

# Back to Basics: The ABCs of Investing

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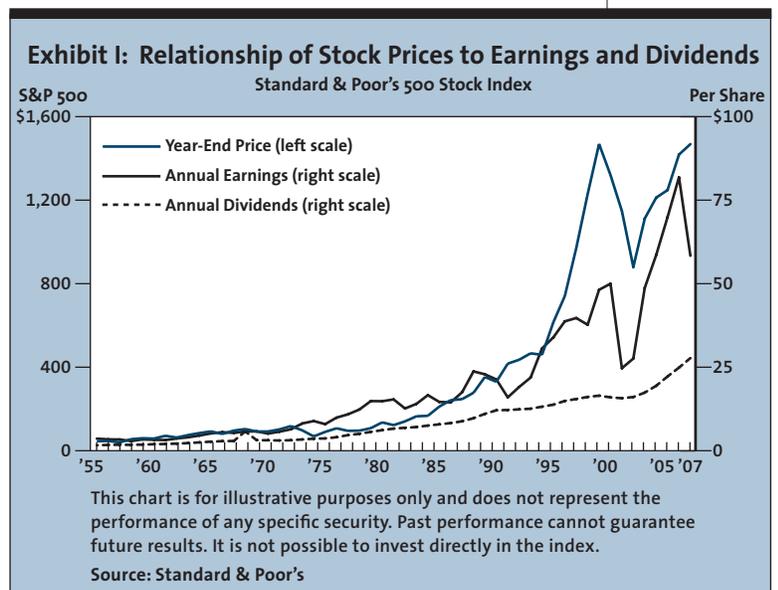
**W**hen it comes to investing, it is sometimes difficult to see the forest for the trees. Understandably, individuals can be overwhelmed by technical details and confused by conflicting investment forecasts, which too often dwell on the next six or 12 months instead of the longer term.

Before succumbing to information overload, it may be helpful to put aside forecasts and focus on some of the basic characteristics of the most traditional forms of investment: common stocks, bonds, and money market securities.

## Common Stocks

Common stocks offer investors a way to participate in the long-term growth of the U.S. economy. As the economy has expanded, corporate profits have grown and share values have risen.

This has not occurred without interruption, of course, but the long-term trend has been upward. Since 1950, the stock market has posted positive returns in all but 13 years, or over 78% of the time. In the short run, stock prices are affected by numerous factors, including the immediate economic outlook, changes in interest rates, and the degree of optimism or pessimism among investors. In the longer run, however, share values reflect the past and projected growth in earnings and dividends of individual companies. The more they grow, the more the stock should increase in value. This relationship is shown in Exhibit I, which illustrates the growth in principal value, earnings, and dividends since 1955. The broad market is represented by the Standard & Poor's 500 Stock Index.



Share prices of even the best-managed, most profitable corporations are subject to market risk, that is, they can fluctuate widely month to month, or even year to year. For this reason, equity investors should have a long-term investment horizon. Market volatility provides long-term investors with the opportunity to accumulate shares of quality companies at bargain prices during inevitable downturns.

In addition, studies have shown that, over longer holding periods, the variation of stock market returns — and the chances of incurring a loss — are reduced considerably. While common stocks have historically been riskier than other types of financial assets, they have provided superior long-term investment returns and a better hedge against inflation. As shown in Exhibit II, stocks significantly outperformed all other asset classes shown over all long-term time frames.

**Exhibit II: Cumulative Investment Returns and Inflation**

Periods Ended 12/31/07

Years

5      10      15      20

Stocks – S&P 500	82.86%	77.56%	346.29%	832.96%
Bonds – Government	20.47	78.46	143.38	297.30
Treasury Bills	15.48	41.66	77.10	140.51
U.S. Inflation (CPI)	16.11	30.21	48.02	82.01

Source: Ibbotson Associates

This chart is for illustrative purposes only and does not represent the performance of any specific security. Past performance cannot guarantee future results. Unlike stocks, Treasury bills are guaranteed as to the timely payment of interest and principal.

In addition to market risk, there is also business risk, or the possibility that a company may not achieve the level of profits anticipated. For this reason, investors should also be diversified, owning shares of several companies, preferably in different industries.

■ *Role of Dividends.* As with any investment, the total return on stocks consists of changes in principal value for a given period plus dividend income. Dividends have been a significant component of equity returns, especially when reinvested in additional shares.

