

T. ROWE PRICE REPORT



» A Perspective On Financial Topics For Our Investors

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T. Rowe Price
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Is the Great Reversal Sustainable?

What a difference a year makes. At this time last year, the global economy was reeling from the worst meltdown since the Great Depression, and investors were enduring the worst bear market since then. Global stocks continued plummeting into last spring, and the only place to hide seemed to be the increasingly crowded haven of U.S. Treasuries.

By contrast, 2010 opened with investors heartened by the sharpest recovery they've ever seen but warily wondering whether huge gains off market bottoms can be sustained.

Brian Rogers, T. Rowe Price chairman and chief investment officer, likens last year's great reversal to a badly injured victim of a car wreck who was saved by feverish efforts in the emergency room, had a couple of setbacks while in intensive care, and now is an outpatient. "While still requiring treatment, clearly the patient feels much better and one hopes not to experience a relapse," he says.


All eyes are on the still sluggish U.S. economy. At some point, demand growth may trigger the Federal Reserve to start unwinding its unprecedented stimulus by raising rock-bottom interest rates or withdrawing support for the U.S. mortgage market.

T. Rowe Price's chief economist, Alan Levenson, forecasts an extended economic convalescence in 2010, estimating an annual U.S. gross domestic product growth rate

of 2.6%. But he also notes the Fed could begin tightening monetary policy in some fashion earlier than the usual 12 months after unemployment peaks.

That new rate cycle could challenge global bond markets, particularly U.S. Treasuries. T. Rowe Price bond portfolio managers believe credit sectors that have not received strong government backing—high yield, investment-grade, and emerging market bonds—offer better value entering 2010.

At the same time, the firm's investment managers believe stocks likely will outperform bonds this year, though a repeat of 2009 stock returns is unlikely. Going into the new year, equity portfolio managers generally favored U.S. large-capitalization and international stocks.

For equities in 2010, the key is improved earnings, not just from cost-cutting, but from revenue growth. Mr. Rogers says, "The underpinnings of the equity markets are certainly much better than a year ago, and I think we'll be bailed out by good earnings." 

Ten Lessons From a Tumultuous Time

By Brian Rogers,
T. Rowe Price
chairman and
chief investment
officer, based
on comments
he made at the
firm's recent
Investment
Symposium.



Thinking back on the most recent global meltdown, two quotes come to mind, “What doesn’t kill us makes us stronger” and “Those who cannot remember the past are doomed to repeat it.” At T. Rowe Price, we remember all too well the volatile financial markets of the past and have distilled some lessons from them for companies and individuals as we recover from the worst financial market crisis since the Great Depression.

Watch Your Liquidity: Don’t fund long-term assets with short-term liabilities. In the midst of the financial crisis, the commercial paper and other short-term markets ground to a standstill. This posed a dilemma for companies that did not have enough cash on hand to finance their daily operations. Companies should always ask themselves how they will stay in business when they can’t borrow money from traditional sources.

Balance Sheet Strength Matters: Always be aware of your overall debt load and have a prudent appetite for leverage. While leverage enhances returns in a booming market, it causes problems when markets turn. Keep an eye on your corporate and household balance sheets and don’t get overextended.

We Are All Connected: No company or individual is an island in the global economy. Globalization has linked us all in an intricate network of financial transactions.

When the United States catches a cold, smaller economies in the world are likely to come down with pneumonia.

Financial Innovation Helps Wall Street, Not Main Street: Wall Street had developed financial instruments so exotic that not even their creators fully understood them. Wall Street issued debt, repackaged it, then repackaged the repackaged debt—with a litany of acronyms that camouflaged their complexity and risks.

Get a Map of Washington, D.C.: Like it or not, the federal government is going to become more involved in the financial services industry. We are embarking on an era of greater government involvement and regulation. We welcome transparency and laws designed to protect against fraud, but it would be counterproductive for the regulators to tell well-run companies how to manage their businesses.

Simplicity Is a Virtue: The financial meltdown has brought most of us back to our senses. We are rediscovering the old virtues about how to properly finance our purchases. We are learning once again to live within our means and not to adopt lifestyles we can’t afford.

If It Sounds Too Good to Be True... Well, It Most Surely Is: If someone claims that he can generate outsized gains without a corresponding level of risk, get a firm grip on your wallet. Returns in excess of historical norms are virtually impossible to sustain for long periods. As Nobel prize-winning economist Milton Friedman noted, “There’s no such thing as a free lunch.”

Don’t Reach for Yield in Money Market Funds: Some money market funds, among the safest of investment vehicles, got into a lot of trouble last year by lowering their standards and reaching for higher yields. Their managers invested in securities that didn’t belong there and, as a result, put their investors’ principal at risk. Money funds are supposed to be ultraconservative and satisfy the cash needs of their shareholders.*

The World Doesn’t End That Often: In the midst of a financial crisis, it can appear as though the world is coming to an end. If this were true, civilization would have disappeared centuries ago. In the last century alone, we endured World War I, World War II, the Korean War, Vietnam, Watergate, the savings and loan implosion, the Argentine peso crisis, the Russian ruble crisis, and dozens of other world-shattering events. Had we put our investment capital under the mattress each time, we never would have benefited from the market rebounds that inevitably followed.

We Will Have Other Crises: There is another bubble waiting for us down the road. We need to take measures now to protect ourselves. We do this by not overextending ourselves financially, remaining well diversified, keeping our own tolerance for risk at the forefront of our investment decisions, and establishing a long-term investment strategy that makes sense to us in all market environments. 📖

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

U.S. Economy on Track for Modest Growth, Job Gains

By Alan Levenson, T. Rowe Price Chief Economist

The U.S. economy continues to recover from the deepest recession since World War II and shows evidence of moving toward a broader and more durable expansion.

Real gross domestic product (GDP) expanded at a 2.2% annual rate in the third quarter and at an estimated 5.6% rate in the fourth quarter of last year. More than half of that growth in production is attributable to business's efforts to slow the pace of inventory liquidation. Nonetheless, final demand—consumer spending, home sales, and business plant and equipment spending—has stabilized after the sharp pullback a year ago in the depth of the recession.

Most important to prospects for a sustainable expansion, the downward adjustment of employment has run its course. The silver lining of aggressive job cutting has led to an atypically early surge in productivity that boosted corporate profitability.

This should support the reemergence of job growth, which should lift labor income and consumer spending in turn, encouraging further production and employment.

As the economic recovery evolves toward sustainable expansion, the downside risks so palpable a year ago have faded. Indeed, the tendency for deep recessions to be followed by strong recoveries introduces credible upside risks to the outlook. After real GDP fell 3.8% from its second quarter 2008 peak to its trough a year later, the record would indicate a rebound of 6% or more during the first four quarters of the ensuing recovery.

