

Stock Splits: A Closer Look at Their Effects

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For investors, it can be pretty exciting to hear that a stock you own is about to be split, because a share price that is too high is a good problem to have and one that's typically confronted by successful and growing companies. While a split doesn't actually make your investment any more valuable in and of itself, a lower share price and the resulting increase in trading liquidity can certainly attract additional investors. However, sometimes that initial feeling of pride in a stock split is followed by confusion as investors wonder how the stock split affects things like outstanding market orders, dividend payouts, or capital gains taxes.

The good news is that, in the electronic age, most of the necessary adjustments are made for you. Still, it's a good idea to understand how a split works and how it can impact—or not impact—your investment strategy.

Key Takeaways

- A company will sometimes announce a stock split when the price of the shares has risen to the point that it might be unappealing to investors who are more comfortable with lower-priced securities.
- A dividend, or cash payment made periodically by a company, is typically adjusted proportionately to reflect a stock split, so that the total paid out does not change.

- Stock splits will affect options holders, but the necessary adjustments are made automatically in their accounts.
- Be sure to reset any stop or limit orders with your broker after a stock split takes effect.

Stock Splits 101

Typically, the underlying reason for a stock split is that the company's share price is beginning to look expensive. Say XYZ Bank was selling for \$50 a share a couple of years ago but has risen to \$100 per share. Its investors, no doubt, are pretty happy.

But suppose that other stocks in the financial sector are trading well below this figure. Those other equities aren't necessarily a better value, but casual investors sometimes make that assumption. To fight this perception and improve liquidity, companies will consider increasing their shares outstanding by issuing additional shares to shareholders, which proportionately lowers the share price.

If XYZ Bank announces a 2-for-1 stock split (also described as a 2:1 split), it will issue to investors one additional share for each share they already own. Because the bank's value hasn't changed but the number of shares has doubled, each share is now worth \$50 instead of \$100. The split may elicit additional interest in the company's stock, but fundamentally investors are no better or worse off than before, since the market value of their holdings stays the same.

Advanced Trading Strategies

For most trading activity, the effect of a stock split is pretty straightforward. But naturally, investors with more complicated positions in the stock—for instance, if they're short-selling it or trading options—may wonder how the split affects those trades. If this is you, take a deep breath. In both these cases, your trades are adjusted in a way that neutralizes the impact on your investment.

Selling Short

First, let's look at short-selling, a strategy in which the investor is betting that the stock price will decline. The investor borrows shares through a brokerage account and agrees to return them at a later date. The borrowed shares are immediately sold in the expectation they will decline in value, allowing the short-seller to profit by repurchasing them for less when closing out the trade.

On the surface, a stock split might seem like a stroke of great luck for the short-seller. If you've sold 200 XYZ shares at \$100 each, you can now acquire them at just \$50, right? Unfortunately for short-sellers, it's not that simple. The brokerage will adjust your order to account for the split, so that you'll owe twice as many of the lower-priced shares. When all is said and done, the stock split doesn't affect your position one way or the other.

Options Contracts

The same is also true of options, which give holders the right to buy or sell a stock at a pre-determined price within a certain period of time. If you own an XYZ call option with a strike price of \$80—meaning you have the right to purchase the stock at that price—the split doesn't mean you're suddenly "out of the money." The Options Clearing Corporation automatically adjusts the contract's size to reflect the stock split—in this case, doubling it to 200 shares from 100—while reducing the strike price to \$40. Again, the investor comes out even.

Cancelation of Stop Orders

One area where stock splits can have an impact is a stop order. Such orders instruct the broker to sell a stock if the price goes above or below a given level. Often, people use a stop order to protect against significant losses, especially in cases where they can't, or don't intend to, monitor the stock price regularly.

Don't assume your brokerage will adjust the trigger price following a stock split. In most cases, the stop order is simply voided. Therefore, you'll have to place a new stop order with the broker.

Eligibility for Dividends

One of the common questions that investors have after a stock split is whether their new shares are eligible for previously declared dividends. This usually isn't the case, because companies splitting their stock are not increasing total dividend payments in doing so. Only shares held as of the dividend's record date qualify for dividend payouts. As always, investors shouldn't buy the stock after a dividend record date in the hopes of receiving the related dividend.

In general, dividends declared after a stock split will be reduced proportionately per share to account for the increase in shares outstanding, leaving total dividend payments unaffected. The dividend payout ratio of a company shows the percentage of net income, or earnings, paid out to shareholders in dividends.

If before the 2:1 split, XYZ Bank's target payout ratio is 20% of \$100 million in earnings, that means its target dividend payout to shareholders in total is \$20 million. If XYZ has 10 million shares outstanding, its dividend per share is \$2 per share (\$20 million total dividend payout ÷ 10 million shares outstanding). After the split, the company would have 20 million shares outstanding. Per share dividends would therefore be \$1 (\$20 million total dividend payout ÷ 20 million shares outstanding). You can see that the total dividend payout made by XYZ to its shareholders didn't change at \$20 million, but the per share dividend decreased because of the increase in the number of shares outstanding.

In reality, most companies avoid announcing a stock split close to the date of record in order to avoid any confusion.

Calculating Capital Gains

Figuring out how much capital gains tax you owe can be a pain as it is, and stock splits don't make it any easier.

Investors will have to adjust their cost basis—that is, the cost of the shares they own—to accurately calculate their profit or loss.

If you owned XYZ Bank stock prior to its 2:1 split, your basis for each of those original shares is now \$50, not \$100. Otherwise, it may look like you're trying to hide profit on your tax form—never a good idea.

Keep in mind that you may not sell your stock for several years after a split, so it doesn't hurt to do a little research and figure out if the shares were split at any point after the initial purchase. Of course, you'll want to adjust your basis each and every time the stock was split. Fortunately for investors, many brokerages will make the necessary adjustments when calculating the cost basis for a holding.

New Stock Certificates?

While you may have paper stock certificates for the original shares you purchased, don't necessarily wait for new ones to appear in the mail following a stock split. More companies are now issuing new shares in book-entry form (i.e. electronically) rather than the old-fashioned way.

To figure out how a particular company handles this, check the Investor Relations section of its website. Either way, don't destroy those original paper certificates—they're still valid.

The Bottom Line

In most cases, your brokerage will automatically adjust your trades to reflect the new price of a stock that has split. Still, investors should take extra care when reporting a post-split cost basis and be sure to re-submit any stop orders placed prior to the split.

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1. Options Clearing Corporation. "By-Laws." Page 74.
2. Internal Revenue Service. "Publication 550: Investment Income and Expenses." Page 40.