Dividend Strategy

Dividend Reinvestment Plans: A Guide To DRIPs

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Dividend reinvestment plans, or DRIPs, are one of the most effective tools for income investors to build wealth.

History has shown that a long-term, buy-and-hold approach to stocks is hands down the best way for regular people to grow their investment accounts and achieve financial independence.

But what many people don't realize is the importance of dividends to achieving these impressive results.

As you can see, since 1871 over half of the stock market's returns have come from dividends. However, dividend reinvestment is the real fuel to the market's long-term compounding.

To that end, dividend reinvestment plans are a great way to ensure that your money is working as hard as possible for you.

Strategy	S&P 500 Increase Since 1871	S&P Increase Adjusted For Inflation	S&P CAGR Since 1871	S&P CAGR Since 1871 Adjusted For Inflation
No Dividend Reinvestment	460 Fold	23.32 Fold	4.32%	2.23%
Dividend Reinvestment	285,436 Fold	15,087 Fold	9.05%	6.86%

Source: Moneychimp.com

Let's take a look at this valuable dividend investment method to see why DRIPs might be just the thing to help boost your long-term returns and help you meet your financial goals.

Dividend Reinvestment Plan (NYSEARCA:DRIP) Definition

DRIPs are merely an automated strategy in which a company's dividends are reinvested into additional shares of that company. Instead of being paid dividends in cash, you get additional shares of ownership in the company.

There are three ways to get involved in DRIPs: directly through the company, through your broker, or through a transfer agent.

Company-run DRIPs are generally only available through large, blue chip dividend businesses.

That's because smaller companies don't want to take on the overhead costs of tracking all their shareholders and going through the paperwork headache of calculating how much each one gets in dividends and additional fractional shares.

The company benefits from gaining an additional source of capital, but most of all in creating a more stable base of shareholders, ones who are less likely to panic and sell during a market decline. This can help decrease the volatility of a company's shares.

This is why more and more companies are deciding to use transfer agents, which are third-party DRIP administrators such as American Stock Transfer and Trust or Computershare.

Finally, most large discount brokers, such as Scottrade, TD Ameritrade (NASDAQ:AMTD), and E*Trade (NASDAQ:ETFC), also offer DRIPs, though with different requirements and limitations (which we'll get to shortly).

Benefits of DRIP Investing

There are three primary benefits of participating in DRIP plans.

First, it can often be the most cost effective and efficient means of compounding your wealth. For example, many DRIP plans are commission free and most even allow for fractional shares.

This means that all of your money is constantly working for you and growing exponentially over time instead of sitting idly in cash.

The second major benefit is that some companies offer discounted shares (typically 1% to 10%) if you sign up for their DRIP.

This can be a powerful means of generating much stronger returns over time, but without any of the risks that come with traditional means of boosting returns, such as leverage.

For example, one of the safest, high-yield Master Limited Partnerships ((MLPs)), Enterprise Products Partners (NYSE:EPD), offers a DRIP that automatically grants participants a 5% discount on new units.

The reason Enterprise offers this discount is that it creates an incentive for investors to hold units for the long term (and thus decrease stock price volatility).

In addition, those investors participating in the dividend reinvestment plan represent a means of decreasing how much actual cash needs to be distributed each quarter.

In other words, when investors accept distributions in new discounted shares rather than cash, companies retain more cash to reinvest into future growth.

Just how powerful can this discounted share accumulation be over time? Absolutely massive.

After all, another way to think about discounted shares is that you earn an extra 5% a year, which can add up to a fortune over time if the business does well.

For example, a dividend stock's long-term annual total return will equal its current dividend yield plus its annual earnings growth. All things equal, Enterprise Products Partners would be expected to generate a long-term annual return of around 11% (5.8% dividend yield plus 5% long-term growth rate).

Here is a comparison of how you'd do investing in Enterprise Products Partners over the years, assuming you invested just $100 per month into this blue chip MLP and it delivered close to 11% annualized returns (a bold assumption, but that's not the point of the example below).

