

Getting Started:

Investing With Mutual Funds

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Library

If you have been reviewing your financial situation and realize you need to invest more effectively to meet your goals, you've already taken a big step in the right direction. The next step, choosing those investments, may seem particularly daunting if you're a new investor—or just a busy person.

Don't lose heart. A major advantage of deciding to invest with mutual funds is that you don't need to know everything there is to know about investing. Your major responsibility, discussed in more detail later on, is to choose a fund whose investment objective and risk level are suitable for you. The portfolio manager's task is to invest a pool of money, including yours, in pursuit of the fund's specific objective.

By investing with mutual funds, you gain access to:

- *Professional management.* With a mutual fund, you pay a small annual fee to have your investment managed by experienced professionals. The fund manager selects individual securities, such as stocks, bonds, or money market instruments, that are intended to help the fund achieve its particular objective. Many managers work closely with a team of research and credit analysts in making buy and sell decisions.
- *Diversification.* Each mutual fund share you own is one slice of a huge pie composed of many different stocks, bonds, or other securities. The greater the number and variety of holdings within the portfolio, the smaller the impact on the fund's share price if a particular holding performs

badly. Of course, diversification cannot assure a profit or protect against loss in a declining market. Diversification is a cornerstone of risk management. Funds are required by law to meet certain standards of diversification, and many funds exceed them. Most funds own anywhere from several dozen to hundreds of different securities—a degree of diversification that could be impractical for you to match on your own.

- *Liquidity.* It's easy to sell your shares if you need cash. You can sell them any business day at the current market price less sales charges or

How Mutual Funds Are Organized

A mutual fund company may offer anywhere from one to more than a dozen different types of funds. Each fund is incorporated and has a Board of Directors or Trustees that selects a manager or management team to oversee the portfolio day to day.

Two kinds of expenses are charged by all mutual funds: a management fee, paid to the investment advisor for managing the portfolio, and a fee for administrative and servicing costs (for example, shareholder recordkeeping, mailing fund reports, disbursing dividends, auditing fund statements, and so on). The annual expenses are expressed as a percent of fund assets and are deducted from assets each day before the share price is calculated and any distributions are made. Some funds charge another kind of annual fee called a 12b-1, which is deducted from fund assets to help pay for marketing costs. You will find details on fees and charges at the beginning of each fund's prospectus.

redemption fees, if any. Keep in mind, however, that the share price will reflect financial market developments and may be higher or lower than the price you originally paid. The only exception is money funds, which are managed—but not guaranteed—to maintain a stable share price.

■ *Services.* Services vary among mutual fund companies, but the larger ones provide a broad array that makes investing basically hassle free. For instance, most mutual funds will automatically reinvest your dividends in additional shares and also keep track of your transactions for tax purposes—for free. Many funds also provide systematic investment and withdrawal plans, telephone and sometimes electronic exchange privileges that let you transfer your money from one fund to another (or between your fund and bank accounts), detailed account statements, regular fund reports, and year-end tax information.

How your fund investment can work for you

Mutual funds can provide capital growth and income through the following:

- *Rising share price.* If the overall value of the securities in a fund increases, so does the price of each of your fund shares. This growth is increased (compounded) if you reinvest fund distributions in additional shares. Of course, there is no guarantee the price will rise. If it falls, you may lose money on your fund investment.
- *Income distributions.* Mutual funds pay out net income earned on the securities in the portfolio. Most bond and money funds pay dividends monthly, while stock funds make quarterly or annual income distributions. If you reinvest all or a portion of these distributions in additional fund shares, in effect earning income on income, the income stream will grow at a compounded rate.
- *Capital gain distributions.* If profits from sales of fund securities during a year exceed losses from such sales, the fund will pay shareholders the resulting net capital gains once or sometimes twice a year. (If losses exceed gains, the net loss is carried forward by the fund to the next year.) As with income dividends, reinvesting these distributions can help your account grow faster.

Buying Fund Shares

When you invest in a mutual fund, you buy shares. The share price you pay (the “net asset value” or NAV) is calculated at the end of each business day by adding up the value of all the fund’s assets, deducting the expenses, and dividing that total by the number of shares outstanding. To find a share price, consult the financial pages of major newspapers, call the fund’s toll-free number, or visit the fund company’s Web site.

Mutual fund companies sell shares directly to the public or through a sales force. Funds that sell shares directly to the public advertise in major financial magazines, the business section of newspapers, and sometimes on radio or TV. By calling the 800 number in the advertisement or visiting the Web site, you can request the fund’s prospectus as well as information on how to invest. Most funds sold directly are “no load,” meaning there are no sales charges.

