

The Sound Investor Series #57

Back to Basics – Stock Splits

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This week's column goes back to basics. One area investors are confused about is stock splits. Like many financial concepts, it is relatively simple once explained, but until then can be very confusing.

Stock splits have NO economic consequences for shareholders or companies and that is the most important point to take away from today's column. Companies split stock to control their trading price and most stock splits are purely cosmetic. For a simple example, it is commonly believed that U.S. investors do not like to buy shares for over \$100, so when the stock price approaches that level, companies often split their stock to lower the trading price.

To illustrate the dynamics of a stock split let's look at Lehman Brothers (LEH), the large Wall Street investment bank where I got my start in the business. On April 6, 2006 LEH announced a 2 for 1 stock split when its stock was trading at \$146.

By splitting its stock, LEH was effectively breaking the ownership in the company into smaller pieces. Before the split, LEH's "ownership pie" was divided into 268 million shares, so each share gave investors ownership of 1/268 millionth of the company. After the 2 for 1 split, the "pie" was still the same size, but was cut into smaller pieces and the number of "shares" increased. In the case of LEH's 2 for 1 split, the number of outstanding shares doubled and went from 268 million to 536 million. Since the whole "pie" didn't get bigger, the value and price of each share was cut in half.

Importantly the value of a shareholder's investment didn't change. Owning 1/268 millionth of a company is exactly equivalent to owning 2/536 millionths. If an investor owned 1.0% of LEH shares before the split, their ownership was still 1.0% after the split. Putting it another way, if an investor's stake was worth \$10,000 before the split, it was still worth \$10,000 after the split.

I am sure some readers are shaking their heads and asking why many people think stock splits are positive, if nothing really changes. A good question. Studies show that stocks are just as likely to go down after a split as they are to go up. Just using a "back of the envelope" calculation for the last few months shows that this is generally the case. Of the 110 stock splits, 52 stocks went up, 57 went down and one was unchanged from the time of the announcement to when the split was effective.

I believe one reason investors feel good about splits is because only stocks that have risen, split. If a stock is trading water or falling, it is never split.

As mentioned, investors like to buy stocks in certain price ranges. U.S. investors don't like to buy shares for over \$100 or less than \$5. This dynamic can be observed when companies go public via an initial public offering (IPOs). The companies will often adjust the number of shares outstanding so that the share price is in the high teens or low 20s as investors find these prices to be optically appealing.

Another good example of this phenomenon is Southwest Airlines (LUV). LUV has performed spectacularly over the past 30 years and split its stock 15 times to try and keep it in the range of the high teens to low 30s.

U.S. investors also dislike stocks under \$5, and brokerage firms often impose special restrictions limiting customers' ability to buy them. If a stock falls below \$1, the New York Stock Exchange stops trading them. When this happens companies often use reverse splits to increase their stock prices. In the market turmoil of 2002, a number of companies conducted reverse stock splits to raise share prices by reducing the number of shares outstanding.

Interesting, what's optically appealing to investors is often culturally specific. Most U.K. stocks trade at what we consider very low prices. This doesn't necessarily mean that the companies are worth less, it simply means the "pie" is cut into smaller pieces and more shares are outstanding.

Let's not overlook another point with stock splits. Wall Street firms have an incentive to see more shares trade since commissions are charged based upon the number of shares bought or sold, rather than the amount of dollars involved. A \$10,000 order will cost customers more after a split than before, simply because a greater number of shares are involved. In the U.K. on the other hand, commissions are based on the amount of money involved in the trade, not on the number of shares.

Lastly, let me point out one of the few companies resisting the urge to split their stock to make it look more attractive – Warren Buffet's Berkshire Hathaway. This stock has never split and now the Class A shares trade at \$90,690 each. This high price puts it out of the reach of most individual investors, so 10 years ago Berkshire created a Class B share worth 1/30 of the value of the Class A. The Class B shares currently trade at \$3,023 and to most of us it "feels" very expensive. Just think, if Berkshire split the Class A stock 10,000 to 1 and it started trading at \$9.07, we would all feel it was cheap. See how easily we can fool ourselves!

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