends reduce the agency cost by making the executives think more carefully about how they utilize free cash flow. Executives who know they have to make regular dividend payments should be more careful with their spending decisions.

The taxation of dividends should be unimportant to a company's payout policy. Tax policies do matter to investors, however, and this in turn has an influence on a company's dividend policy. Following the 2003 tax cut in the U.S., which lowered the dividend tax rate to a then top rate of 15% (the top tax rate is now 20% plus a 3.8% surtax), a large number of companies either initiated dividends or increased their dividends.

Finally, dividend policy is dependent on where a company is in terms of its "life cycle." Established firms with greater retained earnings are more likely to pay dividends, in part because of demand by investors for more cash to be returned to them as retained earnings grow in size.

Source: "Dividend Policy: A Selective Review of Results From Around the World," Laurence Booth and Jun Zhou, Global Finance Journal accepted manuscript.

Economic and Market Conditions Influence Stock Splits

Though stock splits should have no impact on a company's value, they often have had a positive immediate impact on the price of the underlying stock. Shares of companies splitting their stock experience short-term excess returns of 3% over a two-day period surrounding the announcement during bull markets. The excess return is even higher for the smallest 20% of stock-splitting firms: 5% during the two-day window in bull markets. During bear markets, the immediate excess returns are smaller: 2% and 3%, respectively.

The association between stock split announcements and higher short-term returns has been previously documented. The common explanation for the pattern is signaling: Corporations use stock splits to signal positive prospects for future earnings. This theory would explain why investors react favorably to split announcements even though a stock split does not change each shareholder's ownership interest nor does it alter the financial or economic outlook for the company.

What has not been previously studied are the roles that market and economic conditions play in the decision by companies to announce a stock split. Researchers at universities in Australia and New Zealand analyzed more than 17,000 stocks splits announced by U.S. companies between 1926 and 2012. Stock splits became popular after the 1960s when the higher returns associated with splits was noticed more.

On average, stock splits are more likely to be announced during bull markets (an average of 20 per month) than in bear markets (13 per month). During the 20-year period of 1980–2000, there were nearly double the number of splits when the stock market was rising than when it was falling.

An even more stark difference exists during different economic conditions. Expansionary periods saw 16,105 split announcements, while only 1,450 splits were announced during recessionary periods. Almost 9,000 splits were announced during the 1982–1990 and 1991–2001 economic expansions.

The study's authors say companies split shares following good earnings performance and then consider taking advantage of increasing investor sentiment in positive market conditions. Though the immediate returns are higher in expansions than in recessions, the two-week, post-announcement excess return is 0.5% higher during recessions. This is because the signaling effect of stock splits is stronger during contracting economic periods.

Source: "Real Determinants of Stock Split Announcements," May Hu, Chi-Chur Chao, Chris Malone and Martin Young, International Review of Economics and Finance accepted manuscript.