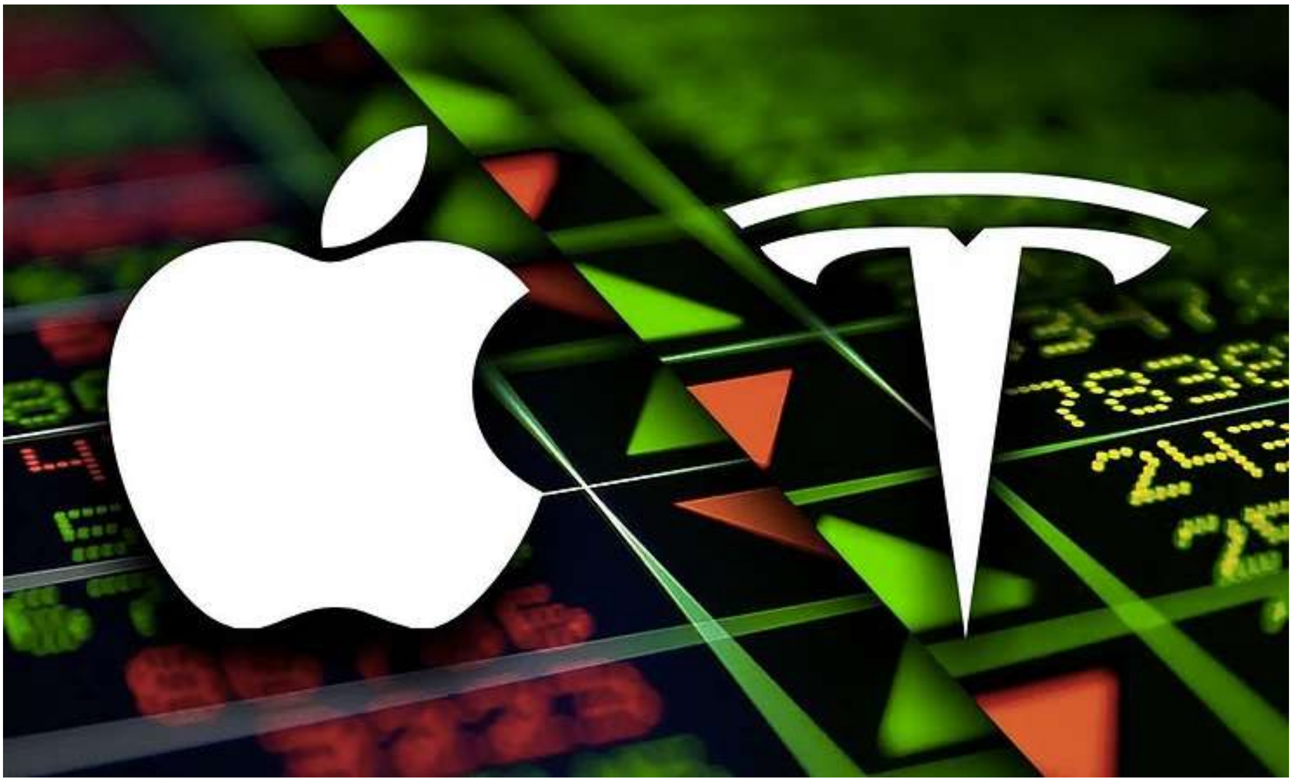
Stock Splits: What They Are, How They Affect Your Portfolio



When you had to split something as a kid, that generally didn't feel like a perk- it meant you had to share!. But as an investor, splits can be a good thing.

Electric car maker Tesla and tech giant Apple took the US market and the broader investment world by storm when they made the surprise decisions to split their stocks a few weeks ago.

Apple decided to enact a 4-for-1 split, while Tesla approved a 5-for-1 split to make the stocks "more accessible to a broader base of investors".

Investors cheered the news, pushing both stocks, already on a tear, higher, at a time when the pandemic-hit market is trying to rebound from the March falls.

This was Tesla's first ever split, whereas it was Apple's first split in six years.

When Apple and Tesla stocks began trading on September 1 for the first time after their splits, they picked up exactly where they left off: clocking nearly 4 per cent and 12 per cent jumps, respectively, for the day.

If you are wondering what this numerical gymnastics is all about, here's a handy pizza themed guide to bring you up to speed with the inner workings of a stock split.

Why pizza? Because as with many things in life, pizza can help.

What is a stock split?

A stock split is when a company issues new shares and distributes them to existing shareholders.

Ok, pizza time…

Imagine a company's value represented by an entire pizza. When its stock began trading, that pizza was sliced into a finite number of pieces, or shares, that were offered to investors. For simplicity's sake, let's say the pizza was divided into eight slices and you owned one slice (or one share).

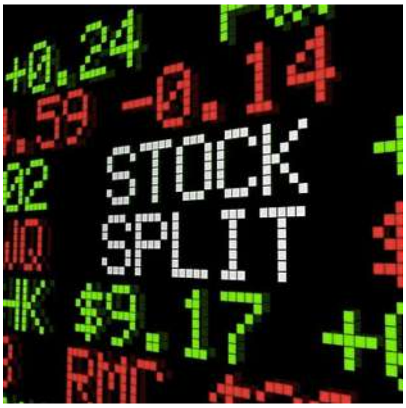
If a company announces a 2-for-1 split, the number of shares doubles, so the original pie will be divvied up into 16 slices. Whereas you owned one-eighth of the company before, as a result of the split you'll now own two-sixteenths. Same amount of pizza, just a different number of slices.

The total aggregate value of your position is the same, you just now own more shares to get to the same total… A stock split has no impact on the intrinsic value of the company.

All a stock split does is change the number of outstanding shares of a company's stock without altering the shareholders' ownership percentage in the company.