Mutual fund shares may also be purchased through brokers, financial planners, insurance agents, banks, and other institutions. Purchasing shares through a sales force usually involves a sales charge (or “load”) that must be paid in addition to the fees you pay indirectly to the fund’s investment manager. However, some directly sold funds also have loads—check the fee table in the prospectus.

Choosing investments: A step-by-step guide

Once you understand the basic concept of mutual funds, the next step is choosing ones that make sense for you. To do this, you’ll first need to define your financial goals, and second, determine the level of risk you can live with. You’ll also need to be acquainted with some basic investment principles, terms, and types of mutual funds.

Step one: Define your financial goals

What do you want? Your choice of investments should always be driven by what you want to do with your money. You may have a long-term goal, such as building a nest egg for retirement, or a precise near-term goal, such as accumulating money for a down payment on a house. You may want an investment that provides income or one that can serve as a rainy-day fund for

emergencies. Taking time to figure out your goals will help you choose the right investments.

When do you want it? Set a time for achieving your goals. This is important because different time horizons require different investment strategies. The sooner you need your money, the safer and more accessible you want that money to be. In contrast, the longer you can leave your money invested, the less you need to worry about ups and downs in the value of your investment and the more you can focus on your goal of earning a high return over time.

Step two: Understand risk and your risk tolerance

For most investors, risk represents the chance of losing money. This is a valid concern since the prices of shares in stock and bond funds will reflect inevitable fluctuations in the value of their portfolio holdings — up and down. Your risk tolerance simply refers to your willingness to accept downward fluctuations in your principal value. This risk, which for simplicity's sake we will call “market risk,” is one of two major types. The other is “inflation risk.”

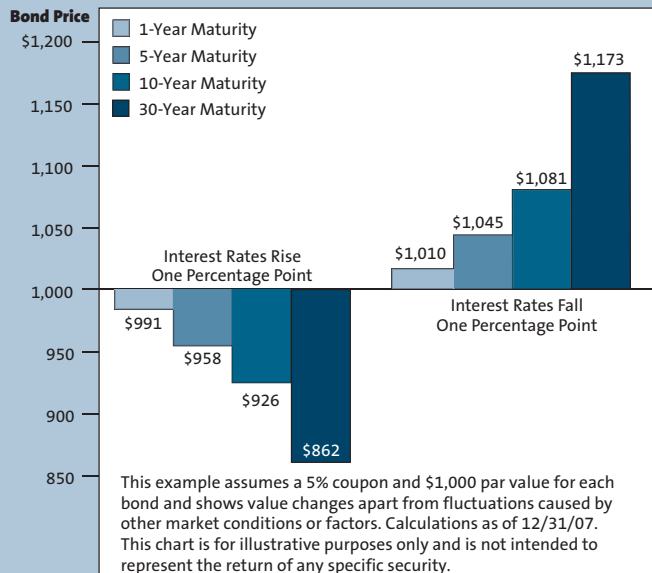
- **Market risk: Stocks.** Many factors can cause stock prices to fluctuate: actual or anticipated developments within a particular company or industry; changes in the outlook for the economy as a whole; and shifts in investor attitudes toward the stock market in general, from optimism to pessimism, for example.

- **Market risk: Bonds.** Bond prices fluctuate with changes in interest rates, rising when interest rates fall and falling when interest rates rise. The longer the maturity of the bond or bond fund, the more the price will rise or fall in response to a given change in rates, as shown in the chart below, left. Bond prices also respond to changes in the creditworthiness of the issuer. Bonds of a company whose finances are deteriorating will probably fall in price as the risk of default (failing to meet required interest and principal payments) increases.

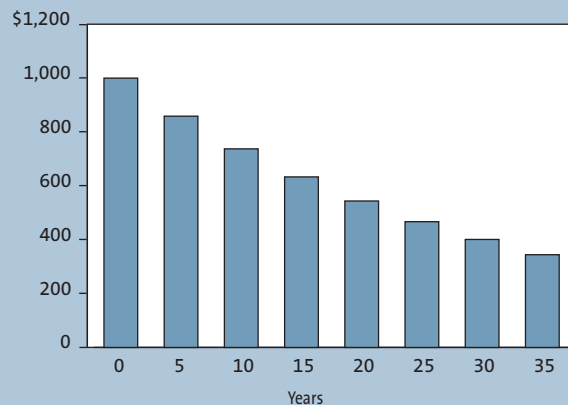
- **Inflation risk.** All investments are subject to this risk, which is erosion in the purchasing power of the money invested due to rising prices. Any level of inflation above zero means that a future dollar is worth less than a present one. Therefore, an important investment goal is to earn a rate of return that exceeds inflation, at a very minimum.

