Dividend Reinvestment Plans

By Michael Kemp

In May last year I sat for a day in the cavernous Century Link Centre, Omaha's largest entertainment complex. I was one of more than 35,000 people shoe-horned into the 1.1 million square foot building to hear Berkshire Hathaway's CEO, Warren Buffett, field questions from the company's shareholders.

He answered plenty of questions that day but one has stuck firmly in my mind. It came from a concerned shareholder wanting to know why, with over $30 billion of cash in the bank and the company's share price sitting at $120,000 a piece, Berkshire's board weren't prepared to pay a dividend. It was a reasonable question given the $200 billion company hadn't paid a dividend for nearly fifty years. Buffett responded politely as if it was the first time he'd ever been asked the question (which it wasn't). He explained that the share price was $120,000 because of years of profit retention backed up by profitable reinvestment. It meant shareholders had been delivered market-beating returns despite receiving no dividends. Their gains were due solely to the lift in the share price. Buffett finished off by adding that if anyone wanted a dividend then they were free to sell some of their stock.

For decades Buffett had been reinvesting the "un-paid" dividends back into the company on behalf of every single shareholder. There's nothing wrong with this as long as management invests the money well, not so good if they don't.

But wouldn't it be nice if you, the shareholder, could make the choice? That is, to either reinvest your dividends straight back into the company or to take the cash if you chose to use it elsewhere. The good news is there are plenty of companies offering that choice. It's called a Dividend Reinvestment Plan (DRP).

How DRPs Operate

Let's run through an example of how DRPs operate. Say you own 10,000 shares in a company and you've elected for 100 percent participation in its DRP. The company is due to pay an upcoming dividend of 17 cents per share. The company's shares have a market value of $8.50 each and are offered at a two percent discount through the DRP (i.e. $8.33). So instead of receiving $1,700 in cash, you receive 204 shares. This increases your total holding to10,204 shares. The cash you've forgone hasn't equated exactly to the value of the shares you've received so to compensate a fractional dollar amount is carried forward to the next dividend payment.

How to find companies offering a Dividend Reinvestment Plan

Most listed companies don't actually operate a DRP. So if you're interested in the concept you first need to find out if your company has one.

You can find this out in a number of different ways. You can check the company's website or your broker's website, or Google 'Smart Investor', click on the Share Tables option in the My Tools drop-down menu and scroll down to Dividend Reinvestment Plans. AFR Smart Investor magazine provides an up-to-date list of all ASX companies with a DRP.

How do you sign up?
If your company is operating a DRP then you will be sent a simple form to fill out when you first become a shareholder. It will ask if you'd prefer to receive your dividends in the form of cash, new shares or a mix of both. If you choose the last option you will be asked to nominate the proportion of the dividend you want to receive as cash and the proportion in the form of new shares. If you are already a shareholder you can change your DRP preference at any time. The necessary form can be downloaded from the website of the company's share registry service provider.

Having signed up you can withdraw at any time, up to the books closing date for a particular dividend. Companies also have the right to suspend or close plans on giving appropriate notice to their shareholders.

Advantages

- Companies see DRPs as useful capital management tools. By paying dividends in the form of shares, rather than cash, companies can retain capital. This can be used either to pay down debt, invest in the company's own business or to acquire new businesses. And remember that an advantage to the company is also an advantage to you. After all, as a shareholder, you are a part owner of the company!
- The second advantage applies particularly to small investors. New shares, acquired under a DRP, are bought without paying any broker's fees. These fees would otherwise take a big bite out of future returns.
- Some DRPs offer new shares at a discount to the market price. If a discount is offered its size can vary. When DRPs first became popular discounts of five to ten per cent were offered. More recently this has been reduced to the one to five per cent range. Many offer no discount at all.
- DRPs simplify the reinvestment process. They appeal to a set-and-forget investment philosophy since dividends are automatically reinvested for you.
- DRPs are a form of forced saving. If you don't see the cash, you're not tempted to spend it.
- They provide the benefit of compounding - Each time a dividend is issued it will be delivered from a larger number of shares than the previous dividend. Linked to profitable companies this will to lead to growing dividend payments and compounding of your holding over time.

Disadvantages

- Investors, who fancy themselves as value investors, will immediately see a drawback with DRPs. And that is discretion regarding the price paid for new shares is relinquished. The purchase has become automatic, with the price established by the prevailing market price at dividend time. But whether this is a problem or not really depends upon how you view things. If you're not a gun at valuing shares remember that new shares will be purchased at all stages of the market cycle. At times they will be bought cheaply, at other times more expensively. But over time, it should even out.
- More onerous record keeping. The ATO requires the purchase price of shares be recorded for the purpose of calculating your Capital Gains Tax liability (should you come to sell). For example, if you hold shares in a company for 15 years and it issues dividends twice a year, you would need to keep track of 30 separate transactions for tax purposes – and that's just for one company.

- The DRP-associated shareholdings in your portfolio will tend to grow disproportionately compared to other companies you hold. Unless you are justifiably confident in the outlook for these companies its best not to let them dominate your portfolio. Be conscious of this and periodically rebalance your portfolio as it will allow you to sleep better at night.

How DRPs are Taxed
All shares issued under DRPs are treated, for tax purposes, as if a cash dividend had been received. Franking credits are also dealt with in exactly the same manner.

When shares issued under a DRP are sold the cost base for capital gains tax purposes is determined by the market price of the shares at the time of the associated dividend distribution.

If the shares were issued at a discount the discount doesn't constitute assessable income at the time of issue. However, it does result in a lower acquisition cost for the new shares and this will result in a correspondingly higher taxable capital gain on any subsequent disposal.

Underwritten DRPs
Those companies with a significant need for capital would prefer all their shareholders participate in the company's DRP. Since this isn't practicable a company can arrange to have its DRP underwritten. Under this arrangement the company issues enough shares to fund the full dividend amount. Those shareholders who choose to participate in the DRP will receive shares as payment. The remaining shares are then sold to another party under the terms of the underwriting agreement. The cash the company receives from this sale is then used to pay those shareholders who opted for the cash dividend.

In this sense the company is declaring a dividend, but then not paying one. Essentially it's a futile exercise, a game of musical chairs with the loser being the shareholders since they're the ones paying the costs of the underwriting. In my view if the company doesn't want to pay a dividend then the only sensible thing to do is simply not pay one.

So do you DRP or not DRP? It depends. But consider all the pros and cons carefully because ultimately the decision is yours.

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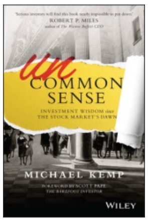

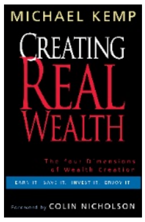

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Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.