Nonetheless, we are forecasting only 2.8% growth over the first four quarters of this recovery (assuming that it began in July of last year) and 2.6% over the four quarters of 2010.

Resumption of Job Growth

Perhaps most prominently, consumer spending will be limited by a continuing focus on reducing previously accumulated debt. This emphasis on balance sheet repair will be reflected in a higher personal savings rate, which will reduce consumer spending by 1.0 to 1.5 percentage points relative to income growth.


In addition, we expect a relatively slow recovery in business capital

spending, as firms focus on reducing debt levels. Finally, the recovery in housing construction will be dampened by the overhang of vacant housing units available.

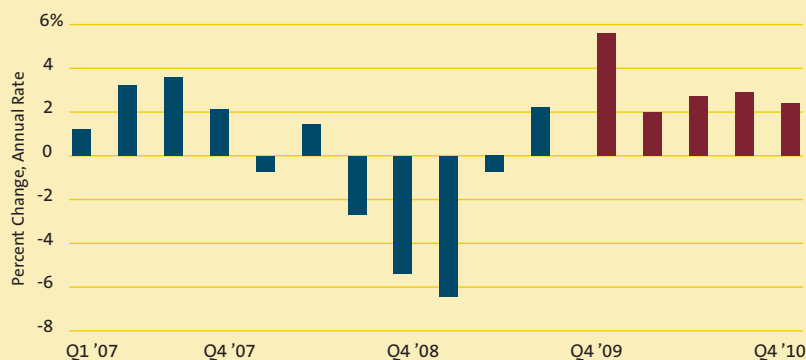
The muted rebound in demand will limit the call on labor to produce those goods and services. We expect a steady improvement in monthly net job gains to roughly 150,000 by the end of the year, with the unemployment rate peaking at around 10.5% by midyear and declining gradually thereafter.

Ample capacity suggests that inflation will remain subdued, but a weak dollar and further gains in commodity prices could provide an upward impulse, particularly in commodity-based food and energy costs. We expect the consumer price index to rise 1.3% over the four quarters of 2010, on par with last year's performance, with higher food and energy inflation offsetting a decline in so-called core inflation.

The renormalization of economic policy will be a prominent feature of the 2010 landscape. The Fed will continue to wind down emergency lending and asset purchase programs, and we will probably see the first of a series of interest rate increases this summer.

In the meantime, several issues bearing on the intermediate-term budget outlook—including health care reform, financials sector regulation, energy policy, the fate of Bush administration tax cuts set to expire at the end of the year, and the future of the estate tax—will bear importantly on the economy's longer-term growth potential. 

Recovering From the Great Recession: Quarterly Real GDP



2009 Q4 through 2010 Q4 are T. Rowe Price estimates.

Sources: Bureau of Economic Analysis, Haver Analytics, and T. Rowe Price.

Equity Landscape Improving Amid Many Potential Pitfalls

After experiencing the worst bear market and most exuberant rally since the 1930s, U.S. equity markets are expected to make further progress this year with less drama as they continue recovering from the financial crisis.

The speed and magnitude of the rebound from the market low on March 9 took many investors by surprise as large-cap U.S. stocks (S&P 500 Stock Index) gained 26.5% in 2009, led by the technology and materials sectors. Meanwhile, mid-cap stocks (Russell Midcap Index) surged 40.5% and small-caps (Russell 2000 Index) gained 27.2%.

While T. Rowe Price managers expect the environment to continue improving this year, the markets face wide-ranging risks.

The equity markets did enter the year with some positive developments to build on. The economy is emerging from a steep recession, stock valuations are still reasonable, and earnings have held up better than expected.

In addition, companies have regained access to the capital markets as the financial system heals, interest rates remain low, investor and corporate confidence seem to be improving, merger and acquisition activity is reviving, and a huge amount of cash sits on the sidelines available for investment.

“I think markets will be generally good in 2010,” says Brian Rogers, the firm’s chairman, chief investment officer, and manager of the Equity Income Fund. “The underpinnings are certainly much better, and I think we’ll see good earnings and dividend performance as we move through the year. Money continues to move in the direction of greater risk, and I think we’ll see much more merger

and acquisition activity, which should provide strong support.”

At the same time, there is an old expression that bull markets climb a wall of worry, and the wall facing this one is formidable—though not insurmountable.

Among the obstacles that concern managers: residual fragility in the financial system, the strength of the recovery, corporate revenues and earnings, the Federal Reserve’s exit strategy for reducing liquidity in the system, mammoth U.S. budget deficits and related dollar weakness, a tougher legislative and regulatory environment with possibly higher tax rates, weakness in the commercial real estate market, and high unemployment and the financial health of consumers.

How these trends unfold will significantly influence market outcomes this year. Here is a look at some of them.

• **The Economy and Earnings:** “The biggest question for 2010 is the pace of the economic recovery,” says John Linehan, the firm’s co-head of U.S. equities. “For the market to continue its gains, we need to see durable economic growth. Clearly, the market’s performance in ’09 was

not driven by earnings but rather by the expectation of future earnings. If those earnings don’t come through, it will be a significant headwind for the market.”

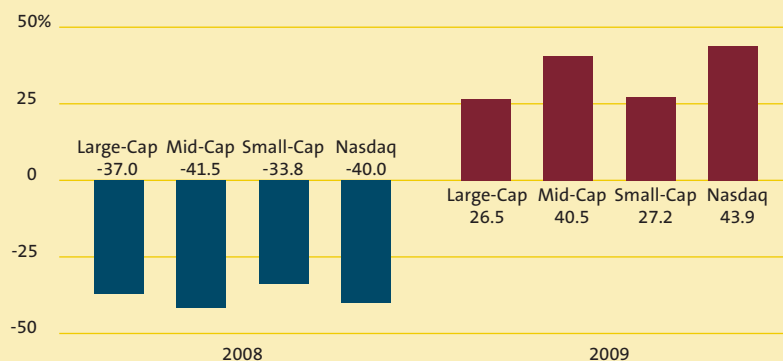
While earnings did not decline as much as feared last year despite precipitous falls in revenue, it was largely due to massive cost-cutting by corporations. “But companies can’t cut their way to prosperity,” Mr. Linehan adds. “At some point we need to see top-line revenue growth to drive bottom-line earnings growth.”

Mr. Linehan is optimistic about the outlook for earnings and economic prospects. “The U.S. economy may not be as robust as many emerging markets, but it is extraordinarily resilient and very innovative. Several of our companies, such as Apple and Google, are really driving innovation in the global economy.”

