

# DRIP Investing

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### Definition:

- DRIP, dividend reinvestment, plans allow investors to purchase shares of a company directly, bypassing brokers. After owning one share of a company (in most cases), investors are eligible to enroll in DRIP plans. Plans are administered by transfer agents, usually large banks such as The Bank of New York and Wells Fargo.
- Once you are enrolled in a plan, you are allowed to make optional cash payments, usually on a monthly basis. Instead of buying shares of stock, you send in a dollar amount and are allowed to purchase fractional shares. For example, a \$25 OCP (optional cash payment) will get you 0.25 shares of a \$100 stock.
- Plans also allow participants to reinvest dividends, purchasing additional fractional shares of the company in question.
- In addition to traditional DRIPs, plans that usually require you to hold at least one share of stock in your name ahead of time, there are some newer types of plans such as DSPs (Direct Stock Plans) and synthetic DRIPs. DSPs allow you to make your original purchase directly from the company's transfer agent. Such plans are usually associated with larger fees (but not always) because they give the investor more affordances. Synthetic (or pseudo) DRIPs are brokerage based plans that allow the reinvestment of dividends (and OCPs) in a regular brokerage account. Such services as BuyAndHold.com and Sharebuilder.com allow you to set up an online DRIP with any company (including non-dividend paying Nasdaq securities). Again, such services usually carry larger fees. It is optimal to join fee free DRIP plans if possible (many great companies offer them such as INTC, JNJ, PEP, WM, etc.).
- Throughout the rest of this handout, I will be using the term DRIP investor to refer a DRIP investor that invests in free free plans, makes regular optional cash payments each month, reinvests all dividends, and picks reliable stalwart companies.

### Advantages:

- Compound interest over the long term is very powerful. Investors who have enough discipline to hold onto DRIPs over the long term and are diligent enough to pick viable companies enjoy enormous compound interest benefits over the years. Optional cash payments, dividends, and the existing investment all compound. The power of compound interest cannot be overstated. The reinvestment of dividends is essential in this formula and consequently simply holding an equity for the long term does not afford the same benefits as DRIPing. Since 1926, the S&P 500 has returned around 11% annually with dividends reinvested. Not reinvesting dividends, the S&P 500 has only returned 7.4% (p. 18, *Investing Without a Silver Spoon*). One share of Coca-Cola (KO) purchased in 1919 is now worth \$5,737,188 with dividends reinvested. Not reinvesting dividends, the share is only worth \$258,760 (p. 20, *Investing Without a Silver Spoon*).
- Dollar cost averaging is easy with DRIPs. Statistically, the average investor is more likely to get a better average price when buying 12 times over the course of a year than when buying all shares at once. Following this point, DRIP investing allows the investor to have increased peace of mind. A stock heading south is not a reason to panic (if the fundamentals have not changed) but is a good buying opportunity, one that the DRIP investor knows she will get. Since all shares are not bought up front, a stock heading south affords the investor a lower average purchase price. DRIP

plans allow for time diversification.

- No commissions or fees. Many DRIP plans have no fees (watch out for those that do). Commissions add up very much over the years. Saving and investing this money is very powerful.
- No trading. While this can also be seen as a disadvantage (as explained later), it is also an advantage in many situations (including my own). For many investors, trading is tempting as it is an exciting experience. Trading is not always profitable for the average investor. Rather, it eats up commissions and adds little value unless the investor is very astute and has a lot of time. Since trading is pretty much impossible in DRIP plans, this situation is ideal for those who are prone to make trades (who should not be).
- Low requirements. Many DRIP plans allow the investor to send in as little as \$25 for an optional cash payment, an ideal setup for the small investor.

### Case Studies:

#### Situation One:

An investor starts with \$500 and adds \$100 monthly. At the end of 20 years \$24,500 has been invested and at the end of 40 years \$48,500 has been invested.

	Value when <u>growing at 7%</u>	Value when <u>growing at 11%</u>	Value when <u>growing at 15%</u>
Year 1	1745	1820	1866
Year 5	7868	8816	9911
Year 10	18313	23194	29741
Year 15	33120	48052	71528
Year 20	54112	91031	59581
Year 30	126055	293806	736098
Year 40	270637	899929	3295955

#### Situation Two:

An investor starts with \$1000 and adds \$200 monthly. At the end of 20 years \$49,000 has been invested and at the end of 40 years \$97,000 has been invested.

	Value when <u>growing at 7%</u>	Value when <u>growing at 11%</u>	Value when <u>growing at 15%</u>
Year 1	3550	3640	3732
Year 5	15736	17632	19822
Year 10	36626	46388	59483
Year 15	66241	96105	143057
Year 20	108224	182062	319163
Year 30	252110	587612	1472196
Year 40	541274	1799589	6591911

#### Key Points From Situations:

- With DRIP investing, time is very important, as it allows for compound interest to generate large sums of money over the long term. Time is as important if not more important than capital (especially initial capital).
- Compound interest generates the most money toward the end of the portfolio's life span. DRIP investing makes the most sense for the 10+ year time horizon.
- Each percentage point makes a huge difference in the long term.

