Dividend Reinvestment Plans

Dividend reinvestment plans sound simple, but there are more issues with dividend reinvestment plans than many investors realise.

A dividend reinvestment plan is where a company offers to pay the dividend in the form of additional shares. These additional shares are offered at a price determined by the company, which is usually a small discount to the average market price over a defined period prior to the payment. The amount of the discount may be varied by the company from time to time. No brokerage is levied on the new shares. Dividend reinvestment plans can therefore be a cost-effective way to increase shareholdings in the company.

Not all companies will offer dividend reinvestment plans. Some companies may also turn off their dividend reinvestment plans for periods where they do not need additional capital. This means that sometimes the shareholder will get additional shares to the value of their dividend, or part thereof if they have not enrolled their entire shareholding in the scheme. At other times they will receive the dividend in cash (by direct credit or cheque).

Clearly, dividend reinvestment plans have little relevance for traders, because traders are speculating on short-term changes in the price of shares. Their timeframe will rarely be long enough to consider a reinvestment plan. Moreover, the commitment to a plan cannot be terminated at short notice if a longer-term speculation hits a stop-loss. The result may be delayed payment of a dividend in a small parcel of shares that are then not economic to sell.

The type of investor who will be most interested in dividend reinvestment plans will be the passive or buy-and-hold investor. Their timeframe will lend itself to building a long-term holding in a company. To the extent that the dividend reinvestment plan reduces their cost of acquisition, it may also give a nice boost to their return.

Active investors will have a more difficult time deciding whether to enrol in a dividend reinvestment plan. On the one hand, they have the advantage of economically building a holding in a company over time in the same manner as a passive investor. This would tend to boost their return. On the other hand, because they are timing the market, active investors will have the problem that was described above for a speculator: they may be left with a small parcel of shares in a company they sold because it violated their stop-loss, with no time to cancel the dividend reinvestment plan.

An important issue is that by enrolling in a dividend reinvestment plan, the decision to increase the holding in the company concerned needs to be made in advance. After that it is automatic unless the investor consciously remembers to reconsider the decision at the appropriate time. This can be a real difficulty, because by the time a dividend is declared, there may be little or no time to change the decision to participate in the plan. To that extent, the decision whether to invest more capital in the company has become automatic and is not therefore a considered one that takes into account the recent performance and prospects for the company.

Now, if the investor was a passive investor, this would not really be an issue. The passive investor rarely, if ever, sells. The company would have to encounter real problems to prompt a sale. However, the problem here is that passive investors are generally not psychologically attuned to the risks of continuing to hold a losing investment. They tend to be emotionally unable to take a loss at any time. They may hold on in the belief that the business of the company is sound and that it will come good again in the long term. Then again, they may not hold any such belief and just hold on in hope. Many of these investors really believe that they will not have made a loss unless they sell. This does not extend forever, though: if the company fails completely, then at some point they must recognize the loss unless they put the CHESS holding statement in the notorious ‘bottom drawer’ and forget they ever owned the shares.

However, if we assume that the investor is active rather than passive in their approach to investing, the issue in the preamble to the question becomes very relevant: as an active investor, the decision to build a holding in a stock should ideally be a conscious one. There should be a good reason to increase the holding. Sure, the increase in the holding from any one dividend may be fairly small in percentage terms, but over time it could amount to a significant increase in the holding and therefore the amount of capital tied up in the company. This is a decision that each investor needs to think through in depth before committing to a dividend reinvestment plan. Once the initial decision is made the whole issue falls out of sight and does not emerge until the CHESS holding statement arrives after the event.

In order for an active investor to use a dividend reinvestment plan effectively there must be an extremely disciplined attention to detail. The key dates must be researched and diarised. Then a conscious effort must be made to review the situation and decide whether to cancel the plan by the cut-off date. I think I could count on the fingers of one hand the number of investors I know who might even attempt this level of discipline. For most people, dividend reinvestment just happens and they just accept it and never take the actions to change the situation. They live with the consequences of their carelessness.

There is one further issue to consider. In Australia we have capital gain tax. Where numerous half-yearly dividend reinvestments have been made, the record-keeping requirements are not to be lightly dismissed. Usually, the investor does not even think about the capital gain tax implications in terms of records until after they eventually sell the shares and come to fill out their tax return (usually delegated to a tax accountant, but the investor still has to supply the documentation). I have helped a friend who sold a 30-year shareholding with dividend reinvestments and numerous bonus and rights issues (either side of the start of capital gain tax) for which few records had been kept. I got some help from the company share registrar, but beyond that it was a nightmare to try to reconstruct the picture for taxation.

I never enrol in dividend reinvestment plans – life is too short to waste doing all the paperwork for the saving involved. Of course, my readers may have a different life philosophy…

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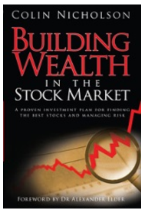

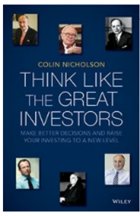

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