• **Government Spending:** While managers agree that the huge stimulus was needed to support the economy, the U.S. fiscal situation is top of mind. “There is a danger in withdrawing stimulus too soon,” says Brian Berghuis, manager of the Mid-Cap Growth Fund, “but we need to see really tangible plans on how

A Startling Reversal in Stock Market Performance

Total Return for Various Stock Market Sectors



Sources: Returns based on S&P 500, Russell Midcap, Russell 2000, and Nasdaq Composite Indexes.

government spending can be pulled back because it is so egregiously out of balance. It is not sustainable in the long term, and not even in the intermediate term. Withdrawing that stimulus gradually without tipping the economy back into recession and passing the baton from the public sector back to the private sector is really a delicate process, but that is really the key to a sustainable recovery.”

Mr. Linehan adds, “Fiscal policy is the real wild card. So far the market views the deficits as temporary—something that we can grow our way out of. But if it becomes viewed as systemic deficits going forward, the weight of that could be considerable.”

• **Monetary Policy:** The Federal Reserve has pursued unprecedented quantitative and monetary easing to stabilize the financial system, but it faces “a real dilemma,” Mr. Linehan says. “Over the next year or two, it clearly has to reduce its balance sheet and begin raising rates and that will have repercussions in the market.”

“At what point do you take the punch bowl away from the party?” he asks. “If the Fed moves too quickly, it can hurt the recovery and put us back in recession. If it moves too slowly, it will increase the potential for inflationary pressures. I would expect them to err on the side of moving too slowly because they have more tools in their arsenal to fight inflation than deflation, and deflation is far worse.”

But Preston Athey, manager of the Small-Cap Value Fund, warns, “I think we’re going to have a better than even chance that inflation will be the topic of the day sometime in the next five years, and it could be as early as 2012.”

• **The Financial System:** “The thing that worries me the most is just the fragility in the financial system,” Mr. Linehan says. “I think the worst

of the credit crisis is behind us, but we need to see bank lending pick up.”

Adds Mr. Berghuis, “Are we safely out of the financial crisis? I’m not willing to give the all clear. The banking system is still struggling to right itself. However, it is in better shape than a few months ago.”

“Many banks have done huge equity deals that have allowed them to survive. And credit conditions are a lot better; large companies are able to access the capital markets now on terms that seemed inconceivable six months ago.”

Large- and Small-Cap Stocks

With the market rebound generally led by smaller, more volatile, lower-quality stocks, managers say larger companies with stable earnings and cash flow offer more opportunity and indeed attracted more investor interest in the fourth quarter.

“There are several high-quality growth companies that look very reasonably valued,” says Larry Puglia, manager of the Blue Chip Growth Fund. He also notes that large multinational companies have

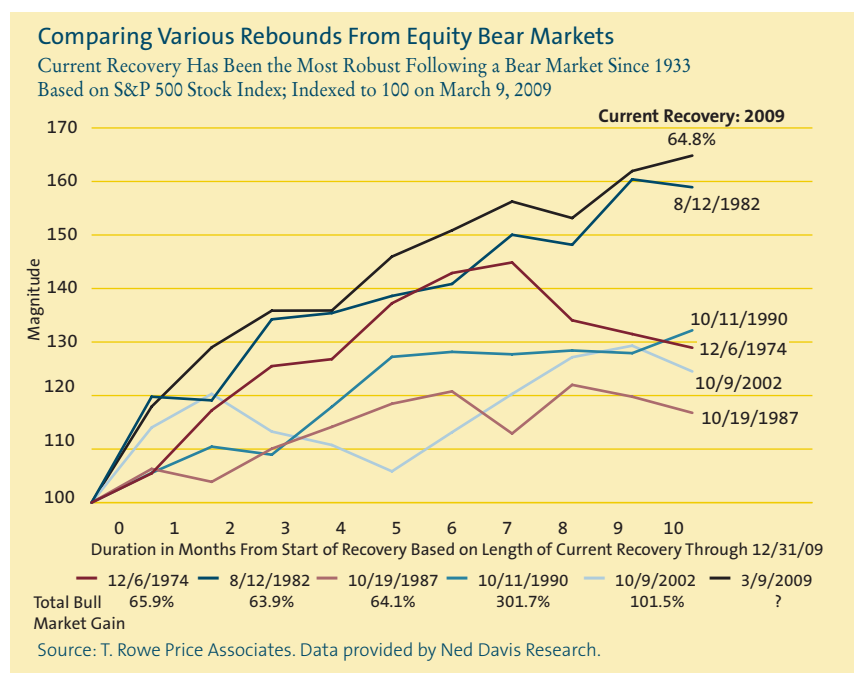
benefited from the weak U.S. dollar because about 40% of the revenues of the S&P 500 are derived from overseas markets, compared with only 20% to 25% for smaller companies.

In addition, larger companies with strong balance sheets are typically better able to cope with a sluggish economic growth environment, Mr. Puglia adds, “because they are more diversified in terms of products and markets, have better access to capital, and can often make opportunistic acquisitions.”

“One of the reasons we are attracted to the health care, financials, consumer staples, and certain technology sectors,” he says, “is that many of those companies are not quite as dependent on a robust economic recovery as are some of the consumer discretionary and industrial companies where valuations have been stretched.”

“In this environment, it is important to be balanced. We don’t want to be too dependent on cyclical companies, which have performed quite well. We like companies that

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Equity Outlook

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should take market share even if we have an inconsistent recovery.”

Small-cap stocks, true to the historical pattern, surged off the market bottom; they have outperformed large-caps in the first 12 months after a bear market 80% of the time since 1932. Their relative performance lost steam, however, in the fourth quarter.

While smaller companies are expected to perform well if the overall market continues its advance, “it will be challenging for them to keep up with the S&P 500 without a robust economic recovery,” says Greg McCrickard, manager of the Small-Cap Stock Fund.

One reason for the caution is that small-cap valuations based on expected earnings did not fall as drastically as they normally do in bear markets, and they have emerged from the last one at a modest premium to large-cap stocks. By contrast, small-caps historically have sold at a modest discount.

While valuations on other measures, such as price to sales and price to cash flow, are more reasonable, “it doesn’t look like the layup you would normally get at this point in the cycle,” Mr. McCrickard says. “So we need to see significant gains in earnings.”

Jack Laporte, veteran manager of the New Horizons Fund, notes that many small companies are well financed and, like larger companies, “have been able to cut back so dramatically that they are generating free cash flow even when their earnings have been cut in half. Corporate America has gotten religion, and it’s not just the large-cap companies. It’s the small-cap companies, too.”

