What is a stock split, and should I buy?

I had several clients call after Amazon announced a 20 for 1 stock split several weeks ago. It got me thinking "do investors understand what a stock split means?".

So, what is a stock split? Each shareholder on the day of a stock split will receive additional shares for each share that they own. For instance, on a 5 for 1 stock split, the investor will receive 4 additional shares for each share that they own. Sounds good? You do have more shares; however, the stock price is also adjusted accordingly. In the 5-1 example, if a stock was trading at $500 per share, pre-split, the stock price is adjusted down to $100 per share. Your portfolio value pre-split was $500 and post-split is still $500. Dividends are similar. If a company was paying $1.00 per share pre 5 for 1 split will be adjusted down to 20 cents.

Why companies split shares? The impact on the company is nothing. However, there can be a short-term pop in the stock price. This is more of a behavioral finance issue than economic. Shares are cheaper so therefore felt like a bargain. Historically, stocks in the S&P 500 have risen 5% in the year following a stock split.

In the case of Amazon, the pre-split price was $2,447 and post-split was $124.79. That feels like a bargain, right? However, it is still at over 52x earnings, which is 2 times what the S&P500 is currently trading at.

It should be noted that at the time of writing this piece, Amazon is trading at $107.55.