

What Is a Stock Split?

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Here Is What a Stock Split Means for the Average Investor

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New York Yankee legend Yogi Berra once said, “You better cut my pizza into four slices because I’m not hungry enough to eat six.”

But the pizza pie is still worth the same no matter how many slices you cut it into.

That's essentially what a stock split is. A stock split allows a company to break each existing share into multiple new shares without affecting its market capitalization (total value of all its shares) or each investor's stake in the company. A stock split can be a good sign for both current and prospective shareholders.

In recently stock split news, GameStop announced it plans to seek a stock split. The company says it wants to request approval at an upcoming shareholder meeting, and increase the number of authorized shares of Class A common stock from 300 million to 1 billion in the form of a dividend. Shares of GameStop soared in after hours trading on the heels of this news.

And recently, Tesla requested its shareholders approve a stock split at the next annual shareholder meeting in an effort to pay stock dividends to investors. This is through a filing with The Securities and Exchange Commission. (Dividends are payouts to shareholders on a recurring basis.) The electric car maker last had a 5-for-1 stock split that went into effect on Aug. 31, 2020.

Stock splits don't really change anything, except for making shares of companies easier to buy.

"If you own 1% of the company before the split, you will own 1% of the company after the split," says Robert Johnson, a professor of finance at the Heider College of Business at Creighton University. "Investors tend to like splits because it signals that they are invested in a thriving company."

Keep reading to learn how stock splits work, how it affects you as a shareholder, and whether it's worth investing in a company after a stock split.

A stock split is a corporate action that companies take to increase the number of outstanding shares and decrease the value of each share. In other words, as a company's stock price increases, investors are rewarded with higher returns. But eventually, the stock may reach a price that makes it difficult for new investors to jump in, which is when the stock split comes in.

When a company goes through a stock split, it uses a particular ratio to indicate how many new shares each outstanding share will be broken into. Investors will receive a number of shares that's equal to their current stake in the company but reflects the stock split.

"A stock split is when a company that is issuing stocks wants to change the per-share price," said Meghan Railey, a Certified Financial Planner and the CFO and co-founder of Optas Capital. "There is no change to the market cap of the company. For example, if it's a 2-1 split and the stock is \$10, you go from having one share of stock at \$10 to two shares of stock at \$5 each. There's no economic value change."

A recent example of a stock split occurred in August 2020 when Apple did a 4-for-1 split, meaning each share of the company's stock was broken into four new shares. Shares went from costing \$499.23 per share to just \$124.81.

Why Companies Do Stock Splits

A stock split is often a sign that a company is thriving and that its stock price has increased. While that's a good thing, it also means the stock has become less affordable for investors. As a result, companies may do a stock split to make the stock more affordable and enticing to individual investors.

"When a stock starts to creep up and looks expensive, it used to be common practice to do a stock split to make your stock look more attractive from a per-share price to encourage buying of the stock," Railey said.

And while stock splits can increase a stock's liquidity and make it more accessible for investors, not all companies engage in them. According to Railey, some companies prefer to keep their stock prices high.

"There are two types of companies," Railey said. "Growth companies want to see their stock price go way up. Tesla is happy that their per-share price is high because it adds to the allure of their stock. Value stocks still have the opportunity to utilize stock splits to attract investors."

In perhaps the most famous example of a company avoiding a stock split, Warren Buffet's company, Berkshire Hathaway, has never split its Class A stock. In December 2021, the stock was trading at about \$420,000

What Happens When A Stock You Own Splits?

As a shareholder, you may worry that a stock split will affect your investment. But ultimately, there's little impact on you as an investor.

"It is important to remember that the owner is in exactly the same position as before — their ownership percentage is identical," says Johnson. "They will own more shares, but each share will represent a correspondingly smaller percentage of ownership in the company."

If anything, investors may actually notice a boost after a stock split. As the stock becomes more affordable and more people can trade it, the stock's price can go up.

What Does This Mean for the Average Investor?

Typically, stock splits are neither good nor bad, especially in the long run. When a stock splits, investors usually see an uptick in interest in that stock but everything should settle down in a few days when the fuss is over.

But if a stock split still worries you, consider investing a majority of your investment portfolio in an index fund or ETF which is a collection of hundreds of stocks, rather than just one. Experts agree that this is a better way to diversify your portfolio and save for retirement. Putting your money in lots of different companies is better in the long run when compared to just investing in a select few. Investing this way typically is the clear winner when compared to stock picking.

What Is a Reverse Stock Split?

The opposite of a stock split is a reverse stock split. It's when a company reduces the number of outstanding shares. Rather than breaking each share into multiple new shares, a reverse stock split is when a company condenses multiple shares into a single share, which trades at a higher price point.

"Just as stock splits are a sign that a firm is thriving, reverse stock splits are an admission of a struggling firm — a huge red flag," Johnson said. "Investors are well served to sell their holdings of firms announcing reverse stock splits. Investors not holding securities of those firms should refrain from buying them."

Just as with a stock split, there's no change to the market capitalization of a company, nor is there a change to each investor's stake. However, they can still be a sign of trouble.

Companies may go through reverse stock splits to avoid being delisted from a stock exchange if they're nearing the minimum share price allowed on that exchange. They also might do a reverse stock split to improve the company's public image or draw attention from high-profile investors or analysts.

Are Stock Splits Announced Before They Happen?

If a company that you're a shareholder of goes through a stock split, you'll get some advanced notice. Once a company's board of directors approves a stock split, the company is required to notify the Securities and Exchange Commission at least 10 days before the proposed split. The company generally makes a formal public announcement to alert its shareholders.

"When a company announces a stock split, they give out two dates that are important to shareholders: a record date and an ex-date," Johnson said. "You must hold the stock at the close of business on the record date to be eligible for the split, while the actual split itself and the adjustment to the number of shares in your account takes place on the ex-date."

Should You Invest After a Stock Split?

If you've been considering investing in a particular company, after a stock split can be a good time to do so. Stock splits are generally a sign that a company is doing well, meaning it could be a good investment. Additionally, because the per-share price is lower, they're more affordable and you can potentially buy more shares.

Pro Tip

If you're considering investing in a particular company, after a stock split can be a good time to do so. But remember, the key to building wealth is diversification so individual stocks may not be the answer.

But remember, diversifying your portfolio is the key to building wealth so consider broad-based investments like index funds and ETFs first before individually stock picking. The S&P 500 index fund is a great place to start.

Also, remember that if you're investing in a company after a stock split, approach it with the same level of analysis and curiosity that you would any other company. While a stock split can be a good sign, it's important to do your research before investing in any company.