Another favorable development for small-cap stocks is a pickup in merger and acquisition activity. “There is a huge amount of dry powder on large companies’ balance sheets as

they search for growth in a relatively stagnant environment,” says Hugh Evans, a T. Rowe Price small-cap manager. “One way they get there is to buy smaller companies.”

The Bottom Line

While there are many crosscurrents to navigate, on balance the firm’s equity managers are optimistic about this year’s prospects.

“This is a challenging investment environment, and I doubt that the market could have another year in 2010 like 2009,” Mr. Puglia says. “But I would not be surprised if the market is up 10% to 15% in 2010.”

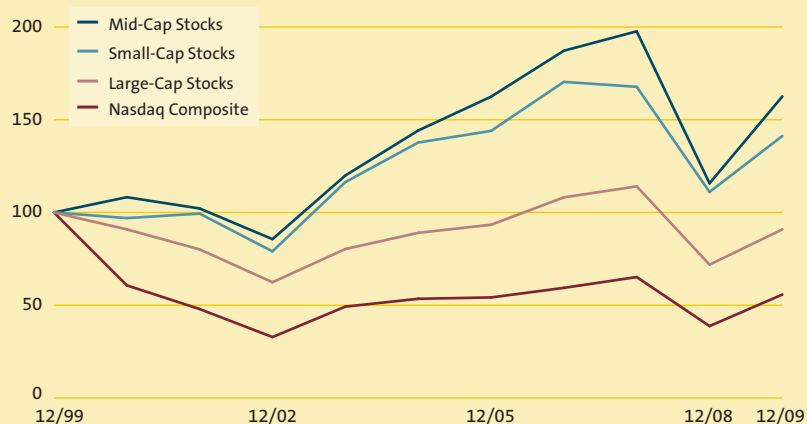
Mr. Athey agrees that gains in that range are attainable, but adds, “I think the chance of a down market is reasonably low, but I also think the chance of another boom is fairly low also.”

Rob Bartolo, manager of the Growth Stock Fund, is “pretty bullish for 2010. A year ago we were in the shock and awe period, but now consumers and companies are repairing their balance sheets and confidence is improving. And with interest rates likely to remain low, the alternatives to the equity market are not that attractive.”

Mr. Berghuis concludes, “I see the market continuing to recover, but we’ve had an extremely brisk rebound and gains will become harder from here. A lot of imbalances have developed in the global economy over the past few years and, frankly, most of those imbalances are still there.”

The Value Fund that Mr. Linehan managed as of December 31, 2009, did not own any of the securities that he mentioned.

A Tough Decade for Equity Investing: Performance of Various Market Sectors
Total Return From December 31, 1999, to December 31, 2009, Indexed to 100



In a decade marked by two severe bear markets at the beginning and the end, large-cap stocks (S&P 500 Index) and technology stocks (Nasdaq Composite) lost money while mid-cap stocks (Russell Midcap Index) and small-cap stocks (Russell 2000 Index) managed modest gains. It also marked the first decade when the S&P 500 had a negative total return. However, it followed two straight decades of extraordinary returns. In the 1980s and 1990s, the S&P 500 had annualized returns of 17.5% and 18.2%, respectively. Small-cap stocks had an annualized gain of 14.5% in the 1980s and 13.4% in the 1990s.

Note: Performance for the Nasdaq Composite reflects principal only.

Financial Stocks: Turning the Corner on Road to Recovery

As investor fears over the possibility of a second Great Depression receded early last year, the financials sector skyrocketed off the March 9 market low. Jeff



Arricale, manager of the Financial Services Fund, discusses the health of the banking system and the current outlook for financial stocks.

Q. How do you assess the health of the banking industry now, more than two years after the credit crisis emerged?

A. The health of the industry is solid. Obviously, it's been better, but the 19 largest banks underwent a very strenuous stress test. The financials sector has raised over \$200 billion in equity and equity-linked securities in 2009, so it has ample capital and earnings power to absorb losses that could incur over the next couple of years on commercial real estate, business, and consumer loans.

There will be a lot of small banks that will continue to fail, but there are over 8,000 banks in the U.S., and the ones that are likely to fail are inconsequential to the overall health of the financial system. The mid-size and large regional banks and the large conglomerate banks are all sound.

Q. What are the key challenges still facing the banks and continued recovery of the financial system?

A. One thing that would really hurt the banks is a significant rise in unemployment. If people don't have jobs, they don't pay their credit card bills or mortgages or consumer loans. If unemployment gets materially

worse from the recent 10% level, stocks will not perform well and a lot of companies will have to raise more capital. This problem is closely related to new government regulation. Small business owners are the driver of job growth and if they face higher taxes and greater health care costs, what will be the catalyst to offset this and get small business growing again.

Also, commercial real estate will be a drag on banks' balance sheets and the economy at large for the next couple of years. About \$190 billion of really lousy securities were underwritten in 2006 and 2007 backed by commercial real estate. Those loans come due in 2011 and 2012, so banks are reluctant to loan into that sector while those loans are being worked out.

If short-term interest rates rise and long-term rates do not—the yield curve flattens instead of remaining steep—that would hurt bank earnings because banks' net interest margins [what they earn from borrowing at short-term rates and lending at long-term rates]

have been favorable. But my sense is if short rates rise, long rates will follow suit, and that would actually be quite good for banks.

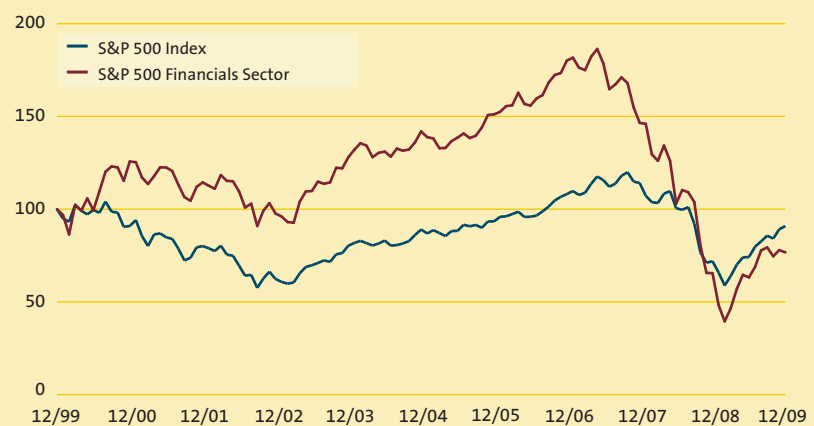
Q. What impact will greater regulation have on the financials sector?

A. I think we are facing the largest regulatory rewrite since the Great Depression and the securities acts of 1933 and 1934. It will likely require companies to hold more capital and result in lower returns on equity. But that's not necessarily a bad thing given current depressed valuations and the fact that companies with more capital will be viewed as safer and potentially worth a higher valuation multiple.