How Changes in Interest Rates Affect Bond Prices

Starting Price of \$1,000, 5% Coupon Are Assumed



Purchasing Power of \$1,000 at 3% Annual Inflation



Step three: Finding funds to match your objectives

Now that you have defined your financial goals and have a basic understanding of risk, you can choose specific funds. You will find that the concepts of risk, return, and time horizon are all related as you consider your choices. The higher a fund's potential return over time, for example, the more suitable it probably is for your more distant goals. A long investment horizon enables you to take on higher risk because it allows you to more easily ride out

losses and benefit from positive longer-term trends. In contrast, funds that are relatively stable in price and provide more modest returns are more suitable for your near-term needs.

Since the most common investor goals are *stability, income, and growth*, most funds are organized around these objectives. Each fund's objectives and investment program are explained in its prospectus.

- **Stability.** Investing for stability means that your main concern is to protect your principal (the initial amount you invested) from loss. *Only money market mutual funds are managed to maintain a stable share price.* All other funds have prices that vary — some modestly, some a great deal.

Money funds, which invest in very short-term, high-quality securities, are the lowest-risk investment among all mutual funds, but they also usually provide the lowest returns. Unlike many bank accounts, *an investment in a money fund is not insured or guaranteed by the FDIC or any other government agency. Although these funds seek to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in them.* When interest rates are low, you won't make very much, but when rates rise, a money fund's short maturity means that its yield should also rise fairly quickly.

Among mutual funds, money funds are the best choice for stability. If you can accept modest price fluctuations, however, short-term bond funds should provide a higher income return and the potential for a higher overall return in addition to their higher risk.

- **Income.** If your main objective is a reasonable level of monthly income, you should select some type of bond, or fixed-income fund. Bonds represent loans to governments or corporations, which, in turn, must pay interest to the investor over the life (or maturity) of the bond. Which bond fund you choose depends on how much income you wish to earn and how well you tolerate share price increases and decreases—the risk/reward trade-off.

The higher the income paid by a bond fund, the higher the risk in the form of greater swings in the fund's share price. If you want to

keep price swings to a minimum, select a bond fund with a weighted average maturity under five years and high overall credit quality. But, if you can tolerate price changes in exchange for higher income, choose a longer-term fund or perhaps one with lower average credit quality.

Lastly, you may wish to consider whether you would benefit from tax-exempt bond funds. Income earned on municipal bonds issued by state and local governments is not subject to federal income taxes and may also be exempt from state and local income taxes in the state of issuance. The catch is that municipal bonds usually offer lower interest rates than comparable bonds that are taxable, so you need to compare the income you would actually keep on each type of bond after paying taxes at your particular marginal tax rate.

- **Growth.** Growth means growth of capital. If you are investing now to build a reservoir of money for the future—at least five years from now—you should select a stock fund. Stocks represent ownership of a company, so if the company prospers, its stock price should rise.

Cumulative Investment Returns and Inflation				
Periods Ended 12/31/07				
	Years			
	5	10	15	20
Stocks — S&P 500	83%	78%	346%	833%
Bonds — Intermed. Gov't.	20	78	143	297
Treasury Bills — 30 Day	15	42	77	141
U.S. Inflation (CPI)	16	30	48	82
Source: Ibbotson Associates				
This chart is for illustrative purposes only and does not represent an investment in any specific security. Past performance cannot guarantee future results. Unlike stocks, U.S. Treasury securities are guaranteed as to the timely payment of principal and interest. It is not possible to invest in an index.				

While stocks have the greatest potential market risk, they also have the lowest inflation risk and offer the highest potential for growth over time.

Stock funds come in every imaginable variety. If you are a conservative investor, look for one that includes income among its main objectives; such funds tend to have more moderate price fluctuations than those that de-emphasize income. Likewise, funds that invest across a wide variety of industries should be less volatile than those investing in a narrow sector, such as

technology or energy. If you expect to invest in several stock funds, consider diversifying overseas. Since international stocks do not usually move in concert with U.S. stocks, they can help smooth out the ups and downs of your total stock holdings and increase the potential for higher long-term returns. However, along with these benefits comes a higher level of risk. While political and economic instability, illiquid markets, and regional concentration must be considered, one of the primary concerns of investing abroad is currency risk. As always, the greater the risk you are willing to tolerate, the greater your potential long-term growth of capital.

Several types of mutual funds offer programs that allow you to accomplish more than one investment goal in a single investment. You may need some income and some capital growth, for instance. Instead of choosing separate income and growth funds, you may prefer a single fund that invests for both objectives.