Both of the above studies were taken from *Investing Without A Silver Spoon* by Jeff

Fischer (pages 3 and 4).

## Disadvantages:

- Most DRIP plans only allow the investor to buy shares one day each month (this day is predetermined by the plan administrator). Money you send before the investment date does not earn interest. Consequently, this method of investing is not for the shorter term investor who wishes to buy at the correct moment (time the market).
- Along the same lines, selling is not instantaneous with DRIP plans. Most plans allow you to sell daily or weekly. Even though this is better than monthly, it is very difficult to sell on bad news; cutting loses is not easy. While this is a disadvantage, it is important to note that making rash sell decisions is not part of the DRIP philosophy and you should not DRIP a stock you intend on selling within 5-10 or more years.
- Some DRIP plans charge hefty fees. While it is important to look at companies before fees, fees can add up over time on monthly investments. Those plans that charge high fees should be avoided if the fees make up more than 2% of your investment principal. The best DRIP plans are those that charge no fees, allowing the investor to make use of every last dollar.
- DRIP investing is relatively boring compared to buying and selling all the time.
- Increased record keeping. Over the lifespan of a DRIP portfolio, 100s of purchases will be made. Records must be kept for when you sell.
- 10+ years is a very long time. It is not easy to pick companies that will be leaders so far out. Due to the long term time frame and necessity for a level of certainty, DRIP investors are often limited to larger corporations (and some reliable midcaps).

## My Game Plan:

Following is a general idea of my DRIP portfolio investment strategy. This is by no means the only way to DRIP and is just one perspective. Further, this is a strategy by which I manage my *DRIP* portfolio. While most of the ideas will also apply to a general portfolio, some are DRIP centric and ought not to be huge factors in an intermediate term stock portfolio.

### (1) Find a good company.

- In addition to applying all of the traditional fundamental metrics that we utilize in the Blyth Fund, there are some other quantifiers that determine a good DRIP candidate.
- A long history of increased dividends. I like to invest in companies that have increased dividends every year for the last 10+ years (often 20-30 years). Johnson & Johnson and 3M are both good examples of this principle.
- Successful share repurchase programs. I like companies that buy back their own shares.
- Reliable over the long term. I avoid new companies that have only been around a few years or companies that seem overly risky (ie they may not be in business in 10+ years). While this restricts the possible companies to invest in, I believe it is essential to guarantee as much as possible that the company will be around and vibrant for the lifespan of the investment. Companies that epitomize this idea are GE and Johnson & Johnson.
- Strive for 10-15% annualized gains (not 25%+ gains). Compound interest will work wonderfully with a 10-15% annualized gain. There is no need to take on unnecessary risk. It is ok to invest in stocks that have the potential to appreciate tremendously (several hundred percent) in a short period of time. If you are interested in such opportunities, segregate such investments into a brokerage

account (not into a DRIP portfolio).

(2) Does the company have a good plan (or a plan at all)?

- I tend to only invest in fee free DRIPs, as I want all of my investment dollars going toward purchasing shares.
- I will only DRIP a stock that charges fees if the underlying company is incredibly strong, suggesting that the fees will be more than overcome by capital and dividend appreciation.
- If the company offers no DRIP plan, you may opt for a synthetic (pseudo) DRIP. Again, only do so if the underlying company is incredibly strong.

(3) Buy, Buy, Buy.

- After I find something I like, I make a purchase and start a DRIP plan. I make optional cash payments in my DRIP plans each month and plan to for the next 40+ years. Doing so, I expect to generate enormous amounts of money (especially after I get a job and start contributing a lot of money each month).
- All dividends are reinvested.
- As a general rule, I don't like to have a lot of stocks in my portfolio. I currently have 4 and don't plan on owning more than 6 over the next few years.

## Resources:

The Motley Fool: DRIP Portfolio

<http://www.fool.com/DripPort/>

- Many good articles here.

Netstock Direct

<http://www.netstockdirect.com/>

- Searchable database that allows you to see if a company offers a DRIP/DSP plan. The database lets you know if the plan in question charges fees and offers other relevant information.

Moneypaper

<http://www.moneypaper.com/>

- Allows you to purchase shares of stock to get started in a DRIP. As noted above, most DRIP plans require you to own one share of stock (registered in your name) ahead of time. This service allows you to do so if you do not already have a broker.

*The Motley Fool's Investing Without A Silver Spoon*

Jeff Fischer

- Great introductory book. Quick read.

*All About DRIPs and DSPs*

George Fisher

- Another great book.