Strategy	After 10 Years	After 20 Years	After 30 Years	After 40 Years	After 50 Years
Non-Discounted EPD Units	$22,529.88	$87,663.72	$275,965.56	$820,345.93	$2,394,149
DRIP Discounted EPD Units	$30,023.38	$164,770.93	$769,529.68	$3,483,740	$15,665,351

Source: Dave Ramsey Investment Calculator

As you can see, the benefits of those discounted units compound over time and eventually can be worth millions of dollars even with only $1,200 per year in initial capital investment.

Now of course, this only applies to certain companies (which we'll discuss in detail shortly) because not every dividend stock makes for a good dividend reinvestment plan candidate.

However, the biggest benefit of reinvesting dividends is simply that it's automated, which helps investors to take emotions out of their investing decisions. History has taught us that this is often the most important thing that can improve one's returns over time.

After all, in the words of Warren Buffett, history's greatest investor: "since the basic game is so favorable, it's a terrible mistake to try to dance in and out of it ... the risks of being out of the game are huge compared to the risks of being in it."

Specifically, Buffett is talking about market timing and over-trading, two huge mistakes that investors often do and that can cost millions in the long-run. There are two main factors contributing to this this.

First, market timing, whether it be rotating out of certain asset classes (stocks vs. bonds) or equity classes (energy vs. tech vs. pharmaceuticals), requires that you be right both in terms of selling out and buying back in.

Nobel Laureate William Sharpe has studied market timing in detail and his work, plus subsequent market studies, have found that investors would need to be correct 70% to 85% of the time on both accounts (when to buy and when to sell) just to match the S&P 500.

The problem with this? Even the most successful investors in history are generally only right no more than 60% of the time.

According to Javier Estrada, a professor of financial IESE Business School in Barcelona, Spain, (who studied market timing throughout history in 15 different nation's stock markets): "the odds against successful market timing are staggering."

This is because the majority of stock returns are generated by a very small fraction of the market's best days, which often occur during bear markets.

For example, here's how returns for the S&P 500 were affected between 1993 and 2013, if you had missed out on just a fraction of the market's top performing days.

Buy And Hold	Miss Top 5 Days	Miss Top 20 Days	Miss Top 40 Days
9.22% CAGR	7.00%	3.02%	**-1.02%**

Note that over this 20-year period a buy-and-hold strategy would have resulted in pretty much the long-term, historical market return. But missing just the top 40 days or the best 1% of performing days? Well, then you would have actually *lost* money.

And lest you think that this is cherry-picked data, another study looking at market returns from 1926 through 1990, a period of 64 years, found that the top 7% of market months accounted for 100% of the returns over this time.

But here's the most shocking fact of all. Most of the market's best days occur at the most terrifying time, economically speaking.

For example, here's when the market's top 20 days (1900-2013), which accounted for about 65% of the total gains during this time, occurred:

- 1 was days after the infamous 20% one day market crash in 1987
- 2 were during the 2008 financial crisis
- 17 were during the Great Depression

So how exactly do legends like Buffett manage to generate such incredible outperformance?

Simply put, they don't try to time the market. Rather they use a time-tested strategy called time arbitrage, in which they buy great companies at fair or undervalued prices (taking advantage of short-term market irrationality), and then sit back and let the company grow over time and appreciate in value (price eventually approaches intrinsic value).

Or to put it another way, "The stock market is designed to transfer money from the active to the patient." – Warren Buffett

How does DRIP investing help you to avoid the pitfall of market timing? That's thanks to the beneficial effects that occur when you run your portfolio like a business and keep emotions to a minimum.

The reason that market bubbles form (and inevitably crash) is because of human nature (i.e. emotion). During a bull market almost all stocks are rising, and getting rich relatively quickly seems easy.

Of course, regular investors who were burned during the last bear market are skeptical and stay on the sidelines, certain that shares are overvalued and just waiting to crash.

As the market continues to rally, fear of losses gets replaced with fear of missing out and eventually investors end up buying into the rally, generally only after all the reasonable profits have been made.

Essentially, greed eventually gets the most skeptical investors in, right at the top, and then a correction, bear market, or outright crash occurs. As the saying goes, stock rise on an escalator but drop in an elevator (i.e. shares decline much faster than they rise).