While the move does not alter stock valuation, what can happen is that investors increase their demand for the stock and the stock moves up on the news, like Tesla did in a massive way.

Why do companies do it?



It is widely believed that companies perform stock splits to "democratise" ownership of their shares. Stocks that have had a wild run-up in prices tend to squeeze out small investors who may not be able to afford the higher price of an individual share.

By undertaking a stock split, companies try to make their shares more attractive and accessible to smaller investors. On a more psychological level, it also (gently) fuels the notion among existing shareholders that they now have "more" shares of a company than they did previously.

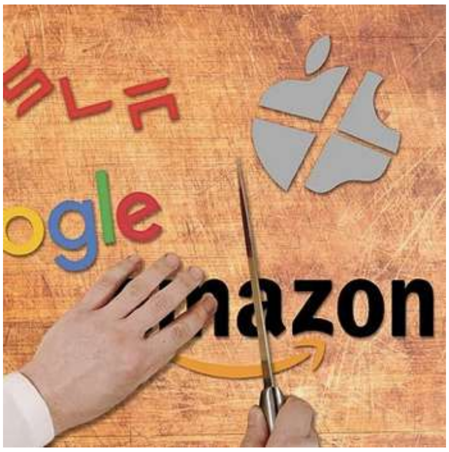
It is worth noting that some companies have not done splits, and this could be seen by some as a way of 'keeping the riff-raff' out.

Berkshire Hathaway is one example, to buy one 'A' share of Berkshire Hathaway, you need more than $327,000! (Berkshire Hathaway's 'B' shares are somewhat cheaper we must note)

It is also argued that the introduction of fractional share ownership provided by online brokerage platforms has rendered the rationale for a stock split obsolete. Some industry experts point to fractional investing as the reason why companies are no longer splitting their stocks as they did in the 1990s.

Are stock splits making a comeback?

Stock splits have been out of vogue in recent years. While 1997 saw 102 stock splits among companies in the S&P 500, there have only been a handful so far this year.



However, with Apple and Tesla announcing stock splits within days of each other, speculation is rife that others may follow suit.

It's difficult to say what other tech firms will do, but Amazon and Alphabet have had a long time to split and don't currently seem interested. But the fact that both Apple and Tesla had seen large increases in value before their respective splits might change the thinking of similar companies.

A slew of new stock splits could be in the cards if those of Apple and Tesla prove successful in the short to medium term. Amazon has not split its stock since before the dot-com bubble in the late 1990s. As such, its high share price without doubt limits the majority of investors' ability to purchase its shares.

Throughout the 2000s and 2010s, companies largely shied away from stock splits, viewing their share price rises as a status symbol. (Mine's bigger than yours syndrome!)

The Apple and Tesla stock splits herald a shift, though. As I said, their shares have been increasing significantly over time and share splits can thus provide the opportunity for greater inflows into these stocks, ultimately increasing the value of the company.

However, In terms of its financial impact, it's a "non-event" because the share split does nothing on the day of the split to increase wealth, but a company that continually goes up and splits is a good investment - and tech seems to be the industry where that is likely to continue to happen in the current environment - So actually, it might be the opposite of a 'non-event"!

Why should investors care?

Regular stock splits don't mean anything in particular. While the individual unit costs less to buy after the split, the fundamentals of a company – from the valuation metrics to price-to-earnings ratios and the market cap – remain unchanged.

The perception of affordability among a larger base of investors, though, could add value to a company's equity.

The fact is corroborated by the whopping 12 per cent jump in Tesla shares the day after its 5-for-1 split was announced. Nothing fundamentally changes, but smaller investors may now be able to invest, or at least feel more comfortable investing, which can benefit the stock.

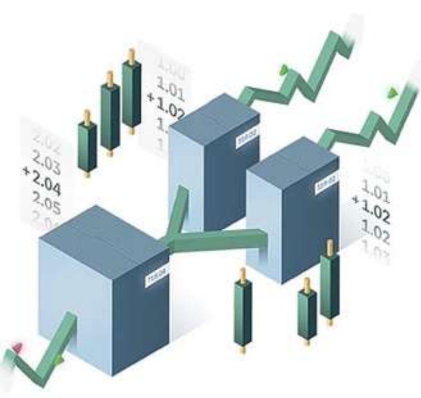
There is another reason to keep a close eye on stock splits. It is particularly relevant to those who invest in index funds and exchange-traded funds (ETFs) that track indices, especially the Dow.

As the index is price-weighted, Apple's stock split diminished the company's oversized influence on the benchmark. Apple went from having the biggest weighting in the index to 16th, post-split. This has implications for Dow 30 investors as their returns will depend considerably less on Apple's performance going forward, and many would see that as a more balanced Dow 30.

A stock split is also a measure of confidence a company has in its growth prospects. One factor that is often quoted is that a share split can be viewed as a positive from the management of a company as they would be unlikely to split a stock that they thought would fall.

What comes after the split?

Some market observers say there's evidence that a split represents a "buy" signal.



Notably, between 1990 and 2015, stocks averaged a hefty 21% return during the 12 months following a split, compared to a 9% gain for the S&P 500.

History shows Apple typically outperformed the S&P 500 by nearly 8% in the six months following its stock splits in 1987, 2005 and 2014, according to Evercore ISI Research.

Numerous other studies have concluded that, historically, shares that have split have beaten the market over the following one and three years.

This could be caused by the publicity of the split, the belief that the split conveys important private information on future performance, or from the increased investment from smaller investors building up the price of their shares further.

Finally…

That being said, there is a significant amount of information to factor into share prices and a share split alone is not enough to guarantee future performance, so as always I stress the need for "a broadly diversified approach" that minimises your risk but optimises the chance of achieving your investment objectives.