We're likely to see regulators apply a higher risk weighting for certain types of assets. So if a big conglomerate bank has a lot of proprietary trading activity, the assets it holds will have a higher risk weighting and the bank will have to hold more capital against it versus a bank that is simply making loans to corporations.

Continued on page 8

Relative Performance of the S&P 500 Versus the Financials Sector
Total Return Indexed to 100 as of December 31, 1999



Source: T. Rowe Price. Data provided by Ibbotson Associates.

Investment Viewpoint

Continued from page 7

It will be harder for banks to engage in speculative activities, but Boards of Directors are already more in tune with what management is doing, and risk managers have uniformly taken a more elevated role in their organizations.

Regardless of regulation, I think companies and investors will use less leverage going forward. An unlevered company can make a lot of mistakes and survive, but if a company with a lot of leverage makes mistakes, as Lehman and AIG did, investors can be wiped out.

Q. The financials sector led the market down in the crisis but surged 134% from the low on March 9 to year-end. What accounted for that startling turnaround?

A. The initial phase of the recovery had little to do with fundamentals. Across the world, investors threw in the towel and stocks were very oversold. As commerce restarted and an incipient recovery began, there was a huge sigh of relief by investors that we were not going into a global depression.

The second part of the rally reflected a recognition that the fundamentals—whether it was housing prices, losses on nonperforming loans, or banks' losses—were still getting worse but at a declining rate and that the economy was going to recover in 2010 and beyond. Also, investors were looking ahead to companies being profitable again this year and next, though it may take until 2012 before we see the financials sector, and the banks in particular, return to normalized earnings. We don't expect earnings in the sector to reach 2006–2007 levels for some time simply because there is going to be less leverage in the system.

Q. What areas do you find attractive?

A. Valuations are appealing in a number of companies, particularly the banks. Some have been trading at prices below their tangible value or a modest premium. Others are trading at only five to seven times what we expect them to earn in 2012. Some are profitable today and others should be in another two or three quarters. These banks have healthy

balance sheets and should weather the storm.

Among the larger banks, we like Bank of America. Among investment banks, we have significant investments in Goldman Sachs, which trades at a reasonable valuation, has a very good balance sheet, and has expanded its market shares in almost all of its businesses. J.P. Morgan Chase remains our largest holding. Like Goldman, it is a best-in-class company, a market leader in almost everything it does, and trades at a fair (price/earnings) multiple.

We also like insurance brokers, companies like Aon, which will benefit from economic recovery and a rise in interest rates.

Q. What is your general outlook for the financials sector?

A. A lot depends on the trajectory of the economic recovery, but we are past the worst of the crisis, and I remain optimistic. I don't expect the volatility to be as frenetic as it has been. I wouldn't be surprised to see a move of 10% up or down from here, but I would be surprised to see another dramatic sell-off or a double-dip recession.

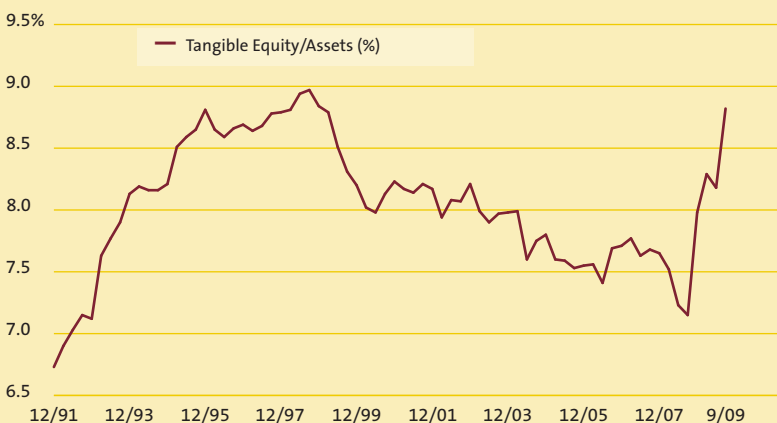
I don't necessarily believe financials will regain the market leadership that they enjoyed for several years leading up to 2007. However, as long as the balance sheets are in good shape, there are several areas that should provide sensible returns over the next couple of years. 📈

Financial services companies may be hurt when interest rates rise sharply and may also be vulnerable to rapidly rising inflation.

The securities mentioned accounted for 17.7% of the fund's portfolio as of December 31, 2009.

Banks' Financial Stability on the Mend

This chart shows the recent sharp rise in tangible equity capital as a percentage of tangible assets for all publicly traded banks and thrifts. In other words, the banks have substantially increased their equity capital as a buffer against potential losses on bad loans on their balance sheets. This influx of capital into the banking system and a more defensive balance sheet profile bodes well for the financial health of the industry.



Data include capital raised as of December 15, 2009; reflects banking industry median values. Sources: KBW Research and company filings.

Possible New Rate Cycle Clouds Bond Market Outlook

Fixed income investors over the past 15 months have lived through the worst and best of times.

Most bond sectors other than U.S. Treasuries lost money when global credit markets seized up in the fall of 2008. But after investors stampeded to increasingly low-yielding Treasuries, the bond market flipped to its mirror image, with riskier sectors—high yield, emerging market, and investment-grade corporate debt—racking up remarkable returns in 2009.

With this dramatic turnabout, the range of returns over the last two years has been startling. For example, the difference in returns for high yield bonds from 2008 to 2009 was 80 percentage points. (See chart on this page.) Moreover, within each year, there also has been a very wide range of returns from sector to sector.

So fixed income investors may be excused if they braced themselves a bit as they entered 2010. The year opened with short-term Treasuries at record low yields and the strong possibility that the U.S. Federal Reserve, at some point, could begin taking steps that would lead to higher interest rates.

No one can predict with certainty when this new interest rate cycle

will begin—and some analysts believe it even may not be before 2011. Its impact will depend on how effectively federal officials manage an exit strategy from the unprecedented support that they provided to the nation’s credit markets after their near collapse in late 2008.

The Rate Dilemma

Meanwhile, bond investors appear to be faced with a difficult dilemma: Invest in short-duration Treasury bills for principal protection, earning next to nothing in yield, or invest in longer-term bonds and in riskier credit and global sectors for greater yields but risk principal losses if the Fed sharply tightens and rates rise.

“We’re really in uncharted territory here,” says Steven Huber, head of T. Rowe Price’s fixed income portfolio strategy teams and portfolio manager of the multi-sector Strategic Income Fund. “When the Fed acts or a move is imminent, short rates could increase quickly. So the question then for investors who have fled from low-yielding money market rates into longer-duration and riskier sectors is how will these sectors perform as interest rates increase?”