That's thanks to loss aversion, a well-known psychological principle that says that it hurts twice as much to lose a dollar as to gain a dollar. This explains why stocks fall so quickly, because investors panic and focus on the short-term pain, rather than the fact that market pullbacks represent great long-term buying opportunities.

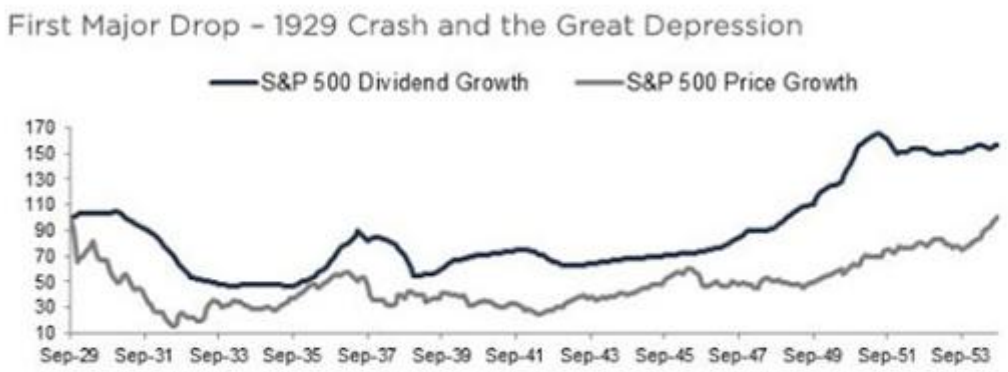
DRIP investing is a form of dollar cost averaging, a strategy in which you invest consistently into the market over time, no matter what share prices are doing.

Better yet, during times of peak market panic, when shares are selling at fire sale prices, DRIP-ing dividends from rock solid blue chips that generally maintain or even grow dividends during the downturn, results in what I like to call dividend hyper-compounding.

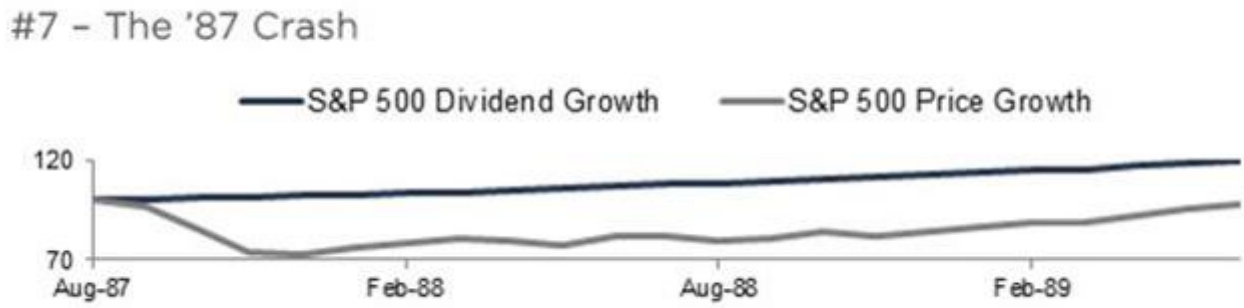
This is when companies grow their dividends exponentially, and that money is then reinvested into an exponentially growing number of additional shares, each which is also paying an exponentially growing dividend.

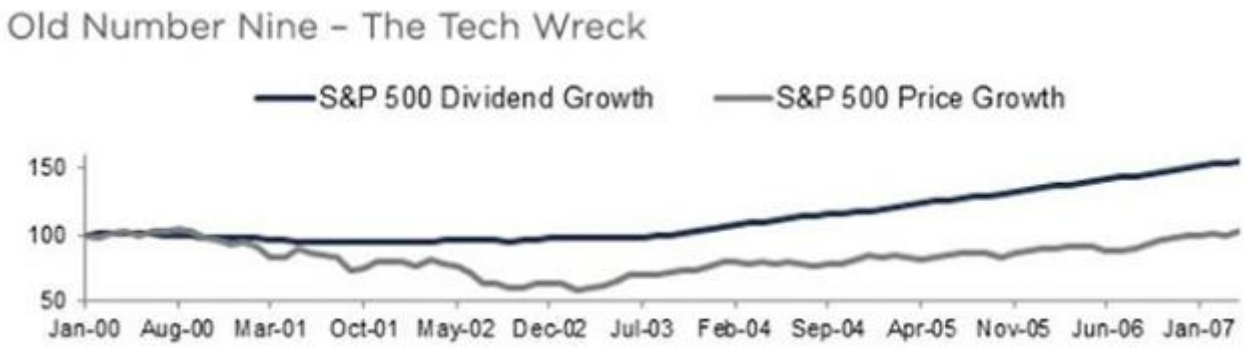
This creates an exponentially growing stream of cash flow that when applied to DRIPs can become one of the most powerful forms of income and wealth creation.

