1   **Q.**   **Reference: Dr. Booth Evidence, Appendix D, Page 17, Lines 23-25: Please**

2   **explain how smoothing of dividend payments necessarily leads to a higher long-term**

3   **growth rate for earnings. Could the earnings growth rate also be lower?**

4

5   A.   It is the same principle as geometric (compound) growth versus arithmetic

6   growth. The more intermediate uncertainty, the greater the difference between AM and

7   GM growth. For example, suppose earnings (EPS) go from \$1 to \$2 to \$1 whereas

8   dividends (DPS) are smoothed and grow from \$0.50 to 0.60 to \$0.50 then the AM and

9   GM growth rates for EPS are 25% and 0% and DPS 1.7% and 0%. With a constant long

10   run payout we can expect both DPS and EPS to grow at the same long run growth rate,

11   but when analysts forecast short run EPS growth this over estimates the DPS growth,

12   since firms do not follow a constant payout policy in the short run, but instead smooth

13   their dividends.