A *Dividend Investor Canada* Special Report

Reinvested Dividends:

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By Jonathan Chevreau

In an earlier article on this topic, I chatted with David Chilton, author of *The Wealthy Barber*, about the many portfolios readers have sent him over the years. Invariably, Chilton told me, the portfolios that had done the best over the long haul were of individual blue-chip Canadian stocks bought a long time ago and never sold. More often than not, they simply reinvested the dividends into more of the same stock.

I use DRIPs in my own portfolio, both for individual stocks and for some ETFs. They're practically idiot-proof, automatic, and cost-effective, since you incur no trading costs when the dividends are reinvested. Just as importantly, they take advantage of the power of compounding: doubly effective if they're held in registered vehicles and escape tax drag on dividends and capital gains.

Perhaps that's why Victoria-based investor and writer Robert Gibb once called DRIPS a "get-rich, eventually scheme." In a column in the *Financial Post*, Peter Hodson of 5i Research listed several common traits of successful investors. Successful Investors, he said, "love and use DRIPs," which he praised as "one of the wonders of the investment world." And they also continue investing on a regular basis, which is also reflected in a DRIP strategy.

Patrick McKeough, publisher of several Canadian newsletters, notes that "dividends and dividend reinvestment plans are in fashion with investors right now, and that's always a good thing. … Dividends can produce as much as a third of your total return over long periods. Stick to dividend payers and you'll avoid most of the market's greatest disasters."

What exactly IS a DRIP?

DRIP stands for Dividend Reinvestment Plan (some say Program, so take your pick!). When you use a DRIP, the dividends you'd normally receive as a cheque or in your brokerage account are instead reinvested back into the underlying stock.

The very word DRIP nicely conveys what's going on here: just like a constant drip of a leaky tap into a bucket will eventually fill up, so too can the constant activity of saved brokerage commissions and the discipline of making small regular reinvestments of dividends result in the filling of your retirement savings bucket.

With DRIPs, you buy shares in a company and register the shares with that company's DRIP program. But instead of getting (and often spending!) the cash dividends, you get more shares, often at a discount of 2% to 5% of market price—and with no commission. As Hodson observed, with the discount, this is "the closest thing to 'free money' you can get in the stock market." (Note that the investor must still pay tax on this income each year, whether it is received directly or reinvested, a fact that some investors fail to understand.)

DRIPs are therefore cost-effective ways to compound your money: some companies don't charge for this while others may charge reasonable fees or proportional commissions. In addition to individual stocks, you can "DRIP" Canadian income trusts and closed-end funds, as well as many exchange-traded funds (ETFs), either directly through the manufacturers or through your brokerage firm. (More on this later.) With income trusts like Royalty Trusts or REITs, a monthly distribution is often made, in which case you can consider DRIP to mean Distribution Reinvestment Plan. But they operate the same way.

There are many types of DRIP plans, says certified financial planner Aaron Hector, of

Calgary-based Doherty & Bryant Financial Strategists (a division of T.E. Financial Consultants). The "classic" DRIP is set up directly with the offering companies (via a so-called private transfer.). If your employer happens to be a publicly traded company with a DRIP program, it probably makes sense to set this "classic DRIP" directly, especially if employees qualify for a discount on the price of the shares. If going the private exchange rate, you'll have to buy at least one share: you can find the seller through local investment or DRIP clubs, or the Share Exchange Board at the DRIP Resource Center. For sheer value and cost savings, the classic DRIP set up directly with a company is hard to beat.

Once you've set up a classic DRIP directly with a company, you can buy fractional shares, there are no commissions, and shares may be offered at a discount to the market price. DRIP plans can also be set up with a broker to simulate company-sponsored DRIP plans: we'll look at these in detail in the second half of this report. Share registration, whether through a traditional or a discount broker, will cost roughly $40 to $50 per company.

But even if a DRIP plan is not officially available, an individual investor could replicate a DRIP by letting dividends accumulate, then buy more shares, Hector suggests. Of course, this gambit isn't quite as good as the real thing: the downside is you would be charged a commission on the trade and you wouldn't be able to buy fractional shares.

The History of DRIPs

DRIPs have a long history that certainly predates the modern Internet era and that of online investing. They actually started in the United States during the economic and population boom of the 1960s, according to the *Millionaire Maker Investment Advisory*. As America's basic infrastructure was upgraded to keep up with this growth, companies needed new capital and Washington came up with an innovative solution based on employee stock purchase plans, which originated in many of the biggest blue chips early in the 20th century. The U.S. government made it possible for their employees to buy shares directly from companies at a discount (sometimes as much as 10%!) and as dividends rolled in to automatically reinvest them in more shares. In the 1960s, Washington expanded this format to the general public: it let companies sell their shares directly to the public rather than through traditional financial markets. Americans could become stock investors without using a traditional stock broker.

