Buy more or take the cash?

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DRPs are an easy way to build your stake in a company, but they're not for the set-and-forget crowd.

Dividend reinvestment plans (DRPs) are as iconic as Aussie rock 'n' rollers AC/DC (forgive the appropriation, fellas). Chart-toppingly popular among investors and around for decades, DRPs can help power wealth creation sky high.

But what's music to the ears of some might not be to the taste of others. As ever, pick the playlist, be it musical or financial, that meets your needs.

How does a DRP work?

A DRP is offered by a listed company when it allows its shareholders to use their dividends to purchase (or reinvest in) new shares in the company instead of receiving cash.

Many providers of exchange traded funds (ETFs) and real estate investment trusts (REITs) offer similar programs.

The new shares or units may be issued at a discount to the current market price and without any charge for brokerage.

Investors usually have the choice to reinvest the whole amount of the dividend or distribution in new stock or only part of it. Instructions can be altered as circumstances change.

This 'empowerment' is one of the reasons why DRPs endear themselves to AMP's chief economist, Shane Oliver. "They enable investors to exercise choice," he says.

While many of Australia's major listed companies offer them, DRPs are not compulsory (nor is paying a dividend or distribution). Check the entity's website or that of its registry for details.

Also check what happens to any residual balance after shares or units via a DRP have been purchased. Fractional share allocations (less than a whole number) are not generally offered via DRPs in Australia. Most entities will add the leftover to the next period's DRP pot. However, some donate any residual money to charity.

What are the benefits?

Rachel Waterhouse, chief executive of the Australian Shareholders' Association (ASA), says the popularity of DRPs lies in the franking credit system, which enhances the after-tax value of dividends, making them attractive. "DRPs also allow investors to reinvest earnings efficiently, build portfolios over time, and benefit from compounding without the cost of brokerage fees."

The opportunity to benefit from compounding growth by automatically reinvesting dividends or distributions and steadily increasing your holding – like forced savings – is the primary attraction of DRPs. Acquiring more shares or units enlarges an investor's holding and magnifies the potential returns over time.

It's a variation of what Albert Einstein called the 'eighth wonder of the world' – compounding interest. Better to earn it than pay it.

The simplicity and convenience of DRPs are also appealing. "Once established," says Waterhouse, "they require minimal ongoing effort." This automatic feature enables investors to buy more shares on a regular basis every time they get a dividend or distribution. They don't have to think about it – until they change their mind.

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Companies can benefit from offering DRPs, too. By allowing existing shareholders to conveniently increase their holdings, DRPs encourage loyalty and stabilise a company's investor base. Investor participation is a sign of confidence in the company's performance.

This sign, reckons Oliver, also "provides an additional check on a company", ensuring that it keeps investor expectations in mind.

DRPs keep cash within the company as retained (rather than distributed) earnings, which may be used for debt reduction, operating improvements or expansion opportunities.

Waterhouse points out that the appropriateness of offering a DRP "will depend on factors such as a company's growth strategy, capital needs and shareholder expectations".

What you need to know

Instead of reinvesting in more shares or units, you may require cash to meet immediate needs. Retirees, for example, might rely on income from their portfolio for living expenses.

Reinvesting automatically could create an over-weighting in certain positions, diminishing your portfolio's diversity and elevating risk. Taking the cash allows you to diversify into other assets, rather than adding to a position you already have.

But this is not a problem, as Oliver points out, if all your stocks have DRPs. As ever, "keep an eye on your portfolio to ensure there's balance and not over-exposure", he cautions.

Participating in a DRP transfers control over the price and timing of purchases from the investor to a company's payout policy and calendar. This could make DRPs unsuitable for traders and short-term investors who might find it more advantageous to transact directly on the market on their terms, rather than waiting for the reinvestment from a DRP at a specified time.

You may also prefer to take your payout in cash to have the flexibility to buy or sell in response to dynamic market conditions. Say, for example, the underlying asset is performing poorly or no longer providing value. It might make more sense to invest elsewhere.

DRPs are not a way to avoid tax. Income tax is paid on the dividend or distribution whether you take the cash or reinvest in further shares or units. But it does create a capital gain (or loss) event in the future when you dispose of the investment.

This requires diligent record keeping. Stock acquired under each DRP will have a different cost base from the shares or units purchased at other periods.

Focus on fundamentals

The ASA's Waterhouse emphasises that "while DRPs can be a powerful wealth-building strategy, they are not without risks and require careful consideration". Shareholder choices "often depend on their individual strategies and the composition of their investment portfolios".

In other words, DRPs are not a simple set-and-forget option. The fundamentals of good investing still apply: know what you're doing, review regularly and adjust when desirable.

And remember, the quality of the underlying asset and its management matter more than the presence of a DRP.

When aligned with your financial goals, DRPs can be an ideal tool to build wealth steadily over time. Or as Acca Dacca might say, perfect for putting your portfolio Back in [the] Black and keeping it there. ■