What Is a Dividend Reinvestment Plan (DRIP)?

A dividend reinvestment plan (DRIP) is a program that allows investors to reinvest their cash dividends into additional shares or fractional shares of the underlying stock on the dividend payment date. Although the term can apply to any automatic reinvestment arrangement set up through a brokerage or investment company, it generally refers to a formal program offered by a publicly traded corporation to existing shareholders. Around 650 companies and 500 closed-end funds currently do so.

KEY TAKEAWAYS

- A dividend reinvestment plan, or DRIP, automatically uses the proceeds generated from dividend stocks to purchase more shares of the company.
- This strategy allows investors to compound their returns over time by accumulating more shares, which themselves pay dividends that will be reinvested.
- Note that dividends paid into DRIPs are taxed as ordinary dividends even though they are used to purchase shares.

Understanding a Dividend Reinvestment Plan (DRIP)

Normally, when dividends are paid, they are received by shareholders as a check or a direct deposit into their bank account. DRIPs, which are also known as dividend reinvestment programs, give shareholders the option of reinvesting the amount of a declared dividend into additional shares, which are bought directly from the company. Because shares purchased through a DRIP typically come from the company's own reserve, they are not marketable through stock exchanges. Shares must be redeemed directly through the company, also.

Most DRIPs allow investors to buy shares commission-free or for a nominal fee, and at a significant discount to the current share price; they may set dollar minimums. However, most do not allow reinvestments much lower than $10. While DRIPs are usually intended for existing shareholders, some companies

do make them available to new investors, usually specifying a minimum purchase amount.

Additional Considerations for DRIPs

There are several advantages of purchasing shares through a DRIP, for both the company issuing the shares and the shareholder.

Advantages for the Investor

DRIPs offer shareholders a way to accumulate more shares without having to pay a commission. Many companies offer shares at a discount through their DRIP from 1% to 10% off the current share price. Between no commissions and a price discount, the cost basis for owning the shares can be significantly lower than if the shares were purchased on the open market. Through DRIPs, investors can also buy fractional shares, so every dividend dollar is really going to work.

Long term, the biggest advantage is the effect of automatic reinvestment on the compounding of returns. When dividends are increased, shareholders receive an increasing amount on each share they own, which can also purchase a larger number of shares. Over time, this increases the total return potential of the investment. Because more shares can be purchased whenever the stock price decreases, the long-term potential for bigger gains is increased.

Advantages for the Company

Dividend-paying companies also benefit from DRIPs in a couple of ways. First, when shares are purchased from the company for a DRIP, it creates more capital for the company to use. Second, shareholders who participate in a DRIP are less likely to sell their shares when the stock market declines. Partly that's because participants tend to be long-term investors and recognize the role their dividends play in the long-term growth of their portfolios. Of course, another factor is that DRIP-purchased shares are not as liquid as shares purchased on the open market—they can only be redeemed via the company.