

WHITE PAPER

Common v. Preferred Stocks with Split Basics for Physician Investors



Timothy J. McIntoch MBA MPH CFP® CMP®

Jeffery S. Coons PhD CFA

Dr. David Edward Marcinko MBA CMP®

Any medical professional who wants to save money for retirement or plan for a child's education needs to understand the basic tenets of investing. It allows them to improve the prospects of meeting future financial goals.

Common versus Preferred Stock

A common stock is the least senior of securities issued by a company. A preferred stock, in contrast, is slightly more senior to common stock, since dividends owed to the preferred stockholders should be paid before distributions are made to common stockholders. However, distributions to preferred stockholders are limited to the level outlined in the preferred stock agreement (i.e., the stated dividend payments). Like a fixed income security, preferred stocks have a specific periodic payment that is either a fixed dollar amount or an amount adjusted based upon short-term market interest rates.

However, unlike fixed income securities, preferred stocks typically do not have a specific maturity date and preferred stock dividend payments are made from the corporation's after tax income rather than its pre-tax income. Likewise, dividends paid to preferred stockholders are considered income distributions to the company's equity owners rather than creditors, so the issuing corporation does not have the same requirement to make dividend distributions to preferred stockholders.

Thus, preferred stock is generally referred to as a "hybrid" security, since it has elements similar to both fixed income securities (i.e., a stated periodic payments) and equity securities (i.e., shareholders are considered owners of the issuing company rather than creditors).

Convertible preferred stocks (and convertible corporate bonds) are also considered hybrid securities since they have both equity and fixed income characteristics. A convertible security whether a preferred stock or a corporate bond, generally includes a provision that allow the security to be exchanged for a given number of common stock shares in the issuing corporation. The holder of a convertible security essentially owns both the preferred stock (or the corporate bond) and an option to exchange the preferred stock (or corporate bond) for shares of common stock in the company.

Thus, at times the convertible security may behave more like the issuing company's common stock than it does the issuing company's preferred stock (or corporate bonds), depending upon how close the common stock's market price is to the designated conversion price of the convertible security.

Stock Splits

One final equity concept that medical professionals should be aware of is the idea of stock splits. In a stock split, a corporation issues a set number of shares in exchange for each share held by shareholders. Typically, a stock split increases the number of shares owned by a shareholder.

For example, XYZ Corp. may declare a 2-for-1 split, which means that shareholders will receive two shares for each share that they own. However, corporations can also declare a reverse stock split, such as a 1-for-2 split where shareholders would receive 1 share for every two shares that they own.

While stock splits can either increase or decrease the number of shares that a shareholder owns, the most important thing to understand about stock splits is that they have no impact on the aggregate value of the shareholder's position in the company.

Using the XYZ Corp. example above, if the stock is trading at \$10 per share, an investor owning 100 shares has a total position of \$1,000. After the 2-for-1 split occurs the investor will now own 200 shares, but the value of the stock will adjust downward from \$10 per share to \$5 per share.

Thus, the physician investor still owns \$1,000 of XYZ stock. While stock splits are often interpreted as signals from management that conditions in the company are strong, there is no intrinsic reason that a stock split will result in subsequent stock appreciation.

CONCLUSION

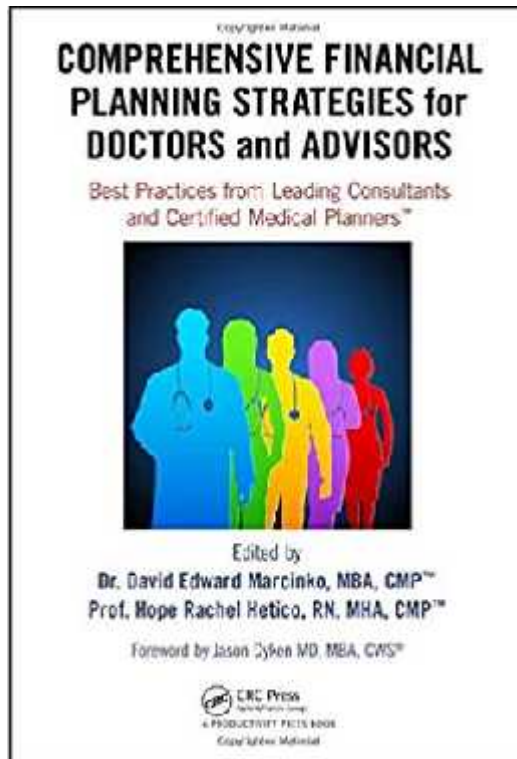
This paper reviewed common and preferred stocks with splits for the physician-investor and medical professional.

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CONTACT:
Ann Miller RN MHA CMP®
Phone: 770-448-0769

WEB: www.MedicalBusinessAdvisors.com
WEB: www.CertifiedMedicalPlanner.org
Email: MarcinkoAdvisors@msn.com



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