

Investing in Common Stocks

There is nothing common about common stocks. They have outperformed other financial assets on an average annual basis during the past 80 years. One dollar invested in stocks at the end of 1926 would have grown to \$2,908.33 by the end of 2007. Had that dollar been invested in Treasury bonds or Treasury bills instead, it would have been worth far less, as can be seen in the table below.

I. Return on \$1 Invested at Year-End 1926 Through 2007

Stocks (S&P 500)	\$2,908.33
Bonds (U.S. Gov't. Intermediate)	67.51
Treasury Bills (30-Day)	19.55
Inflation (CPI) (amount needed to maintain purchasing power)	11.89

Source: Ibbotson Associates.

This table is for illustrative purposes only and does not represent an investment in any specific security. Past performance cannot guarantee future results. Unlike stocks, Treasury bonds and Treasury bills are guaranteed as to the timely payment of interest and principal. It is not possible to invest directly in the index.

What Are Stocks?

Unlike corporate bonds, which are securities representing debt owed by companies to investors, stocks are shares of ownership or equity in the corporation that issued them. The common stocks of *publicly* owned companies trade in a *liquid* market — that is, an open market such as a stock exchange where shares are bought and sold. We will talk more about these markets a little later.

Holders of common stock are the actual owners of the issuing corporation in proportion to their number of shares. If you own stocks, you have certain rights, including the right to your

proportional share of the company's earnings *after* the interest on bonds and dividends on preferred stocks have been paid.

How Are Common Stocks Bought and Sold?

All stocks are either *listed* or *unlisted*. Listed stocks trade on one of the established securities exchanges, such as the national New York and American Stock Exchanges, or on a regional exchange. Unlisted stocks are bought and sold on Nasdaq, which does not have a physical location, but is rather an electronic network where brokerage firms “make markets” and negotiate stock prices among themselves. The Nasdaq system serves as a national electronic marketplace for a broad variety of unlisted stocks, but many smaller stocks trade outside the system via the “pink sheets,” a daily publication that details the bid and asked prices of thousands of over-the-counter stocks.

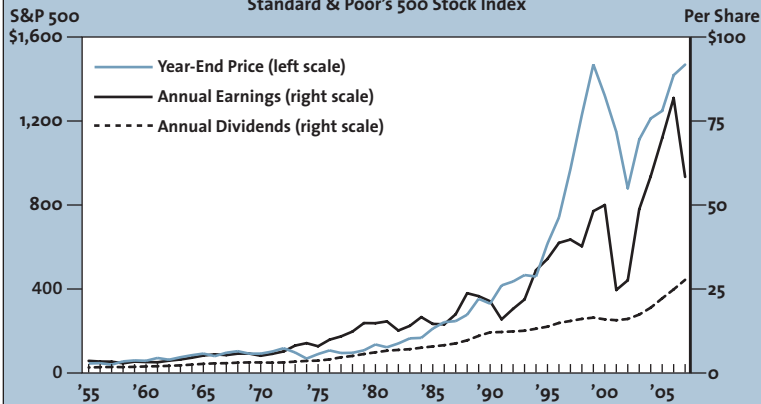
While most Fortune 500 corporations list their stocks on the national exchanges, many major companies in various industries choose to remain unlisted for a number of reasons. Some do not feel that they need a physical marketplace since there is already a continuous market for their shares. Others may not want to comply with the procedures and paperwork involved in getting listed.

How Are Stock Prices Set?

The *market* value of any stock — the price people are willing to buy and sell it for — is strictly a function of the marketplace. Stocks are just like any other commodity: Buyers and sellers come together in a competitive marketplace and transact business at mutually agreeable prices. Supply and demand rule the stock market, as all free markets. Prices are largely driven by corporate earnings and the level of dividends paid to shareholders. The relationship between earnings and stock returns is illustrated

II. Relationship of Stock Prices to Earnings and Dividends

Standard & Poor's 500 Stock Index



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Source: Standard & Poor's.

in chart II. During years of increasing corporate earnings, such as the 2002 to 2007 period, stocks rose. When earnings contract, as they did after 2000, stock prices have tumbled as well.

Institutional forces, such as mutual fund demand for particular stocks at any moment, and a host of psychological factors can either boost or depress stock prices. Investor sentiment also plays a major role in moving the market. At times, it can drive prices beyond reasonable valuations, as evidenced by the dot-com bubble of the late 1990s, while at other times investor disinterest pushes stock prices lower and lower.

The political climate is also a major influence on stock prices, as is the general state of the economy, the level of interest rates, and the attractiveness of competing investments. For these and other reasons, investors may be willing to pay \$25 today for a stock that seems fairly valued at \$20, and six months from now pass up the opportunity to buy it for \$15.

What Role Do Dividends Play in Stock Performance?