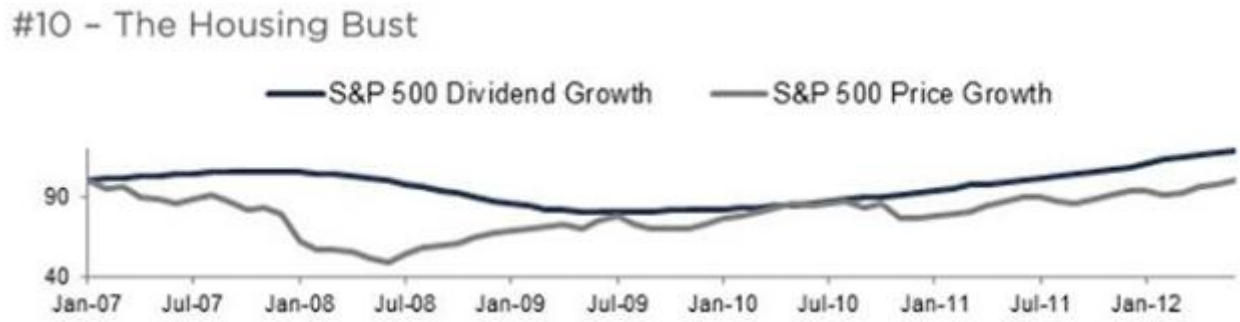
That's especially true when DRIP-ing is combined with buy-and-hold investing. For example, because dividends are a lot less volatile than share prices during a recession (see below), even if a few of your companies cut their dividends, the overall yield on your portfolio can still increase.



September 3, 1929, through September 30, 1953. Past performance does not guarantee future results. Source: Robert Shiller, Reality Shares Research







During these times of high negative market volatility, dividend reinvestment plans can ensure that you are buying at the right time (when share prices are lowest and yields highest).

Locking in high yields during market crashes helps to raise your yield on invested capital over time and is why dividend growth investing, when executed through a buy-and-hold strategy utilizing DRIPs, is one of the best long-term wealth creation engines.

In other words, the key to long-term returns and income growth is to change one's mindset, by adopting a long-term buy, hold, add on dips, and reinvest the dividend strategy.

Don't fear volatility, embrace it as an ally; the key factor that separates bad investors from good, and good from great.

Dividend Reinvestment Plan Disadvantages

As great as it is to invest your money into a diversified portfolio of quality dividend growth stocks, set a DRIP, and then just let your portfolio run on auto-pilot, there are a few downsides to consider.

First, because DRIP investing is a form of dollar cost averaging, it can at times be a suboptimal strategy. For example, during strong bull markets your dividends will be buying potentially overvalued shares with much lower dividend yields

Ideally, assuming you could minimize commissions, you could achieve better long-term income and total returns by investing not necessarily into the same stock that pays the dividend, but whatever is most undervalued in your portfolio at that time.

After all, even when the market is overheated, as it is today, generally there is always some beaten down sector creating reasonable buying opportunities for long-term investors.

Of course, that only applies if you are a hands-on investor who has the time, and most importantly, the temperament to be tracking a watch list of quality dividend growth stocks without panicking over short-term drops.

For the vast majority of people, DRIPs are ideal. Unless you have mastered your emotions and learned how to invest with iron-like discipline (according to a time-tested, simple investment process tailored to your own needs), then DRIPs let you invest your money once or twice a month and completely ignore the market.

Studies have shown that tuning out the market is the best way for regular investors to maximize long-term returns.