The importance of compounding dividends is reflected in Exhibit III, which shows the results of a hypothetical \$10,000 investment in the S&P 500 Stock Index over the 20-year period ended December 31, 2007. During that time, the principal increased in value by \$59,435, and the investor would have received \$15,747 in cash dividends. The total value, therefore, was \$85,181, including the \$10,000 original investment. If the income had been reinvested instead of taken in cash, however, the total value would have grown to \$93,296.

High-yielding stocks tend to be those of mature, unglamorous companies, such as electric and telephone utilities, or companies that are slower growing or possibly out of favor with investors. High-yielding stocks have another advantage apart from income: They traditionally have offered below-average downside risk. The principal reason is that dividends are normally a more stable component of return than capital appreciation and, therefore, help to cushion the decline in a stock's price during market

downturns. By the same token, however, high-yielding stocks may provide less capital appreciation in bull markets.

Other companies, such as small, rapidly growing technology firms, provide little or no dividend income since they plow virtually all their earnings back into their businesses. Such “growth” stocks typically offer greater opportunity for capital appreciation than those with higher yields, but their prices also tend to be more volatile.

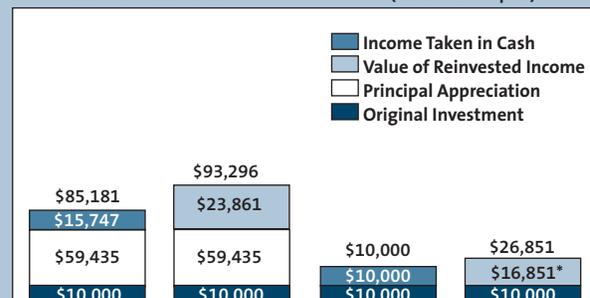
■ *Stock Valuations.* Picking good companies is only half the battle. Paying a reasonable price is also crucial for good, long-term results.

A stock is judged expensive or cheap primarily by measuring its price against the company's earnings, dividends, and asset values. These valuations are then compared with those of similar stocks, the broad market, and historical valuation trends. The most common valuation measure is the price/earnings (P/E) ratio, or the amount investors are willing to pay for each \$1 of earnings. The ratio is calculated by dividing the stock price by the earnings per share.

A high P/E ratio may be justified if the company has an excellent track record of high profitability and strong prospects for growth. But if earnings fall short of projections or if the P/E ratio was unreasonably high to begin with, the investor incurs greater risk. Since 1936, the P/E

**Exhibit III: The Power of Compounding**  
 (\$10,000 Investment)

 Standard & Poor's 500 Stock Index  
 20 Years Ended 12/31/07

 A 20-Year Bond  
 (With 5% Coupon)


\* Assumes income reinvested semiannually at 5%

Source: Ibbotson Associates; analysis by T. Rowe Price Associates

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

ratio of the S&P 500 has fluctuated in a wide band, but has averaged about 15.7.

From time to time, particular types of companies will generate so much enthusiasm that their stocks become expensive relative to their fundamentals, such as earnings. When that happens, they may become particularly vulnerable to developments perceived as negative. For instance, if a high-flying company's operating performance falls even slightly short of expectations, regardless of its absolute earnings progress, the stock can plummet.

Since stocks occasionally become overvalued or undervalued, investors may want to consider using a dollar cost averaging approach. By investing a fixed amount on a regular basis, you will acquire more shares when prices are low and fewer when prices are high. Of course, dollar cost averaging cannot assure a profit or protect against loss in a declining market. Since such a plan involves continuous investment in securities regardless of fluctuating price levels, investors should consider their financial ability to continue purchases through periods of both high and low price levels. Unfortunately, many people invest when enthusiasm and prices are high and sell when prices and investor psychology are depressed.

### **Bonds**

Bonds are debt obligations issued by corporations, state and local governments, the U.S. government, federal agencies, and other borrowers. Bondholders receive a fixed amount of interest each year, which is found by multiplying the bond's coupon rate by its face value. The bond's face amount, or principal, is repaid when the bond matures, unless the issuer has fallen into bankruptcy.

Unlike individual bonds, which usually make interest payments every six months, bond mutual funds distribute monthly dividends to their shareholders. These distributions can vary slightly from one month to the next, depending on changes in the fund's underlying investments. Also, open-end bond funds have no maturity date, since the fund is continuously buying and selling securities as market conditions change.