Adds Dan Shackelford, portfolio manager of the New Income and

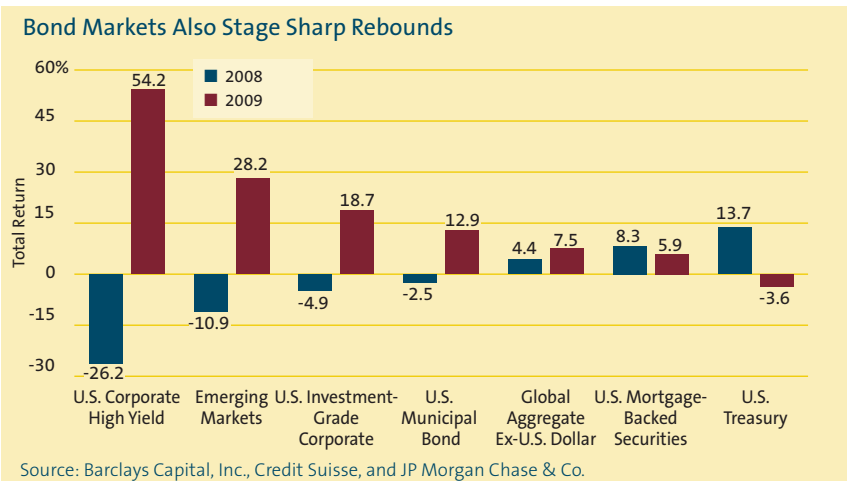
Inflation Protected Bond Funds, “It’s a dangerous game, waiting for the Fed to stop the music so we can find out how much distortion the government has created in the mortgage and other credit markets where it has been directly supportive. It kind of puts you at the edge of your seat versus six months ago.

“But we think the music is going to continue for a while because the system needs more time to heal. Meanwhile, it would be a bitter pill to swallow to give up a significant difference in return by loading up at the short end of the yield curve, at least until we have firm signals about what lies ahead.”

So entering 2010, T. Rowe Price bond portfolio managers generally have only tilted their portfolios toward shorter durations to guard against the impact of possible Fed tightening. Indeed, they say, while the short end of the yield curve (short-term rates) could rise quickly, the longer end (long-term rates) may rise relatively less if the market perceives the moves as combating inflation. In other words, the yield curve may flatten.

As a result, while acknowledging interest rate risks, managers expect a relatively benign outcome for 2010. Treasuries and mortgage-backed securities are not considered attractive because of their dependency on Fed support, but investors could earn mid- to high-single-digit coupon rates in high yield and investment-grade corporate bonds. (Of course, such bonds, unlike Treasuries, are not insured or backed by the U.S. government.)

As with T. Rowe Price stock portfolio managers, bond managers



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Bond Outlook

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also are increasingly searching for more opportunities globally, particularly in emerging market corporate and sovereign bonds, European corporate bonds, and Asian and Latin American currencies.

Credit Sectors

U.S. high yield and investment-grade bonds entered 2009 offering yields at record spreads over yields of comparable Treasuries. Those spreads dramatically compressed as credit markets healed. The result: equity-like returns from tremendous capital appreciation.

Investment-grade bonds returned 18.7% in 2009, one of the sector's top five years since 1973 and its best year since 1995. High yield bonds returned a record high 54.2%.

Even with those gains, T. Rowe Price bond portfolio managers say U.S. corporate credit remains promising for investors content to clip decent coupon rates in a low yield environment. Investors also may gain some capital appreciation if corporate yield spreads shrink further.

"The high yield sector could again be the number one asset class in fixed income," says Mark Vaselkiv, portfolio manager of the High Yield Fund. "It may only earn 6% if rates go up a lot, but if that's the case, many of the other bond sectors could lose money."

Mr. Vaselkiv says the financial health of high yield companies is rapidly improving, with the unusually high 12% default rate last year likely falling to 4% or lower in 2010. He sees high yield spreads over Treasuries, which hit a record of 1,925 basis points (19.25 percentage points) at the end of 2008 but declined to 664 basis points by the start of this year, dropping even more.

With the improving condition of high yield companies, Mr. Vaselkiv

has found better performance at the lower end of the credit quality scale. He expects to continue that strategy in 2010—including investments in companies that have defaulted on their bonds but are now moving out of bankruptcy, which he likens to "making lemonade from lemons."

Of course, high yield bonds pose greater default and liquidity risks than higher-rated bonds, which could cause substantial price swings.

David Tiberii, manager of the Corporate Income Fund, also believes there will be more yield spread compression with investment-grade bonds, even after that sector's yields dropped from 600 basis points over comparable maturity Treasuries to 175 basis points at year-end.

Mr. Tiberii has not yet repositioned his portfolio for an interest rate hike. He says that "it's not clear if rates will go higher over the near term, given the significant slack in the economy."

Most important, he says, is focusing on the quality of investment-grade issuers, "We are looking particularly at firms that have adequate short-term liquidity—no large loan or bond maturities in the near future and sufficient cash. As the economy shifts to growth, we're worried about credit event risk and look for managements

with a track record of protecting bondholders by prudently investing their cash without degrading their balance sheets."

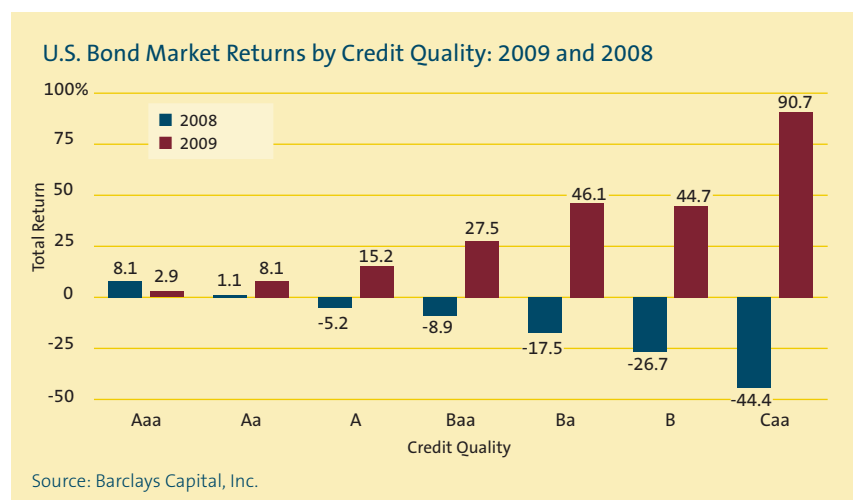
International Markets

T. Rowe Price bond managers increasingly are seeking opportunities in global markets, focusing on emerging market bonds in general and the rapidly growing emerging market corporate sector in particular.

