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DRIPs more than a drop in the bucket

Dividend reinvestment plans help to accumulate wealth

Prudent investors include dividend-producing investments in their portfolios to provide both income and tax advantages. Some use dividends to augment retirement income while others have no immediate need for cash.

Those not requiring the income should consider dividend reinvestment plans (DRIPs). Instead of receiving cash payouts, investors enrolled in DRIPs reinvest dividends in additional shares. There are many benefits.

DRIPs enable investors to acquire shares cost-effectively. Most plans are free of charge and bypass brokerage fees. Some companies even encourage DRIP investment by offering discounts to the market price on shares, likely reflecting the fact that DRIPs are a cost-effective way for them to raise equity. For the investor, that discount is like getting a little extra return on their investment.

Most DRIPs allow single share purchases with immediate reinvestment and some even permit fractional shares, which mean that investors aren't waiting for cash to accumulate before buying more shares.

DRIP investors gain through the power of compounding. If they buy companies with a history of raising dividends, the compounding effect will accelerate as dividends are increased.

Investors benefit from dollar-cost averaging, with cash dividends reinvested on a regular schedule at prevailing prices. During the recent market correction, this strategy enabled investors to acquire shares at historic lows. By regularly reinvesting at each payment cycle, they ultimately lowered the total average cost base of their investment.

DRIPs are very tax-efficient because reinvested dividends are taxable in the same manner as cash dividends. Investors report tax payable as dividend income and benefit from the dividend tax credit.

There are different ways of participating in a DRIP. Registered shareholders can enroll directly through the participating company. Investors holding shares at a brokerage firm can also enroll. Non-registered shareholders simply contact their advisor and ask to be enrolled in that company's plan.

There are many solid companies with excellent DRIP plans. However, as with all investing, the basics still apply so you need to be certain it's a stock you would buy anyway. You will also want to monitor the stock's performance to make sure you want to keep holding it.

DRIPs also have drawbacks. Investors may wind up with an uneven amount of shares, called odd lots. When liquidating a position, this can make it difficult to sell at the desired price, as the price spread can be quite wide. Should an investor need to sell in a hurry, this can pose some problems. As well, some investment firms charge higher brokerage fees for odd lots.

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Continued from Page 1

Once the position is sold, DRIPs will need to be accounted for when calculating the capital gain or loss. Since dividends are regularly reinvested, it means the average cost base is constantly changing. Some investors find this process a bit tedious at tax time.

As a long-term strategy, DRIPs have proven successful. They can be a very effective way to accumulate wealth while reducing the impact of volatility on portfolio performance.

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