As for when DRIPs started in Canada, information is surprisingly scanty but it's believed that DRIPs started to get introduced by Canada's mutual fund companies in the 1970s in order to avoid taxation within RRSP accounts when dividends could be paid in cash.

Advantages of DRIPs

If you're a believer in investing in individual securities instead of "managed money" (mutual funds, Investment Counsel, etc.), then you can hardly avoid the topic of DRIPs and you already know the biggest advantage is cost savings on brokerage commissions. Since many readers of Motley Fool services are believers in investing in individual stocks, it's doubtful you'll find a lower-cost route to building wealth.

Accompanying the cost advantage is the sheer discipline and long-term approach that DRIP investing entails. By reinvesting dividends back into more units of a security, the temptation to spend the dividend is removed. There's also a certain amount of security in knowing that many of the largest blue-chip companies tend to offer DRIPs. Companies that pay dividends are generally more stable and their stock prices less volatile, and you could argue this goes double if they also offer DRIP programs.

DRIPs amount to another form of dollar-cost averaging, so if you stick to the Foolish principle of long-term investing, you'll be investing in more units when markets fall and fewer when the share price is high. This takes the emotions out of investing and trying to time the market, notes Hector. "Over the long term you should have a reasonable cost base but more importantly, you will have been saving throughout the entire holding period."

As Jeremy Siegel has noted, reinvesting dividends is a powerful "total return accelerator" and "bear protector." Professor Siegel, of Wharton's Business School, said "There are two important ways that dividends help investors in bear markets. The greater number of shares accumulated through reinvested dividends cushions the decline in the value of the investor's portfolio. It is because of additional shares purchased in down markets that I call dividends the 'bear market protector.'"

Those extra shares do more than cushion the decline when the market recovers: they will greatly enhance future returns, Siegel said. "So in addition to being a bear market protector, reinvesting dividends turns into a 'return accelerator' once stock prices turn up. This is why dividend-paying stocks provide the highest returns over stock market cycles."

You should also be familiar with the related acronym, SPP, which stands for Share Purchase Plan. These are closely related to DRIPs, says Norman Rothery, publisher of the Stingy Investor. Not all companies with DRIPs also offer SPPs, but many do, and the process is similar. The two are often set up at the same time. The SPP allows you to send the company money to buy more shares at certain dates in the future, typically the dates the dividends are being paid out. If you're dealing directly with the company, there should be no commissions for either the DRIP or the SPP.

Another advantage of DRIP plans is that they usually allow for fractional share purchases, Rothery notes. "So, your $2 dividend can be used to buy 0.2 shares of a $10 stock." In the case of a company offering a DRIP but no SPP, it won't be cost-effective to buy tiny numbers of shares, while it can be if you have a DRIP coupled with an SPP.

If you happen to also be a mutual fund investor, you may have the option when you set up your initial investment to reinvest the fund distributions and buy more units, which is "very similar to a DRIP plan," observes Hector.

Disadvantages

Despite all these compelling potential advantages, DRIPs aren't as popular as you might think. "They're a lot more popular in the United States," observes Rothery. They made a huge amount of sense in an era of sky-high brokerage commissions, such as the 1980s, when brokers charged 2% or more to buy stocks. But the rise of low-commission discount brokerages has made the cost argument by itself far less compelling: as Patrick McKeough notes, today you can buy stocks for a commission of 0.5% or even less. Also, he adds, many companies that formerly offered DRIPs have eliminated the discounts that used to be common: "Now you pay full price to buy through most DRIPs."

While he used DRIPs extensively early in his personal investing career, Rothery has found that keeping track of the tax aspects of DRIPs can be quite complicated for taxable portfolios, although of course this should not be a factor for registered portfolios like RRSPs, RRIFs, and TFSAs.

Aaron Hector agrees, noting that some investors get confused at tax time when they are still taxed on the dividend income, even though they never actually saw (i.e., received) the cash. And he notes that "calculating your Adjusted Cost Base (ACB) within a taxable account when you eventually sell shares can become a nightmare if the ACB is not being tracked by your financial institution." Depending on the holding period, it may be necessary to go back five or 10 years, or even longer.