The second big negative to dividend reinvestment plans is the fees that you may end up paying. Note that not all DRIPs have fees, but those that do require you to be very careful about how you set them up.

For example, both McDonald's (NYSE:MCD) and Wal-Mart (NYSE:WMT) offer DRIPs but charge $5 to set up a DRIP and then $6 each time you reinvest the payout into new shares, in addition to a per share charge that is capped at $50.

Transfer agents also charge fees, which can vary by company. For example, Computershare, one of the most popular transfer agents, has varying charges and minimum funding requirements depending on what stock you want to enroll in a DRIP.

As you can see, setting up a DRIP for Wal-Mart will cost you far more than going through the company directly ($5 vs. $20). In addition, selling shares will cost you $25.50.

WAL-MART STORES, INC.

Plan Brochure	View and Print ▸	Buy Now ▸
Enrollment Form	View and Print ▸	Materials by Mail ▸
New Account Investment Options:		
a) Minimum one-time purchase OR	$250.00	
b) Minimum ongoing automatic investment	$25.00	
Requires at least 25 per transaction for at least 10 consecutive transactions		
Existing Account Investment Options:		
a) Minimum Purchase OR	$50.00	
b) Minimum ongoing automatic investment	$25.00	
Minimum shares required to enroll for existing accounts	1	
Maximum Purchase	$150,000.00 Per Year.	

Note: The minimum purchase requirement is applied separately to ongoing automatic investments and optional cash investments, while the maximum purchase limit is calculated using the total of all invested funds during the specified period of time.

PLAN FEES

Initial Setup Fee	$20.00
Cash Purchase Fee	$5.00
Ongoing Automatic Investment Fee	$1.00
Purchase Processing Fee (per share)	$0.05
Dividend Reinvestment Fee	Company Paid
Batch Sales Fee	$25.50
Batch Sales Processing Fee (per share)	$0.05
Batch Maximum Sales Fee	N/A
Market Order Sales Fee	$25.50
Market Order Processing Fee (per share)	$0.05
Market Order Maximum Sales Fee	N/A

Source: Computershare.com

On the other hand, a Johnson & Johnson (NYSE:JNJ) DRIP costs nothing to set up, has a low minimum funding requirement, and offers very low reinvestment costs ($1 each time).

However, here too you will pay a $25 commission to sell shares, in addition to a 12 cents per share processing fee.

JOHNSON & JOHNSON

Plan Brochure	View and Print ▸	Enroll Now ▸
Enrollment Form	N/A	Materials by Mail ▸
Existing Account Investment Options:		
a) Minimum Purchase OR	$25.00	
b) Minimum ongoing automatic investment	$25.00	
Minimum shares required to enroll for existing accounts	1	
Maximum Purchase	$50,000.00 Per Year.	

PLAN FEES

Initial Setup Fee	$0.00
Cash Purchase Fee	$0.00
Ongoing Automatic Investment Fee	$1.00
Purchase Processing Fee (per share)	$0.00
Dividend Reinvestment Fee	Company Paid
Batch Sales Fee	$15.00
Batch Sales Processing Fee (per share)	$0.12
Batch Maximum Sales Fee	N/A
Market Order Sales Fee	$25.00
Market Order Processing Fee (per share)	$0.12
Market Order Maximum Sales Fee	N/A

Note: Please consult the plan documentation for further details on fees and commissions. ▸

PLAN FEATURES

Discount	No
Allow Non-US Participation	Yes

You also need to keep in mind that if you are planning on using a DRIP without setting up a monthly direct deposit, some companies, such as IBM, require an initial investment of up to $500.

IBM

Plan Brochure	View and Print ▸	Buy Now ▸
Enrollment Form	View and Print ▸	Materials by Mail ▸
New Account Investment Options:		
a) Minimum one-time purchase OR	$500.00	
b) Minimum ongoing automatic investment	$50.00	
Requires 50 per transaction for at least 10 consecutive transactions		
Existing Account Investment Options:		
a) Minimum Purchase OR	$50.00	
b) Minimum ongoing automatic investment	$50.00	
Minimum shares required to enroll for existing accounts	1	
Maximum Purchase	$250,000.00 Per Year.	

