How to DRIP Invest Successfully Using Dividend Stocks

Description

“Dividend-reinvestment plans,” or DRIPs, are provided by some dividend companies. If not, many online brokerages, like **Bank of Nova Scotia’s** trading platform, provide synthetic DRIP investing, which allows investors to reinvest dividends to buy whole shares. This means that if your dividend is $10, and the stock costs $7 at the time of the DRIP, you’ll reinvest $7 for the purchase of one share and receive $3 in cash.

DRIP investing can be an excellent way to automate your reinvestment process. However, there are a few points you need to watch out for to ensure your DRIP investing success.

Choose the right dividend stocks for DRIP investing

In case it’s not apparent to investors immediately, I want to point out that you want to turn on DRIP investing for quality dividend stocks. What are quality dividend stocks? It has little to do with stock price volatility. Instead, the focus is on dividend safety and dividend growth as well as the company having stable and growing earnings or cash flows in the long run to support the dividend.

Royal Bank of Canada (TSX:RY)(NYSE:RY) is a good dividend stock for DRIP investing. Without DRIP investing, the stock has delivered a 10-year rate of return of 12.9%, driven by steady earnings growth in the long haul, despite having some sensitivity to the economic cycle. This means it was able to deliver dividend growth in the long run in spite of having frozen dividends because of regulator restrictions in times of high economic uncertainties. With DRIP turned on, the total returns would be greater.

The leading Canadian bank maintains a safe payout ratio in the mid-40% range in most years. Only during high uncertainties in the economy does the bank’s payout ratio hit the mid-50% range in the last two decades.

Today, RBC stock is fairly priced and offers a yield of close to 3.9%. So, it’s a reasonable buy now. And it’s a quality dividend stock that passive investors can choose for DRIP investing.

DRIP investing monthly versus quarterly versus annually

Assuming the same dividend yield, no earnings or cash flow growth, and same stock price, DRIP investing monthly will deliver higher total returns in the long run (than dividend stocks paying quarterly or annually) because the dividend reinvestment is compounding returns more often.

For example, assuming an initial invest of $1,000 earning a 5% yield over 10 years, adding a new investment totaling $1,200 each year, and the stock staying at a constant price and dividend yield, the investment will grow to the following at the end of the period:

- Monthly DRIP: $17,175.64
- Quarterly DRIP: $17,090.49
- Annual DRIP: $16,722.37

This is a simple example to illustrate the idea of compounding. In the real world, stock prices oscillate, quality companies should increase their earnings or cash flow, and solid dividend stocks raise their dividends, which will markedly change the results.

Be careful about overconcentration in specific stocks

Naturally, investors have a tendency of using high-yield stocks for DRIP investing. For example, **Enbridge** stock yielded close to 8.5% during the pandemic market crash of 2020. Buying at the rock-bottom price and reinvesting its juicy dividends can quickly grow your position. When investors turn on DRIP investing for passive investing in quality dividend stocks, they should still periodically check that their position hasn't grown too large to avoid overexposure to specific stocks or sectors.

DRIP investing doesn't take stock valuation into account

Theoretically, the cheaper the stock (e.g., buying in a market crash), the greater the total return investors get. When you use DRIP investing for the convenience of automation, you don't take stock valuation into account.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. NYSE:RY (Royal Bank of Canada)
2. TSX:RY (Royal Bank of Canada)

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kayng