BUILDING BLOCKS FOR RETIREMENT

Investment Strategy

Stock Splits -- The Good and the Bad

When a publicly traded corporation announces that it plans a stock split, should shareholders be pleased or should they be concerned? The answer? It depends on the situation.

Forward Splits

The price of a stock moves up and down depending on how much investors are willing to pay for it at a given time. Investors typically buy a stock because they believe it will increase in value over time. However, when the price of a stock increases significantly, investors may be reluctant to buy it because they believe its price has peaked or because a single share costs so much. A corporation's board of directors may decide to boost the stock's liquidity and facilitate trading by splitting the stock.

When a stock splits, more shares become available at a lower price, which stimulates interest and trading in the stock. In addition, the increased liquidity can help companies repurchase shares at a lower cost since the typically large trades they place will have less of an impact on a more liquid security. While the number of outstanding shares increases by a specific multiple during a stock split (two-for-one, three-for-one, etc.), the total dollar value of all shares outstanding remains the same. A stock split does not fundamentally change the market capitalization of the corporation issuing the shares.

Example: The stock of Acme Corporation trades at $200 a share. The company announces that it is declaring a two-for-one split on a specified date. That means that owners will receive two shares in Acme Corporation for each share they own. At the same time, the price falls to $100 a share. If you owned 100 shares selling at $200 a share, you would have 200 shares selling at $100 -- yet the value of your shares would remain unchanged at $20,000.

While the total value of the shares an investor owns does not change at the time of a split, the price of each share may rise over time, even to the pre-split price, increasing the value of the investor's stock. The increased number of shares available at a lower price often brings in new buyers. A stock split is generally viewed as a bullish sign for investors since splits often indicate that the company's executives and board of directors have a high degree of confidence in the corporation's prospects.

Reverse Splits

In a reverse split, a corporation decreases the number of shares outstanding while increasing the price proportionately.

Example: Beta Corporation has announced that it plans to give shareholders one share for every 20 shares they own. Thus, if you owned 500 shares of Beta Corporation before the reverse split, you would end up owning 25 shares after the split. Assuming the price of one share was $0.75 pre-split, it would increase to $15 after the reverse split. While the share price has increased, the overall value of your holding in Beta Corporation would remain unchanged.

Why do corporations do a reverse split? By and large, it is an attempt to lift the price of the corporation's stock in order to meet a stock exchange's minimum price for which it will list a stock. In addition, a reverse split may be intended to attract institutional investors, such as state and municipal pension funds, which typically do not buy very low-priced stocks.

A financial professional can explain in more detail what to expect when a company that you own stock in announces a stock split.

PENTEGRA

701 Westchester Ave, Suite 320E, White Plains, New York, 10604