These economies went into the global downturn less indebted and in much better shape than developed economies. Going forward, Mike Conelius, manager of the Emerging Markets Bond Fund, sees their debt markets stabilizing relative to those in developed markets.

In 2009, emerging market bonds also benefited from compression in yield spreads, strong capital inflows, and the growing role of corporate bonds, with the broad sector returning 28.2% for the year.

The emerging corporate market now rivals the U.S. high yield market in size. "This is an exciting secular change that means new companies, new industries, and the ability to focus on the domestic demand story in such countries as Brazil or India that we haven't been able to do before," Mr. Conelius says.



In developed markets, Ian Kelson, manager of the International Bond Fund, is overweight in European corporate bonds and likes certain Asian currencies.

“International bonds won’t be as strong as in 2009—when they derived significant gains from the depreciation of the U.S. dollar—but they should benefit from a further narrowing in credit spreads and could perform well if there is a global loss of confidence in U.S. assets,” he says.

In addition to interest rate and credit risks, international and emerging market bonds also pose currency risk and the general risk of investing in foreign markets.

Fed-Dependent Sectors

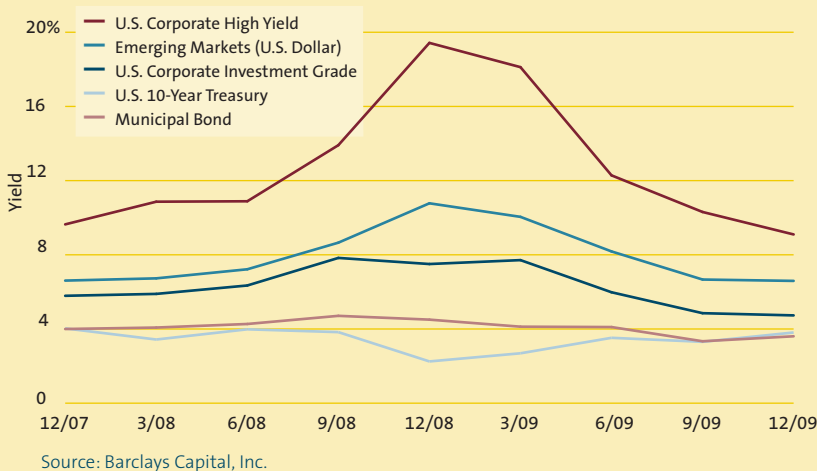
This year opened with Treasury and mortgage rates at record lows, thanks to unprecedented federal support. If the economy strengthens and the Fed tightens credit, the question will be whether it does so in an orderly way, T. Rowe Price bond managers say.

Brian Brennan, portfolio manager of the U.S. Treasury Intermediate and U.S. Treasury Long-Term Funds, acknowledges Treasuries “may not be a great place to be this year.” He estimates as much as \$2 trillion in Treasuries may be auctioned in 2010, a massive supply that may outstrip demand and push yields higher to attract investors.

Still, he believes that the Fed will not raise rates aggressively and that the Treasury environment may be more stable than expected. In managing the intermediate bond portfolio, he is taking a barbell approach, investing in 10-year bonds for more yield and in cash for principal protection.

Bond Yields Relative to Treasuries Fall From Record Highs

10-Year Treasury Rates and Credit Yields From December 31, 2007, to December 29, 2009



The mortgage security market faces similar dynamics with the Fed set to acquire \$1.25 trillion in mortgages by March of this year—posing the question of what happens when it begins to reduce these balance sheet holdings. T. Rowe Price multi-sector bond portfolios now are all underweight in mortgages.

Andrew McCormick, head of the firm’s securitized products group and manager of the GNMA Fund, notes another reason for caution: To date, the recovery has been more corporate than consumer led. U.S. housing prices may be bottoming, but borrowers are still struggling, and foreclosures are spreading among prime borrowers. He has been steering toward “more seasoned” mortgages issued before the subprime collapse and with records of steady payments.

Municipals

Thirty-year municipal bonds entered 2009 yielding a whopping 200% of comparable Treasury yields. Over the last year, that relationship normalized, with 10-year municipal yields dropping to about 80% of comparable Treasuries, close to their long-term average. As a result,

municipal bonds earned extraordinary double-digit returns last year.

Hugh McGuirk, head of T. Rowe Price’s municipal bond group, does not foresee such returns in 2010 because if Treasury rates go up, municipal bond rates will be under pressure as well, causing principal losses. But he still believes municipals offer value.

With tax rates likely to rise, a federal tax-free yield that is 80% of 10-year Treasuries is very favorable for those in higher tax brackets, he says. Second, the supply of tax-free municipals will likely be lighter than historical trends, which may cushion principal losses if rates go up.

At the same time, he expects concerns about the health of state and local budgets to increase over the next year, so he has been tilting T. Rowe Price’s municipal bond portfolios away from direct government bonds in favor of essential service revenue bonds issued by water and sewer authorities and utilities—entities with stable revenue streams. 🐼

Strong Emerging Economies Drive International Markets

International markets staged a strong recovery last year, outperforming their U.S. counterparts and restoring the leadership that they had maintained for the six years before 2008. Improved credit market conditions, a more optimistic outlook for the world economy, and investors' willingness to seek riskier assets were key factors in the rebound.

Developed markets overseas jumped 32.5% (as measured by the MSCI EAFE Index) compared with a more modest gain of 26.5% in the S&P 500 Stock Index. Emerging markets soared 79%—a record high for a calendar year—based on the MSCI Emerging Markets Index.

A large portion of international returns, however, was due to currency translation as the world's major currencies—reversing the trend from the prior year—strengthened versus the U.S. dollar. The developed and emerging market returns in local currency terms were a more modest 25.4% and 62.8%, respectively. (A weaker dollar on foreign exchange markets boosts international returns for U.S. investors.)

T. Rowe Price managers expect much more muted returns this year. Nevertheless, they believe investment opportunities abroad remain compelling, led by emerging markets and fueled by cheap money.

“The outlook for the global economy has improved considerably due in large part to better-than-expected growth in many emerging market economies,” says Ray Mills, manager of the Overseas Stock and International Growth & Income Funds. “We expect the global recovery to gather momentum in 2010 as the developed world rebounds. In this environment, both emerging and developed markets can do well.”

Despite last year's strong performance, Chris Alderson, president of T. Rowe Price International, says, “I don't think the markets have gotten ahead of themselves. While we're back to longer-term norms from a valuation standpoint, if the recovery continues, and earnings come through as we expect, there's still room for growth in international equity markets.”