Compared with stocks, bonds usually offer a higher, more dependable level of current income, have less capital appreciation potential, and are

less volatile in price. Investors in bond mutual funds can automatically reinvest their dividends, buying new fund shares at the current price and adding to their investment. Holders of individual bonds face the challenge of reinvesting their interest payments in similar-quality securities yielding comparable returns.

While bonds provide more current income than stocks, they have not been as good a long-term hedge against inflation. An investor who buys a 10-year Treasury bond with a \$10,000 par value, for example, is assured of receiving \$10,000 back upon maturity, but the purchasing power of that \$10,000 would be worth only \$6,756 if inflation had averaged 4% over the decade. Moreover, the real value of the annual interest payments, because they are fixed at a certain rate, is also eroded if inflation increases.

In addition to possible erosion of purchasing power, fixed-income investors face two basic types of risk: market risk and credit risk.

- *Market risk* refers to the threat of rising interest rates. Since prices of outstanding bonds decline when rates rise and vice versa, the value of a portfolio's bond holdings can fluctuate as well.

Investors can usually obtain higher yields on longer-term issues than on those with shorter maturities, but longer-term bond values will fluctuate more in response to changes in interest rates. This relationship is shown in Exhibit IV, which depicts how values of bonds with various maturities change when interest rates rise or fall by one percentage point. The table assumes a 5% coupon and \$1,000 par value for each bond.

During periods of rising rates, the decline in principal value of longer-term bonds can offset some or all of their interest income. By the same token, when prices rise as interest rates decline, capital appreciation can substantially increase the investor's total return.

Principal volatility may not be a major concern if you are investing for high current income or to compound the earnings over a long period of time. But if you anticipate needing the money in the near future, you should emphasize shorter maturities.

- *Credit risk* refers to the possibility that the borrower (bond issuer) will default, that is, not

Bond maturity in years	Exhibit IV Rates fall 1% and the bond's value rises to:	Rates rise 1% and the bond's value drops to:
1	\$1,009.61	\$990.57
3	\$1,027.74	\$973.28
5	\$1,044.49	\$957.90
10	\$1,080.97	\$926.53
30	\$1,171.25	\$863.87

Chart assumes 5% coupon and \$1,000 par value for each bond and shows value changes apart from fluctuations caused by other market conditions or factors.

meet scheduled interest and principal payments. Rating agencies such as Moody's and Standard & Poor's assign credit ratings to larger bond issues to help investors assess this risk.

Generally, the higher an issuer's credit rating, the lower the bond's coupon rate. As the nation's most creditworthy borrower, the U.S. government can borrow at lower interest rates than any other taxable bond issuer. All bonds rated AAA to BBB are considered investment grade, and bonds rated BB or lower are considered noninvestment grade, or "junk," in Wall Street lingo.

Depending on your tax bracket and the relationship of taxable to tax-exempt yields, you may also want to consider municipal bonds whose interest is exempt from federal taxation and, in some cases, state income taxes as well.

### Money Market Securities

Money market securities include Treasury bills, short-term bank certificates of deposit, banker's acceptances, and commercial paper issued by corporations. These securities trade in a highly developed market, usually in blocks of \$1 million or more. Investors with smaller amounts to invest can participate in the market through money market mutual funds.\*

Because money market securities have short maturities, they usually yield less than bonds but also fluctuate less in price. This makes them an excellent investment for money held for contingencies, near-term expenses, or future investment opportunities. Money market funds are managed to maintain a

constant share price, so that in a rising interest rate environment the investor quickly benefits from the higher yields without principal loss. Conversely, fund yields will fall as short-term rates decline.

Investors should always maintain some cash reserves. But over the long run, returns on money market investments have only marginally out-paced inflation, as shown in Exhibit II.

### The Right Mix

Deciding how to allocate your assets among these and other investments is a personal decision that should reflect your financial goals, how much time you have to achieve them, your tolerance for risk, and how much you have to invest.

For most investors, a diversified approach works best. A combination of stocks, bonds, and money market securities can be rewarding over the long term. While diversification does not eliminate risk, it can reduce your portfolio's overall volatility and help you achieve your financial goals.

**\*An investment in money market funds is not insured or guaranteed by the FDIC or any other government agency. Although they seek to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in them.**

*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.*

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