Dividends play a vital role in overall stock market performance, since they are a guarantee that one of the two components of investment returns—capital appreciation and dividend income—will be positive. For example, in 1994, stock returns measured by the change in the principal value of the Standard & Poor's 500 Stock Index were negative for the year. (The S&P 500 measures the performance of 500 large-company U.S. stocks.) However, the 2.9% average dividend yield at the end of 1994 pushed S&P 500 stocks into positive territory with a yearly total return of 1.3%. Dividends also serve

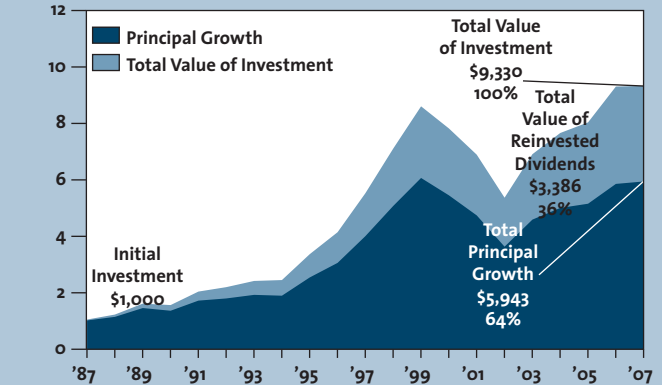
as a protective cushion during volatile market periods as well as a good indicator of a company's overall financial health.

The compounding effect of dividends over time is even more impressive. As illustrated in chart III, a hypothetical \$1,000 investment in stocks composing the S&P 500 Index at the end of 1987 would have grown to \$5,943 by the end

III. Source of Stock Returns: S&P 500 Stock Index

1987–2007

\$ Thousands



Source: Ibbotson Associates.

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of 2007. With dividends reinvested, the same investment would have been worth an additional \$3,386, amounting to 36% of the total return. Of course, not all stocks pay dividends, and dividend levels may fluctuate.

How Can You Tell if a Stock Price Is High or Low?

Stock analysts and investors review certain measures of value to arrive at what they think is a reasonable price for a stock or for stocks in general. Just as you would not pay \$50,000 for a compact car, neither would you want to pay \$50 for a share of stock that, by most reasonable assumptions, has an intrinsic worth closer to \$15 or \$20 per share. Some of the major measures of value are:

- **Price/earnings.** A stock's price/earnings multiple (P/E) provides some idea of whether a stock is overvalued or undervalued. To find the P/E, you divide the current market price by earnings per share. For example, let's say that pharmaceutical stocks are currently trading at an average P/E of 14. If ABC Pharmaceutical's current stock price is \$25 and the company earns \$2.50 per share, the P/E is 10, or less than the industry average. The stock appears undervalued based on this measure, but other data have to be considered to be sure it is a good buy.

- **Dividend yield.** This measure gives you the percentage income return on your investment. You can calculate the dividend yield by dividing the stock's dividend per share by the current stock price. We'll assume that the current average dividend yield in the utility sector is 5%. If XYZ Electric pays a dividend of \$1.60 and its stock is selling for \$40 per share, the 4% yield is below the industry average. The stock may be overvalued according to this measure since the yield is low, but once again investors should look at other factors to see if this is the case.

- **Price/book value.** This refers to the relationship between a stock's current price and its intrinsic worth or book value, which is a company's assets minus its liabilities. By dividing the stock price by the book value per share, you come up with the price/book value ratio. We'll assume that communications stocks are currently selling for two times book value on average. Therefore, if MNO Media's stock is \$30 and the book value is \$20 per share, the price/book value ratio is 1.5. This stock seems attractively priced, but a thorough analysis of other financial data is necessary before deciding to buy it.

What Should Investors Look for When Buying Stocks?

There are different approaches to stock investing. Some investors prefer one, while others rely on no particular method or employ a mix of all of them.

- **Growth** investors focus on companies whose earnings are expected to grow faster than both inflation and the economy over time. These companies usually have several years of consecutive earnings growth well above that of the average Standard & Poor's 500 corporation and prospects for continued rapid growth. Therefore, growth stocks normally carry higher P/Es than the general stock market. Growth companies reinvest much of their earnings back into their businesses and do not pay out large dividends.

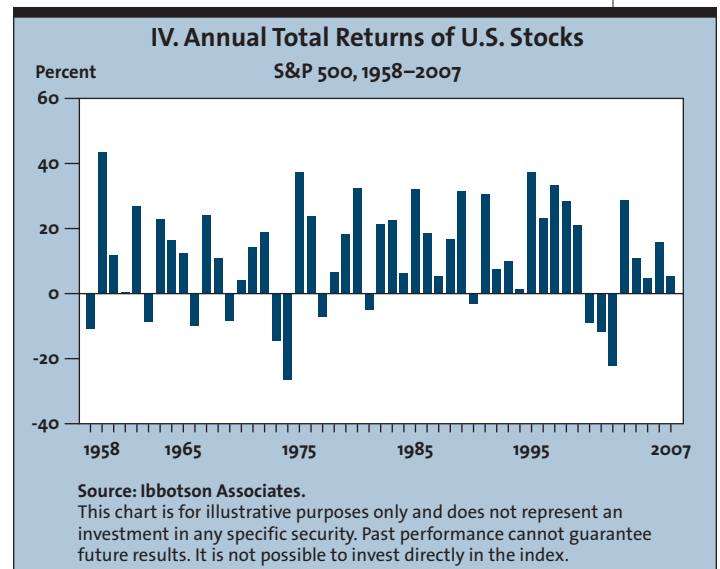
- **Value** investors look for stocks that are temporarily out of favor with investors, who have sold them down to prices sometimes below their intrinsic value. Value stocks ordinarily pay relatively high dividends, and the combination of low P/Es and high dividend yields makes them attractive to investors looking for income and eventual appreciation.

