The Real Reason Stock Splits Matter

Description

During the first part of 2014, **TD Bank** (TSX: TD)(NYSE: TD), **National Bank of Canada** (TSX: NA), and **Canadian National Rail** (TSX: CNR)(NYSE: CNI) all announced they would split existing shares two for one, meaning an existing shareholder would end up with twice as many shares at half the original amount. And, of course, just last week, **Apple** announced that it would split shares seven for one, which paves its way into being included in the Dow Jones Industrial Average.

In theory, a stock split shouldn't matter. It's simply a paper transaction that exchanges one share for two. It doesn't increase earnings or give investors higher dividends, although it is common for companies to increase dividends at the same time as splitting shares. The longstanding argument in favor of splitting shares is that cheaper share prices make more attractive targets for retail investors.

But upon further scrutiny, even that argument doesn't hold up. Computerized systems and high frequency trading have greatly increased volumes, and lower commissions have made trading less than the traditional 100-share lots easy and relatively cheap.

Even the proportion of shares owned by individual investors is going down, dropping steadily from two-thirds of all shares outstanding to one-third, as investors have flocked to managed products and the size of pension funds has increased. Many investors left the market during the Great Recession, and haven't returned. Why bother splitting shares for a shrinking set of investors?

But yet, shares that split continue to outperform the market. Shares in TD, National Bank, and Canadian National Rail have all beat the TSX Composite index since their splits. Apple shot up more than 8% when it announced its split. These aren't isolated cases either.

According to a study quoted by the *Globe and Mail*, shares in companies that split between 1976 and 1991 continued to outperform the market by more than 7% in the first year, 9% in the second year, and 12% in year three. This outperformance is significant enough to warrant further study.

So why does it happen?

There are a couple of theories. If the number of shares doubles, suddenly a company will have a great deal more liquidity. Word spreads, and other investors start to examine the name. It's an easy argument to make for a stock that's not really well known, but it doesn't hold up when offered as an explanation for TD Bank or CN Rail's outperformance. These stocks are among the biggest companies in Canada. Every investor is aware of their existence.

Or, perhaps it's more of a chicken and egg argument. Does splitting shares make a company's shares outperform? Or are successful companies just more likely to split stock?

Management generally has a pretty good idea where a company is headed, at least in the short term. They're on the front lines, talking to employees and looking at numbers. When they make the decision to split shares, it's usually done because management is bullish on the future. Splitting shares is something successful companies do. That explains a lot of the outperformance.

Foolish bottom line

A share split is a powerful message sent out by management. It indicates they're bullish about the future, and generally happens after being successful in the past. It indicates the company is running at full steam, and management sees no major roadblocks in the future.

Ultimately, share splits are a symptom of success, not the cause. Stock splits don't cause a stock to go up, they're just a result of all the other things a company is doing right. That's why stocks that split outperform, and that's why investors should pay attention when a company announces a split. Investing in those names might just be an easy way to boost your portfolio's results.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:CNI (Canadian National Railway Company)
2. NYSE:TD (The Toronto-Dominion Bank)
3. TSX:CNR (Canadian National Railway Company)
4. TSX:NA (National Bank of Canada)
5. TSX:TD (The Toronto-Dominion Bank)

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