Dividends

By Bruce McNutt

This article covers only some of the aspects of dividends. The purpose of this article is to give you a better idea of what dividends are and how they work. This article should not be considered an all encompassing article.

What is a Dividend?

Dividends are simply the profit paid to the owner of a particular stock.

When a company turns a profit, typically for a quarter of the year, the profit is distributed to the owner of the company, namely the stockholder. If the company has $1,000,000 in profit for the quarter and there are 100,000 shares of outstanding stock, each share of stock gets a $10 profit. If you own 10 shares you get $100.

Reinvesting Dividends

Depending on your situation you may elect to either reinvest dividends or take them as cash. If you reinvest them, you simply buy more shares of the stock with that money. For example if you own Home Depot stock and you receive $50 in dividends, your broker would immediately purchase $50 more of Home Depot stock. Inside a qualified plan most people typically reinvest them because you are not allowed to take that money until you turn 62. Other choices in a qualified plan would be to use the dividends to invest in another fund inside your plan.

Three Examples

Let me give you three examples of how dividends work by investigating three different stock purchases I have fictitiously made. The numbers are historically accurate.

Stock 1: Merck

Suppose back in 2002 I bought 100 shares of Merck stock for 59.60 per share for a total of $5960. Since then the price of Merck has dropped to 44.58 so the account should now be worth $4458. A pretty good sized loss...bad stock pick on my part. However, I have been reinvesting my dividends during that time so now I actually own 114.2 shares of Merck for a total value of $5092.23. That is still a $900 loss but remember it isn't a loss until I sell it. My hope is that Merck

will survive it's struggles over the past few years and when it's stock price rises again I will have more shares than I originally bought, and I bought them with money I didn't do anything to get except take some risk. At the same time I was reinvesting those dividends, I could have been taking the gains as cash, but I believe that this huge company will recover and in the long run I will be better for it. Please keep in mind by the way, I may lose all $5960 that I invested should Merck go under, (remember there is no reward without risk), and I may or may not look back and say that reinvesting those dividends was a good idea, and I may wish I had never bought the stock, but these are the decisions that investors have to make.

Stock 2 : Exxon

Now suppose that in 2002 I bought 100 shares of Exxon. The price then was 58.87 so I paid a total of $5887 for my 100 shares. Exxon has done very well over the past 5 years and the share price is now $75.46 so my 100 shares should now be worth $7546, an increase of $1659..good stock pick on my part, but that is only part of the story. Exxon has been turning a profit for the past 5 years and has been consistently paying dividends so I actually don't have 100 shares any more, I actually have 106.35 shares for a total value of $8025, an increase of $2138. It's too bad I didn't know Exxon was going to do that well or I would have mortgaged the house and bought a few thousand shares.

Stock 3 : Ballard Power Systems

Lastly suppose I bought 200 shares of Ballard Power Systems (BPS) in 2002 for $9.72 per share for a total cost of $1944. Ballard Power Systems makes Hydrogen Fuel Cells which some predict to be an energy source of the future. Unfortunately Hydrogen Fuel has turned out to be harder to make practical than originally thought and the price of BPS has dropped to $5.67, so my shares are now worth $1152, a loss of $792..bad stock pick so far, although I still have hope for a hydrogen economy and this stock hits big. Now let's look at the dividends I have received over the past 5 years and see if my dividends have offset the drop in share price. Well, unfortunately BPS has not paid any dividends over the last 5 years so I still only have 200 shares. Well what the heck?

What companies pay dividends?

Not all companies pay dividends. Just because a company turns a profit does not mean they are going to give that money to the owners of the company. It is actually at the discretion of the Board of Directors whether or not to pay dividends. Some companies prefer to take their profit and use it to build their business. Maybe they use it to build more stores, or further their research in a particular area. In the case of Ballard Power Systems, any profit the company makes is probably put back into research into Hydrogen Fuel Cell Technology and developing Hydrogen Energy. I didn't buy BPS for the dividends, I bought it

because hopefully in the future Hydrogen will be a major source of clean energy and BPS will become the Microsoft of the energy world.

(Special Note: Just because a company does not make a profit in a particular year does not mean they don't pay dividends. Some people assess the "health" of a particular company through their ability to pay dividends. If a company has paid dividends for the last 10 years but this year they didn't make a profit, they may choose to pay dividends out of earnings left over from last year, or from some other resource, just to keep up their habit of paying dividends.)

Mutual Funds and Dividends

Mutual funds pay dividends just like individual stocks do. If the companies inside a mutual fund pay dividends you get that profit as well.

Taxes and Dividends

Understanding Dividends and the way they are taxed is crucial to becoming a wise investor.

