SHOULD YOU SPLIT YOUR STOCK?

by Steve Brown

Somewhere in the last semester of corporate finance, we all learned that stock splits are irrelevant because rational investors adjust the share price accordingly. Since no value is inherently created by splitting stock, holding 100 shares at $100 per share is the same as holding 200 shares at $50 per share.

Interestingly, history shows us the market can be split on stock splits. In fact, there have been 4 separate studies that have concluded that splitting shares results in an increase in share price. One study in particular found that stock prices outperformed by an average of 3.4% in the 5 days after the split announcement and another 4.5% over the next 51 days of trading. Meanwhile, 3 of the studies concluded much the same thing Â– companies that have issued splits have outperformed their peers of similar size an average of 8% the first year and 13% in the cumulative 3Ys after the split. For specific evidence, look at Microsoft, who is famous for its series of 2 for 1 splits. In almost every case, the split resulted in a greater market value.

Theories abound about why this real world experience differs from academic theory, but one of the most often cited is that by lowering the share price of a stock, liquidity is improved and appeal for the stock increases. While stock splits have historically reduced the cost of buying a traditional round lot of 100 shares (i.e. odd-lots have been historically subject to an additional brokerage commission) and are therefore more attractive to smaller investors, that doesn't explain everything.

Another oft-cited reason is that stock prices rise after a split because investors tend to see the move as a signal from the company that it expects its stock price to keep going higher. While that one is more difficult to measure, it is an interesting idea nonetheless.

A more recent study suggests stock splits result in higher prices as a result of higher-priced stock returning to a more appropriate range. The theory goes that a stock's minimum change in price determines its optimum price. Therefore, if the minimum change in price is too small relative to the current stock price, investor effort is wasted in haggling over meaningless price changes. Since limit orders at the same price are filled on a first come, first served basis at stock exchanges, stocks without a big enough minimum price change do not give brokerage firms a reason to make an active market in that stock. Once brokerage firms see that more money can be made (because of the split), they are encouraged to jump in, increasing liquidity for the stock.

A 4th theory is that companies that announce stock splits also tend to have higher than average earnings and higher dividends (like Microsoft). As a result, when studies look at these stock split companies, it is natural they find a higher than normal trend of performance, thus influencing the results.

Finally, there is a theory that suggests the mere announcement of a stock split is a form of advertising, which in and of itself leads to higher equity valuation. Companies that tend to have a wider distribution of earnings announcements, also happen to be positively correlated to above average equity valuations for perhaps much the same reason.

For community bankers, the conclusion to be reached is that it is ok to do a stock split. Other than a small incremental transaction cost, there is very little downside not to do it and the empirical evidence is in your favor. In this market, banks need all the liquidity help they can get and solidly performing banks will benefit from the additional scrutiny and conversation that will ensue with a stock split.

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BANK NEWS

Incentives

To help motivate foreclosure lawyers to go against their natural instincts, FNMA will pay an incentive fee to those who help qualify delinquent borrowers for a loan modification or refinancing. Traditionally, these lawyers receive fees for foreclosed loans, but nothing if a loan gets cured.

Innovation Lab

Umpqua Bank ($8B, OR) has opened an "innovation lab" in Portland, OR. The concept store will serve as a testing ground for new initiatives, technologies, products, and services that will enhance the customer experience and store operations and give the bank insight into evolving customer preferences.