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Solving High-Class Problems

Rising stock prices can create challenges for companies and investors. To alleviate these high-class problems, boardrooms often authorize a stock split. What exactly is a stock split, and how does it work?

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Mo Money, Mo Problems

The only thing that looks better than a crisp $100 bill in a wallet is several crisp $100 bills. But the problem with $100 bills is that they are impractical. Most merchants will not accept them, and they don't work well for small purchases. Hence, it's often best to exchange them for smaller bills.

High stock prices can cause similar challenges for companies and investors. For example, Berkshire Hathaway (ticker: BRK.A) is over $305,000/share and has averaged only 330 shares traded daily over the last five years[1]. This makes transacting more difficult and expensive when compared to a stock with higher volume.

Furthermore, individual investors often have a hard time owning higher-priced shares. A mere 10% allocation to BRK.A requires a portfolio size of over $3 million ($305,000 ÷ 10% = $3,050,000). If an investor wants to buy exactly $500,000, they are out of luck unless the broker offers "fractional shares," which is the ability to buy part of a share of stock.

Management can also face challenges paying its employees in stock. For example, if an employee earned a $2,500 bonus to be paid in stock, but the stock is $3,000/share, they may have a problem.

Corporate boardrooms occasionally split their stock to alleviate these issues. A stock split is a corporate action that increases the number of shares, which in turn reduces its price. The stock's market capitalization, or the total value of the equity, remains the same. It's no different than swapping a $100 bill for five $20 bills at the bank. The number of bills in a wallet rises but the total value of cash is unchanged.

For example, a 2-for-1 stock split adds an additional share for each share held, but the value of each share is cut in half. If a shareholder owns 50 shares of a $100 stock for a total of $5,000 ($100 x 50 = $5,000), the investor would now own 100 shares of a $50 stock for the same total of $5,000 ($50 x 100 = $5,000).

Apple Slices

Apple (ticker: AAPL) recently announced that its board approved a 4-for-1 stock split. This means each Apple shareholder will receive three additional shares for every share held. This is not the first time Apple has split its stock, and although it may alleviate some of these challenges, there could be other motivations at play.

Stock splits can impact the marketability of a company's stock in several ways. First, lowering the share price could increase demand from individual investors who have wanted to own Apple but couldn't afford to pay $400+ for a single share. It may also attract those investors who could have owned a handful of Apple shares but were put off by its high price. Now they can own 4 times as many shares.

Second, stock splits are usually announced after a run up in price, and investors tend to favor stocks with positive momentum. This interest along with the media hype that follows can add even more demand.

The third is the Dow Jones Industrial Average (Dow). This closely followed index of 30 stocks is price-weighted, where higher-priced stocks carry larger weights. Since so many money managers and media outlets track the Dow, there is an incentive to get in the index and stay in. Ironically, the best way to do this is by being average.

If a stock in the Dow were to rise or fall too much, it would have an outsized impact on the index since its weight is purely based on the price. Meaning, if Apple or any other constituent were to rise too high, it could risk being removed from the index even though the overall value of the company continues to move in a positive direction.

Since its inclusion in 2015, Apple's stock price has increased so much that it now carries the largest weight in the index at over 11%[2]. By splitting the stock now, Apple can go back to being average.

To be clear, there is nothing nefarious or devious going on here. Apple does a great job marketing its high margin products to consumers, so it's not surprising they have had equal success selling their stock to investors. In fact, all large publicly traded companies have dedicated teams whose sole purpose is to market their stock to prospective investors and answer questions from existing shareholders.

Simply put, Apple is splitting its stock for the same reason any other company splits their stock – to sell more of it.

The Bottom Line

Advances in trading, the elimination of transaction fees, and the rise of passive funds (investors buying more index funds and fewer individual stocks) have made stock splits a lot less common these days. There is also an administrative cost. According to the Wall Street Journal, splitting a stock could run a large company as much as $800,000[4].

But Apple's stock popped nicely after they announced the split, and it's likely that other boardrooms took notice. If so, the herd mentality that drives corporate America may inspire others to follow suit.

Currently, over 41% of companies in the S&P 500 are trading above $100/share[4]. This had historically been the line in the sand where management considered a split. Some high-profile stocks like Amazon, Google, Tesla, and Chipotle all trade above $1,000/share[1]. Meaning, there appears to be a healthy pipeline of companies that could be next.

The bottom line is that a stock split does not increase revenues, profits, cash flow, or competitive positioning in an industry. All it really can do is impact the valuation of the stock by potentially increasing demand, but that's ok. Trends that expand the shareholder base, lower transaction costs, and make diversification easier for individual investors is a big win for all parties involved.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer

Sources

1 yCharts, As of 8/5/2020

2 http://indexarb.com/indexComponentWtsDJ.html

4 https://www.wsj.com/articles/stock-splits-pay-offon-the-rare-occasions-they-occur-11596274200

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