Conservative Stock Investing

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Stocks are often viewed as high risk. That is true in general, but there are areas of the stock market that are comparatively less volatile, where market fluctuations are dampened by certain characteristics of the stocks or companies. As a stock investor, it may help you to know whether the stocks you own are higher risk or more conservative. You might also benefit by knowing how they can be incorporated into a diversified portfolio designed to help you meet your financial goals.

Elements of the conservative approach

The goal of conservative stock investing is to achieve long-term growth of capital without experiencing the extreme fluctuations that sometimes cause investors to cash out at the wrong time. Conservative stocks tend to have one or more of the following characteristics, which can contribute to a steadier ride for investors:

- The underlying companies provide a substantial dividend, which can cushion the impact of price declines in a falling market. Many such companies also look to increase their dividends on a regular basis; over time, compounding those dividends can generate significant returns. These stocks tend to fall into the "equity income" or "dividend growth" categories.
- "Value" stocks tend to have inexpensive valuations compared with the underlying company's earnings, their competition, or their own price history. When stock values are relatively low, their potential for steep declines is muted. "Deep value" stocks are those that are trading below the intrinsic value of the underlying companies.
- The fundamentals of the underlying company are conservative, emphasizing regular revenues and, possibly, modest but sustainable long-term growth. These investments are often referred to as "defensive growth" stocks.

Of these three characteristics, dividends tend to do the most to protect equity investors.

Why emphasize dividends?

There are only two sources of total return in an equity investment—price gains and dividends. Dividends are attractive because they are the one source of return that will always be positive, and they offer several important investing advantages:

- Dividends reinvested in additional shares of a stock or mutual fund instead of being taken in cash can play a powerful role in helping to build capital. During the last 20 years, for example, a hypothetical $1,000 initial investment in the stocks composing the Standard & Poor's 500 Stock Index would have grown to $5,031.89 if all dividends were reinvested (see Chart I).
- Dividends can be a good indicator of corporate health. Corporations are not obligated to share their earnings with stockholders, so cash dividends and consistent dividend increases are the most obvious signs of a company's profitability as well as management's assessment of the future. To the extent that rising dividends reflect rising profits, companies that consistently increase their dividends should enjoy rising share prices over time.

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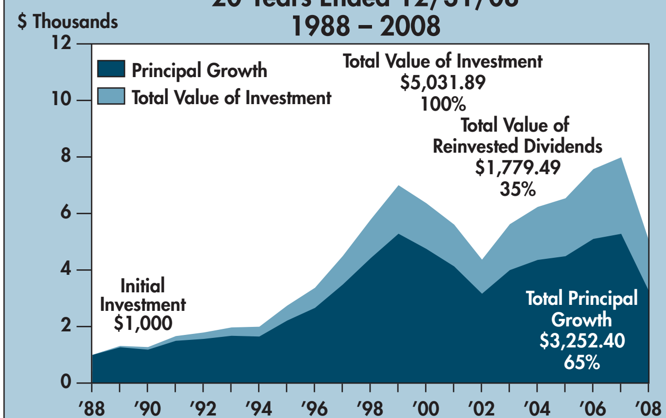
- If you remain invested in a dividend-paying stock for a number of years, you will see your dividend yield gradually rise. The absolute value of company dividends tends to rise, but the price of your original investment doesn't change. So your yield—that is, income as a percentage of your original investment—grows over time.

Chart I: Source of Stock Returns: S&P 500 Stock Index 20 Years Ended 12/31/08 1988 – 2008



Source: Ibbotson Associates

Past performance cannot guarantee future results. This chart is for illustrative purposes only and does not represent the performance of an investment in any specific security. It is not possible to invest directly in the index.

Disadvantages

Investing in conservative stocks is a good strategy for generating growth over time while managing risk. But conservative stocks are not risk free, and they have their own special risk characteristics. For example, dividend-paying companies typically are distributing a sizable portion of their earnings to shareholders, rather than reinvesting them in the business or developing new opportunities. For that reason, dividend-paying stocks may offer less return potential than stocks that do not pay dividends.

Dividend yields can also provide clues into the health of the company. One clue might be the percentage of earnings paid out in dividends. Most industrial companies (excluding utilities) distribute only a portion of their earnings and reinvest the rest in the company. A high ratio might indicate earnings problems or foreshadow a dividend cut.

Similarly, while a value approach to investing helps reduce the risk of overpaying for a stock, a stock may be inexpensive for any number of reasons—some of which may not be beneficial for investors. Low valuations can indicate structural weaknesses in a company, an emerging competitive disadvantage, or a turn for the worse in a company's market environment. The challenge for investors is deciding if the circumstances causing a low price are temporary or more permanent. Price declines associated with economic cycles, corporate restructuring, or shifts in investor preferences may be relatively short-lived, whereas those due to weak management or declining business prospects may be more intractable.

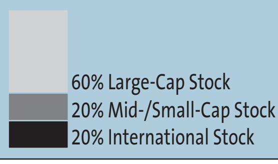
Finally, defensive growth stocks (which typically include certain health care, consumer, and utility companies) often hold up better than other kinds of stocks in down markets, especially ones that are related to weak economic environments (where earnings in general are slumping). But in better times for the market or the economy, earnings potential in these stocks doesn't stack up to other types of growth companies, limiting potential price gains.

Fitting conservative stocks into your portfolio

Before making any investment decision, you need to evaluate your overall financial picture and long-term objectives. To build a portfolio that works for you, we suggest you identify your goals and time horizon, and then determine an appropriate asset allocation.

Conservative stocks don't have to take up an entire equity portfolio, since every long-term investor needs exposure to higher-growth opportunities. However, they can be appropriate as part of the large-cap segment of a typical equity portfolio (also considered the core segment of a portfolio). As shown in Chart II, this large-cap/core segment could take up approximately 60% of the equity portion of a well-diversified portfolio, to include a combination of conservative stocks and large-cap growth investments. (The exact amount of your portfolio that you should have in equities will vary depending on your time horizon; visit troweprice.com for more information.)

Chart II: Suggested Portfolio Diversification—Equity



Conservative stocks may be a good way to help you build capital for long-term goals. A lot of research and patience is needed for a conservative strategy to bear fruit, so the key is to choose investments you are comfortable with and stick with them.

Insights reports provide background information on many aspects of investing. *Call 1-800-638-5660 to request a prospectus, which includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.* T. Rowe Price Investment Services, Inc., Distributor.

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