Note: The minimum purchase requirement is applied separately to ongoing automatic investments and optional cash investments, while the maximum purchase limit is calculated using the total of all invested funds during the specified period of time.

PLAN FEES

Initial Setup Fee	$10.00
Cash Purchase Fee	$5.00
Ongoing Automatic Investment Fee	$1.00
Purchase Processing Fee (per share)	$0.00
Dividend Reinvestment Fee	2% of amount reinvested up to a maximum of $3.00
Batch Sales Fee	$15.00
Batch Sales Processing Fee (per share)	$0.10
Batch Maximum Sales Fee	N/A
Market Order Sales Fee	$25.00
Market Order Processing Fee (per share)	$0.10
Market Order Maximum Sales Fee	N/A

And what about brokers? Things are equally complicated depending on what broker you use.

For example, TradeKing allows dividend reinvestment plans to be set up on any security or ADR above $4 per share. You can choose to enroll individual stocks in a DRIP or have the broker set up your entire portfolio to DRIP all at once.

Another benefit is that you can own fractional shares, so you know that none of your money is sitting idle.

On the other hand, Scottrade offers true commission-free DRIP investing it calls a “flexible reinvestment program” (FRIP), which allows you to allocate what portion of your total portfolio income will go into what stock.

This provides good flexibility for those who want to reinvest more dividends towards particular sectors or individual companies (such as the most undervalued ones).

The bottom line is that there are many ways to set up a DRIP, and your fees will vary. If you want to get the lowest costs you'll likely have to go directly to individual companies, which can be a chore especially since a properly diversified portfolio usually consists of 25 to 110 companies.

Also keep in mind that the shares you get via a DRIP are taken out of a company's share reserve, not purchased directly from the market. This means that in order to sell the shares, you have to sell them to the company directly, at the market price (thus explaining the high commissions to sell).

In addition to the higher fees, it also creates lower liquidity if you want to sell a large portion of your portfolio because you might literally have to put in sales orders with dozens of companies.

Dividend Reinvestment Plan Tax Treatment

Although a DRIP allows you to be paid in shares instead of cash, the IRS still treats your dividend as taxable income.

For most c-Corps such as Pfizer (NYSE:PFE), Microsoft (NASDAQ:MSFT), or ExxonMobil (NYSE:XOM), these are qualified dividends, meaning they are taxed as long-term capital gains (0% to 20% depending on your tax rate).

2016 federal income tax brackets

Tax rate on ordinary income	Single		Tax rate on qualified dividends and long term capital gains
	over	to	
10%	$0	$9,275	0%
15%	$9,275	$37,650	0%
25%	$37,650	$91,150	15%
28%	$91,150	$190,150	15%
33%	$190,150	$413,350	15%
35%	$413,350	$415,050	15%
39.60%	$415,050		20%
	Married filing jointly / Qualifying widow or widower		
	over	to	
10%	$0	$18,550	0%
15%	$18,550	$75,300	0%
25%	$75,300	$151,900	15%
28%	$151,900	$231,450	15%
33%	$231,450	$413,350	15%
35%	$413,350	$466,950	15%
39.60%	$466,950		20%

Source: Charles Schwab

Note that DRIPs for Real Estate Investment Trusts (REITs) are non-qualified and thus taxed at your top marginal tax rate.

DRIPs on Business Development Companies (BDCs) are a mixture of qualified and non-qualified (mostly non-qualified) but this can change year to year.

MLP DRIPs are the most complicated of all because of the way MLPs are structured for tax reasons.

Their DRIPs will be mostly paid in return of capital, which will lower the cost basis on the new units you receive. You won't actually have to pay taxes on this until you sell the units (or your cost basis hits zero).

Should I DRIP?

The most important decision about whether or not to DRIP a stock comes down to how stable the company is and what your investment goals are.

For example, for most blue chips, especially dividend aristocrats or dividend kings, the business is generally stable and predictable enough that you can take a very hands-off approach.

However, for certain equity classes, such as BDCs, mortgage REITs (mREITs), and higher risk MLPs, DRIPs are generally a bad idea.

That's because these are stocks whose business fundamentals, and thus dividends, can vary wildly. If you choose to own them, you need to make sure you maintain a close eye on their financials over time.