Even though the dividends are reinvested automatically, for tax purposes, Hector says you have to consider the dividend and the repurchase as two separate tax items. First, the dividend is taxable in the same way if it was paid out as cash. And second, when the dividend is used to purchase the shares, there will be a corresponding increase to your ACB that would be the exact same as if you had taken cash out and bought the shares directly. If you don't account for the increase in book value when you eventually sell the shares, you will be calculating a larger capital gain than necessary and hence end up paying more tax than you should have.

Also, if you're a retiree or anyone else who needs cash flow from your investments to cover current spending, you might not want to use DRIPs, because then you would need to sell something to raise the cash, cautions Hector. "Similarly, as everything is rolling back into the original stock they do not offer diversification. Some people like to receive their dividends as cash so they can jump on the next opportunity" that might be in another company or sector.

Patrick McKeough concludes DRIP investing is "okay to participate in if you use them to cut commission costs on stocks you would have bought anyway." However, he cautions that the mere existence of a DRIP plan for a particular stock is not in itself a guarantee of investment quality.

Major brokers offer DRIPs

In the early days of the classic DRIP, investors filled out paperwork and dealt directly with the companies issuing the stock, but for large diversified portfolios it's a lot easier and more convenient to buy shares on the open market by setting up DRIPs through your brokerage firm, particularly online brokerages. Of course, with the greater convenience comes slightly less value: Unlike dealing directly with a company's DRIP program, there may be modest fees associated with the brokerage route.

Virtually all the major bank-owned discount brokerages handle DRIPs, as do most of the major independents. You can find a list of Canadian brokerages offering DRIPs and the fees associated with DRIPs at this list of Canadian Discount Brokers.

Online discount brokerages of major banks:	Credit unions or Caisses Populaires:	Independent brokerages:
BMO InvestorLine	**Desjardin's Disnat Direct**	**QTrade Investor**
CIBC Investor's Edge	**Credential Securities' Credential Direct**	**Questrade**
RBC Direct Investing		**Virtual Brokers (BBS Securities)**
TD Direct Investing		**Jitneytrade Online**
Scotia iTrade		**ShareOwner**
HSBC InvestDirect		
National Bank Direct Brokerage		

Major Canadian stocks offering direct DRIPs

The vast majority of Canada's largest companies (and therefore employers) offer DRIPS, but not necessarily all of them. Many also offer Share Purchase Plans or SPPs, although there is a good number that offer DRIPS but not SPPs.

Canadian banks:	Insurance companies:
BMO	Manulife
Scotiabank	Sun Life
CIBC	Industrial Alliance
Laurentian	Intact Financial
National Bank	
Royal Bank	
Equitable Bank	
TD Bank	

Not all offer discounts. According to the Canadian DRIP Primer, BMO and CIBC offer a 2% discount but Royal Bank, ScotiaBank, TD, National Bank, and Laurentian do not offer discounts.

Blue-chip stocks that offer DRIPs but no discounts:	Blue-chip stocks that offer DRIPs WITH discounts:
BCE	Emera
Canadian Tire	Enbridge
Encana	Fortis
Husky Energy	Manitoba Telecom
Imperial Oil	Shaw Communications
Potash	TransCanada
Rogers	TransAlta
Telus	Gold Corp.
Thomson Reuters	Barrick Gold
	CAE

Constellation Software (introduced in 2013), and Hydro One have DRIPs, but it's not clear whether they also offer discounts. Check with the companies directly if this is an important part of your decision.

Don't forget that a large number of income trusts, royalty trusts, and REITs also offer DRIPs, as do closed-end funds and ETFs.

REITs:	Canadian ETF companies:	Closed-end funds:
RioCan REIT	BlackRock iShares	Canadian General Investments
H&R REIT	BMO ETFs	Middlefield (various funds)
Canadian REIT	First Asset ETFs	
Brookfield Office REIT	Horizon AlphaPro ETFs	

In all these cases, don't assume they will also offer SPPs: some do, some don't; start your research with this list. http://www.dripprimer.ca/canadiandriplist.

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The information regarding tax treatment in this piece is informational only and not intended as tax advice. For information on your individual tax situation and how it could be affected by dividends, please consult your tax advisor.

Disclosure: All figures as of February 24, 2017.

Published by: THE MOTLEY FOOL CANADA, ULC 1959 UPPER WATER STREET P.O. BOX 997 HALIFAX , NOVA SCOTIA B3J 3N2

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