October 2000 – Stocks Splits and TIPS

Stock Splits

Since stock splits are an often-misunderstood subject, we thought they merited a brief discussion. They offer no economic windfall since the stockholder owns the same percentage of the company after a split as he or she did before. For simplicity's sake, assume you own 1 share in a company with 10 shares outstanding and with a total market value of $100. You thus own 1 share worth $10 representing a 10% interest. If the stock splits 2 for 1, your 10% interest is then comprised of 2 shares each worth $5. The split therefore did not affect the economics of your ownership. Splits can actually result in increased future costs as commissions to buy or sell more shares and bid-ask spreads as a percentage of share prices may increase.

Historically, two of the reasons companies declare splits are to adjust their share prices to what they perceive as more desirable levels and to show confidence in their prospects. Although there never has been any doubt that the shareholders do not receive a windfall from a split, there has long been a question whether stocks that have split perform better as a result. As reported recently in *The Wall Street Journal* two Rice professors David Ikenbery and Sundaresh Ramnath completed a study of 3,000 splits and found that in the first year after the split such companies performed better by nine percentage points than comparable companies. One reason they offer is that companies that elect splits are confident that their stock prices are not going to fall.

Regardless of whether stock splits hurt, through increased trading costs, or help, through increased future performance, one should remember that the split itself is merely bookkeeping and not an economic event.

Inflation Indexed Treasuries

A relatively new type of security is gaining popularity since it allows one to overcome a major disadvantage of investing in fixed-income vehicles. Historically inflation has eaten away most of the return from such investments. According to Wharton professor Jeremy Siegel, from 1946-1997, the real return (after subtracting the effects of inflation) from long-term government bonds was only 1.1%. Bonds thus have not been effective tools to accumulate wealth. Beginning in 1997 the Treasury began issuing Treasury Inflation-Protection Securities (TIPS) which offer some protection against inflation. TIPS guarantee the owner a real rate of return (currently almost 4%) if held to maturity. They accomplish this result by constantly adjusting the face amount of the bond to compensate for changes in the CPI.

A simplified example can illustrate the basics. Assume you invest $1000 in a ten-year TIPS on January 15 with a 4% real yield. If inflation for the next six months is 2% then on July 15 the face amount would be adjusted to $1020 and your interest payment would be $20.40 ($1020 times

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4% divided by 2). If inflation for the next six months is 1% then on January 15 of the second year the face amount would be adjusted to $1030.20 ($1020 times 1.01) and your interest payment would be $20.604 ($1030.20 times 4% divided by 2). Similar adjustments then would be made throughout the life of the security. Although the adjusted face amount can decrease through deflation, the holder is guaranteed at least the initial face amount at maturity.

TIPS, which are issued in five, ten and thirty year maturities, offer a great alternative to traditional fixed rate securities to anyone who desires the diversification or safety aspects of such investments. Since the yearly principal adjustments constitute taxable events with no corresponding cash flow, TIPS are most appropriate for nontaxable accounts such as IRA's or 401K's.

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