Aside from the type of company, deciding if you should start a dividend reinvestment plan also depends on your phase of life and corresponding investment goals.

One of the biggest benefits of DRIPs is their ability to compound wealth over the long term. However, many dividend investors depend on dividends to supplement their retirement income. They are more focused on preserving their capital and generating current income.

DRIPs are less appropriate for the distribution phase of life. Sure, an investor in need of income could still pick to DRIP and periodically sell shares to generate cash, but this introduces market risk.

Instead of cashing dividend checks from safe dividend stocks and not having to worry about market prices, this investor has the added stress of trying to decide which investments to sell and when to sell them to raise cash.

Taking the dividends and not reinvesting them can make more sense in most of these cases.

How to Select the Best DRIP Stocks?

ETFs are actually decent DRIP candidates because they generally represent automatic diversification, which means that you don't have to worry about any individual company failure causing a large and permanent impairment to the dividend.

This is especially true for large cap dividend ETFs such as the Schwab US Dividend Equity ETF (NYSEARCA:SCHD), which offers exposure to 100 blue chip dividend growth stocks with solid financials.

In addition, with an ultralow expense ratio of 0.07% you don't have to worry about fees causing you to significantly underperform over time.

Other great dividend ETFs include the Vanguard Dividend Appreciation ETF (NYSEARCA:VIG), which focuses on quality dividend payers with a consistent history of payout increases, and the iShares Core High Dividend ETF (NYSEARCA:HDV), which offers the best mix of high-yields (3.4%) from strong, wide moat companies as defined by Morningstar (NASDAQ:MORN).

As far as individual companies go, the best DRIP stocks are generally blue chip names that you are confident will be around for decades, have high free cash flow margins, and that you feel comfortable not monitoring except every quarter or every year.

A great place to start looking is with dividend achievers, which are stocks that have at least 10 years of consecutive dividend increases under their belt.

This tells you that the company is not just financially stable, but also more likely to have a dividend shareholder-friendly corporate culture that is likely to endure changes in management, as well as various economic and interest rate cycles.

Dripinvesting.org also provides a list of no-fee DRIPs for the cost-conscious income investor to consider.

One of the tools we like to use at Simply Safe Dividends to identify the best stocks for dividend reinvestment plans is our Dividend Safety Scores.

Our Dividend Safety Score answers the question, “Is the current dividend payment safe?” We scrub a company’s most important financial metrics, such as its payout ratio, debt levels, profitability, and more.

Dividend Safety Scores range from 0 to 100, with a score of 50 being average. Since tracking the data, companies cutting their dividends had an average Dividend Safety Score below 20 at the time of their dividend reduction announcements.