Both growth and value stocks have taken turns leading the market. Growth stocks are usually more popular when the economy is slowing,

since their high earnings growth makes them more attractive. Value stocks tend to come into their own when the economy is booming, then fade when a recession looks imminent.

In reality, market timing is an inexact science at best, which would explain why investors have been notoriously unsuccessful at predicting changes in market leadership. For that reason, they are better off owning both types of stocks — growth for long-term appreciation and value for both appreciation and the dividends that are a significant component of total return over time.

In addition to growth and value stocks, many investors focus on other criteria when selecting stocks. Some prefer *blue chip* stocks, others *emerging growth* or *foreign* stocks, yet others divide their assets between *large-cap* and *small-cap* stocks. We will discuss in more detail in the sections on risk. No one approach to buying stocks is better than any other. Most investors choose to own a variety of stocks, either on their own or through mutual funds, depending on their investment goals and the level of risk they are willing to assume.



How Risky Are Stocks?

Any investment that offers the potential for substantial returns carries an element of risk. The basic rule of the marketplace is the higher the potential return, the greater the risk.

Stock investors realized substantial returns over the past 50 years, but they had to be willing to ride out a few volatile swings along the way. From the end of 1958 through the end of 2007,

stocks had 39 up years and 11 down years, the worst of which was -26.5% in 1974. However, the cumulative total return for S&P 500 stocks during this period was 18,298%, which is a compound annual growth rate of 10.99%. In 1987, the Dow Jones Industrial Average tumbled 500 points in a single day. This was a roller-coaster ride by anyone's standards, but few investors remember that the Dow was actually up 5% for 1987 as a whole.

Are Stocks Equally Risky?

Not all stocks carry the same degree of risk.

- Established *blue chip* companies, for example, provide a greater margin of safety than do small start-up companies. Blue chip corporations often occupy leading market positions that are expected to be maintained or enhanced.
- *Large-cap* companies with market capitalizations above four or five billion dollars are considered less risky than *mid-cap* or *small-cap* stocks. This is because there is a large, liquid market for their shares and normally a longer history of earnings and dividend growth.
- *Emerging growth* stocks can be among the riskiest of all since they are shares of fledgling companies still in their developing stages, with hopes of superior earnings growth over time. Some of these companies will make it, but others will fall by the wayside.
- *Value* stocks are generally less risky than *growth* stocks since their higher dividend yields and lower P/Es offer some protection in market declines.
- *Foreign* stocks carry the additional risk of currency fluctuation. For example, if U.S. investors put money in European stocks and those currencies decline in relation to the dollar, the falling foreign currencies can reduce an investor's profits or add to losses. In the case of emerging markets, there are also the risks of political instability; extreme volatility as previously state-run economies convert to free markets; illiquidity, which could exaggerate price swings; and other risks associated with particular regions.

Should You Choose Your Own Stocks or Buy Them Through Funds?

Investors attempting to go it alone run the risk of not doing their homework as thoroughly as professional analysts. Many investors reduce risk by *diversifying* their assets. Mutual funds themselves are a form of diversification since

they invest in a broad variety of securities sometimes encompassing many different industries and types of stocks.

However, investors building their own portfolios can also diversify by searching for stocks in different sectors, choosing among various types of stocks, and adding an international component to their holdings. Whichever path you choose, selecting stocks on your own or buying one or more stock funds, diversification helps reduce your exposure to a steep decline in a particular market. Please note that diversification cannot assure a profit or protect against loss in a declining market.

When Is the Best Time to Buy Stocks?

The best strategy for every investor is to have some assets in stocks all the time to keep abreast of inflation and protect their purchasing power, rather than trying to time market swings. Not even professionals are consistently successful at predicting the direction of the overall market.

Some of the stock market's most powerful moves have occurred during short periods, and investors who missed them in an effort to time major swings have suffered for their wrong moves. For example, \$1 invested continuously in the stock market from 1977 through 2007 would have grown to \$15.44. However, if investors missed the best 90 trading days during this period, their \$1 investment would have actually fallen, to \$0.77.

This is not to say that investors should have all or even most of their assets invested in stocks at all times. Every portfolio should be diversified to suit the investment goals, time horizon, and risk profile of the individual investor. However, it does mean that stocks, which have generated the best historical returns of all financial investments, should be an integral part of your long-term financial plans.

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