Some Types of Mutual Funds — by Objective

Stability

Money market

Income

Conservative
Short-term bond
Moderate
Ginnie Mae (GNMA)
Intermediate-term bond
Aggressive
International or global bond
Long-term bond
High-yield bond

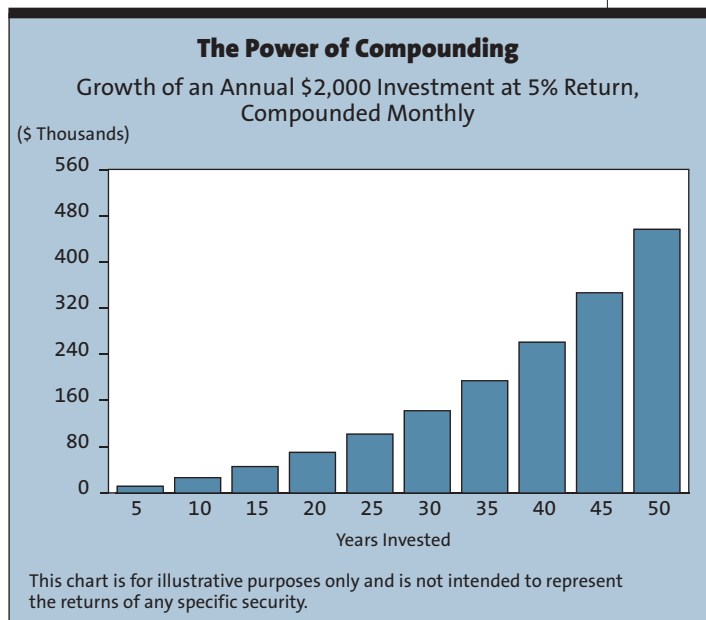
Growth

Conservative
Balanced
Equity income
Moderate
Large- and medium-sized company growth
Growth and income
Global stock
Aggressive
Small-company stock
International stock
Sector (e.g., precious metals, science and technology, health sciences)

The best time to invest

The markets will always fluctuate, and waiting for the ideal moment is an exercise in futility. Time is money in the investment world. You want to put your money to work, add to it regularly if possible, and, if you can forgo the current income, reinvest the earnings to benefit from the power of compounding.

As the following chart shows, compounding over time can mean a difference of hundreds of thousands of dollars in investment returns. A \$2,000 investment at the beginning of each year, which compounds monthly at a 5% annual rate, is worth about \$45,764 after 15 years, \$101,960 after 25 years, and \$456,913 after 50 years.



So when is the best time to invest? Answering this frequently asked question is easy. The best time is *now*.

Summary

Mutual funds offer a convenient, efficient way to invest for income and capital growth. They can help you realize your financial objectives — but only if you invest in funds that are suitable to your particular needs and circumstances. Before investing, review your objectives, your tolerance for risk, and your time horizons. Be sure to read the prospectus and any other literature supplied by the fund before you become a shareholder.

Useful Terms

Average Weighted Maturity and Quality – Numbers provided by money market and bond funds to give you an idea of the fund's potential market and credit risk and its overall return, respectively. Other things being equal, the longer a fund's maturity and the lower its quality, the greater its potential risk and reward—and vice versa.

Automatic Reinvestment – A fund's dividend and capital gain distributions are automatically used to buy more shares, enabling them to benefit from compounding.

Distributions – Payments to shareholders of net income earned on portfolio holdings or net gains from the sale of securities in the portfolio.

Diversification – Spreading investments among a number of securities or mutual funds to reduce risk. Mutual funds must meet certain diversification standards.

Equity Funds – Invest primarily in common stocks.

Fixed-Income Funds – Invest primarily in bonds or money market securities.

Management Fee – Charged by mutual fund advisors for managing the fund's assets.

Mutual Fund Company – A corporation or trust that invests a pool of assets in pursuit of a specific investment objective.

Net Asset Value Per Share – The market value (price) of one share of a mutual fund, found by totaling the values of all the assets, deducting liabilities and expenses, and dividing the result (net assets) by the number of shares outstanding.

Load and No-Load Funds – Load funds charge a commission to buy and sell shares; no-load funds do not.

Profile – A summary of key information about the fund, normally shorter than a prospectus.

Prospectus – A booklet describing the fund. The U.S. Securities and Exchange Commission requires each prospectus to explain the fund's investment objectives, policies, and restrictions; risks; fees and charges; and other information, such as how shares can be bought and sold.

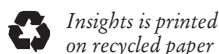
Real Rate of Return – The total return on an investment after subtracting the rate of inflation, e.g., a fund that returns 10% for a year in which inflation averages 4% has a "real" return of 6%.

Total Return – Measures the overall change in value of an investment over a designated period of time. A fund's total return reflects any income earned and the net increase or decrease in the share price; it assumes that all distributions were invested in additional fund shares during the given period.

Yield – A fund's income for a given day or period of time, expressed at annual rates, divided by its share price on a particular day or its average price for the particular period. Yield is not the same as total return.

Request a prospectus or a briefier profile; each includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.

Insights reports provide background information on many aspects of investing. T. Rowe Price Investment Services, Inc., Distributor.



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