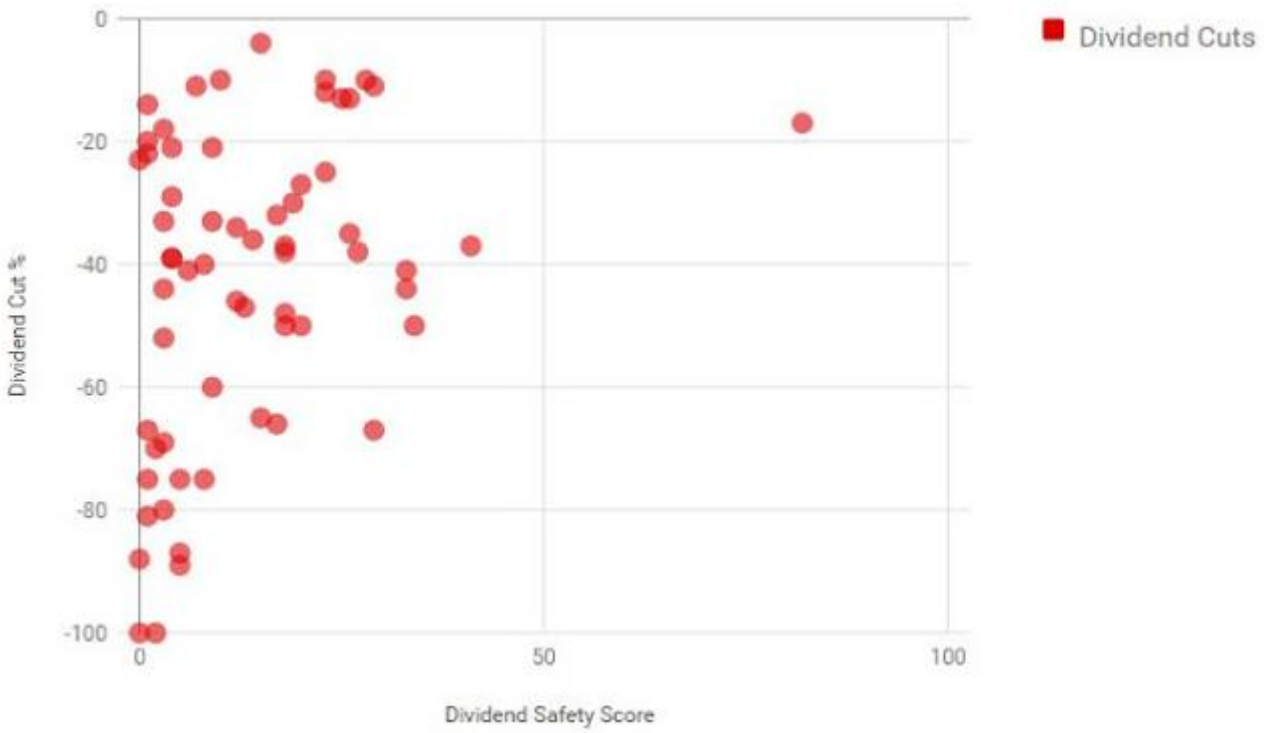
Dividend Safety Score	**81 - 100**	**61 - 80**	**41 - 60**	**21 - 40**	**0 - 20**
Is the current dividend safe?	**Very Safe:** Cut is extremely unlikely	**Safe:** Unlikely to be cut	**Average:** Moderate risk of being cut	**Unsafe:** Heightened risk of being cut	**Extremely Unsafe:** High risk of being cut

The chart below plots each company’s Dividend Safety Score on the x-axis and the size of its dividend cut on the y-axis.

Almost all companies cutting their dividends scored below 40 for Dividend Safety at the time of their announcements, including giants such as Kinder Morgan (NYSE:KMI), ConocoPhillips (NYSE:COP), and BHP Billiton (NYSE:BHP).

The one exception was a micro-cap stock that had healthy fundamentals but decided to reduce its dividend in order to invest more capital in growth projects.

You can also see that companies with lower Dividend Safety Scores generally experienced larger dividend cuts.



Source: Simply Safe Dividends

We wrote a detailed analysis reviewing how Dividend Safety Scores are calculated, what their real-time track record has been (including analysis of every dividend cut in the chart above), and how to use them for your portfolio. You can review this analysis by clicking here.

Reinvesting dividends into companies that cut their dividends or have risky business models is extremely dangerous. Instead of enjoying the long-term benefits of compounding, DRIP-ing into lower quality dividend stocks can have the exact opposite effect.

Dividend Safety Scores can help income investors avoid such traps, and the most conservative stocks for dividend reinvestment plans are companies that score at least 80 for Dividend Safety.

DRIPs can be excellent to use if you are investing with a long time horizon and in high quality businesses, which Dividend Safety Scores can help identify.

As long as those stocks aren't trading at really excessive prices, a DRIP is a reasonable way to go if current income is not needed.

Closing Thoughts on Dividend Reinvestment Plans

For most investors, dividend reinvestment plans represent a great low cost way of putting their investment portfolios on auto-pilot and are certainly worth taking part in, especially if you are a hands-off investor (which most people should be).

Just make sure you choose carefully how you set up each DRIP to keep costs to a minimum and stay focused on high quality companies that are aligned with your investment goals and risk tolerance.

Even for more hands-on, active investors who like to track different individual companies, DRIPs generally will be lower cost than manually reinvesting dividends, unless your broker allows commission-free trades (Robinhood or certain brokers offering commission-free dividend ETFs).

Just be sure you understand that dividend reinvestment plans are designed as an automation tool, and thus should only be used for high-quality dividend growth names that you would feel comfortable "setting and forgetting."

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