If a stock is held outside a qualified plan like an IRA or a 403(b), at the end of the year you have to pay taxes on the dividends as if you had made the profit yourself, which basically you did. (Many people will buy stock in a particular company not because they think the stock is going to go up but rather because the stock traditionally pays good dividends.) If your stocks are held inside a qualified plan like an IRA or 403(b), then you do not pay taxes on the dividends, i.e. tax deferred growth, a good thing indeed.

For the investor who owns stocks, either through individual stocks or mutual funds, he needs to be careful about how he manages his dividends. For example, lets say you are having taxes taken out of you paycheck to pay your income taxes and at the end of the year you have paid your income taxes perfectly so you don't owe the government any taxes and they don't owe you a refund. Perfect. Now let's say you also own 300 shares of ExxonMobil stock and they paid total dividends of $10 per share this year. That is $3000 in dividends you received this year. $3000 in "free money" is a great thing, but what if you reinvested those dividends? If you reinvested them you just bought another $3000 worth of ExxonMobil stock with your "free money" but the Tax Man is coming. When you fill out your income tax return you will be expected to pay taxes on that $3000 and if you didn't plan on having $450, (dividends are typically taxed at 15%), laying around to pay those taxes, you may be up the creek trying to come up with the $450 to pay the taxes. The moral to the story is you need to keep in mind that dividends represent profits and you need to be prepared to pay the taxes on the dividends at the end of the year.

Going back to my story about buying Merck stock, just because I reinvested those dividends doesn't mean I didn't have to pay taxes on those dividends. My Merck stock is held in a brokerage account at Vanguard and at the end of the year Vanguard sends me a "1099 Form-DIV" that shows my total dividends for the year. Every year that Merck paid me dividends I had to make sure I had the cash to pay the taxes.

What many older people do is hold stocks that tend to pay out larger dividends and they take that money as their income for the year. These older types aren't so interested in the stock price going up, they are more concerned in receiving steady dividends and since dividends are typically taxed at 15% that is a pretty good rate.

Dividends inside a 403(b) and Tax Deferred Growth

For you, the 403(b)(7) investor, dividends are **GREAT**. For example, recently I was helping someone understand their Vanguard statement and they have about $140,000 in their 403(b)(7) in an S&P 500 fund. This past year they earned around $4000 in dividends. Those dividends were reinvested right back in the same S&P 500 fund. That means that last year she contributed $15,000 to her 403(b) of her own money, plus a **FREE ADDITIONAL $4000**. All it cost her was the risk she took in making the investment in the first place. In case you don't understand; Dividends are great, Dividends inside a 403(b) are REALLY GREAT.

So here is your first quiz, why are Dividends so great when earned inside a 403(b)? The answer of course is Tax Deferral. **You do not have to pay taxes on the dividends you receive in a 403(b)**! So not only did she invest an additional $4000 “free dollars”, she got to invest them tax free. That's why when you use one of those online calculators I’ve suggested you check out, your money can grow to such huge amounts. Next year it is likely that she earns even more in dividends because she has even more shares of those stocks. (Compounded growth right?) In fact, even if the market goes stale for a few years, like it has from 2000 until now, you can still reap the benefits of a 403(b) by reinvesting your dividends and when the market hopefully grows again, you will be even better off because you continued to buy shares all along, plus you now have extra shares that you bought with your dividends.

(To Keep in Mind: While it is true that when you reinvest dividends in your 403(b) you do so tax free, meaning that in the year in which you received the dividends you do not pay income tax on them, you do not however never have to pay taxes on the dividends. When you eventually get around to taking the money out of your 403(b) you pay taxes on that money as if it was ordinary income. For example, let's say that in the year 2025 you

take $10,000 from your 403(b)(7). That $10,000 is made up of original money you put in 30 years ago plus dividends you have received over time plus capital gains. It would be impossible to tell what part of the $10,000 is what, but it doesn't matter. What matters is that you just took out $10,000 and that money is treated as if you had made it working at a job i.e. ordinary income. On your tax return that year you would list the $10,000 on the "ordinary income" line of your tax return and you would then finally pay taxes. That is what "tax-deferred" really means, you will pay taxes, but not until later, hopefully after your money has had time to grow.)

Why not only invest in stocks that pay dividends?

Just because a stock doesn't pay dividends doesn't mean that it isn't a good stock to purchase. If I knew that a stock was going to go from $10 per share to $90 per share over the next 10 years, I couldn't care less that that stock was going to pay dividends. The point is that sometimes the benefit of owning a particular stock is it's change in price, sometimes it is it's dividend paying, and sometimes it is a combination of both. Some companies pay dividends now but may not in the future, and some don't pay dividends now but will pay them in the future. That's just another reason people diversify.

Conclusion

Hopefully you now have a better idea of dividends and how they affect you as an investor. It's time to go do some research on your own. First, go through your year end statements and see what kind of dividends you have been earning, you may be pleasantly surprised. Then Google "Dividends" and see if you can read and understand. If you can, you'll know you are on your way.

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