Emerging Market Trends

Bob Smith, manager of the International Stock Fund, cautions,

“While economies are improving in all regions, companies exposed to the U.S. consumer will face strong headwinds for a long time. Conversely, consumer spending in emerging countries is going to be a strong global growth driver, especially in Brazil, China, and India.

“Unlike in the U.S. where the consumer is over-levered and there are restrained prospects for job growth, in international markets, and particularly emerging markets, jobs are growing, wages are going up, and there is no debt. Longer term, that's a very positive trend.”

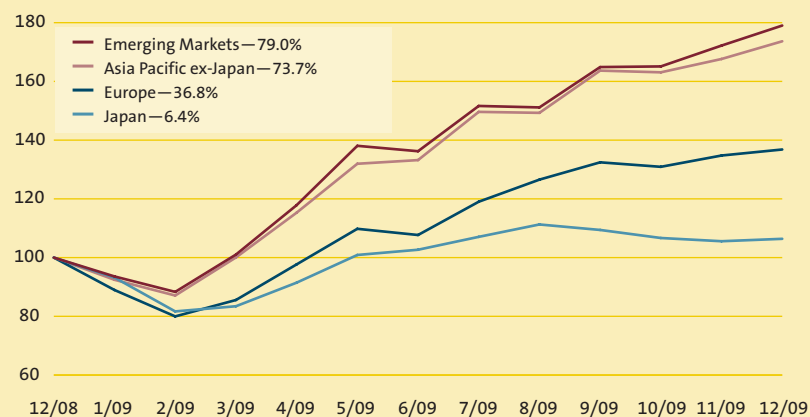
Gonzalo Pángaro, manager of the Emerging Markets Stock Fund, says that in many areas of Asia and Latin America, the return on capital is higher than in developed markets.

“Strong productivity, favorable demographics, and solid domestic demand are likely to continue pushing these markets higher,” he says. “Banking systems in general are much healthier than in the developed world, with little or no impact from the credit crisis. Consumers and corporations have significantly less debt than their developed market peers. Consumption is a key theme in emerging markets, and the domestic economies remain strong.”

Although he expects emerging markets to outperform developed markets, Mr. Pángaro says that with earnings expectations high, there's not a lot of room for disappointment. Another key risk would be a double-dip recession in the U.S. Another flight to quality could result, with commodities weakening and the dollar possibly strengthening, which would be negative for emerging markets.

2009 International Stock Market Performance

Total Return in U.S. Dollars Indexed to 100 as of December 31, 2008



Source: T. Rowe Price Associates. Data supplied by Rimes Technologies. Returns are based on MSCI indices for these regions.

Mr. Pángaro also notes, however, that stronger fundamentals throughout the emerging market world have significantly reduced the likelihood of widespread contagion in the event of a short-term sell-off.

Another potential pillar for market support is an expected pickup in merger and acquisition activity, says Justin Thomson, manager of the International Discovery Fund. “Unique to this cycle, however, is that you’re also likely to see emerging markets companies leading the process and buying developed market companies—particularly where you’ve had weak currencies—making some companies more vulnerable.”

After last year’s extraordinary returns, Mr. Smith says valuations in emerging markets are not nearly as compelling but remain “reasonable relative to historical levels and are attractive compared with their longer-term compound growth potential.”

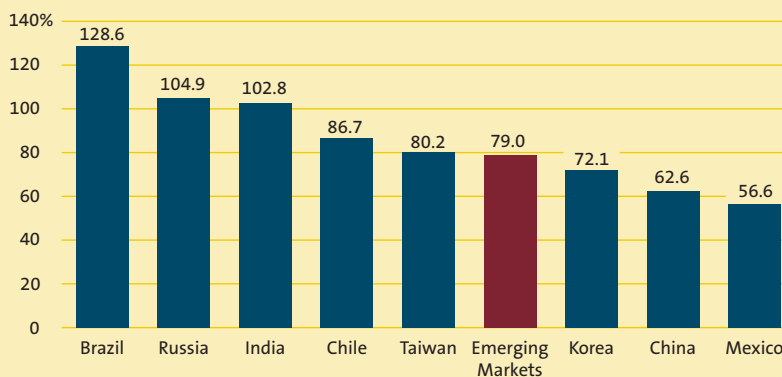
Mr. Mills observes, however, that valuations are generally more attractive in developed markets. “Many high-quality companies in developed markets remain undervalued,” he says. “As long as the recovery does not get cut short, these companies should post strong and improving earnings.”

“We also see opportunities in companies that are headquartered and listed in developed markets—but with exposure to emerging market growth—that have a valuation edge over a pure-play emerging market stock. Spain, for example, was a strong performer last year partly because many large Spanish companies have exposure to Latin America.”

Acknowledging that it is “very tough” to forecast shorter-term currency movements, Mr. Mills adds that U.S. investors could continue to benefit from a weaker dollar relative to other currencies.

2009 Emerging Stock Market Performance

Total Return in U.S. Dollars



Performance of each country is based on its respective MSCI index. Source: T. Rowe Price Associates. Data supplied by Rimes Technologies.

Here’s a look at the outlook for various international regions.

Emerging Asia

Like emerging markets in general, Asia’s markets remain fundamentally sound and are reasonably priced compared with their long-term growth potential.

“The long-term case for investment in the Asia ex-Japan region remains strong, supported by rising levels of urbanization, industrialization, and domestic consumption,” says Anh Lu, manager of the New Asia Fund.

“While economic growth in the region is unlikely to match the levels seen from 2003 to 2007, emerging Asia continues to offer attractive growth opportunities within a global context, although at significantly higher valuations.

“China and India remain the most attractive economies in Asia. While Chinese stocks are above their long-term averages on most valuation metrics, with a low interest rate environment and easy monetary conditions globally, it is likely that stocks will climb further.”

Although in the past it was dependent on exports to fuel its growth, China is also beginning to take steps to lay the foundation for consumer-driven gains.

“The fall in U.S. consumption has been more than matched by growth in Chinese consumption,” says Mark Edwards, a T. Rowe Price international manager. “The Chinese consumer is not as wealthy as the U.S. consumer, but there are a lot more of them. And the government has been putting a lot of stimulus into the hands of consumers, particularly in rural areas.”

Ms. Lu remains positive on the outlook for India, given that it is a young economy in terms of growth and demographics and that investment-related spending is robust. While the large fiscal deficit poses risks to economic growth, “as long as capital is available, and as long as the government is allowing infrastructure to be built, it can grow at 7% to 8% annually for a long time,” she says.

Another country beginning to garner the attention of T. Rowe Price managers is Indonesia, which has the fourth-largest population in the world and tremendous natural resources.

Europe

Although earnings surpassed expectations for many European companies last year, the strength of

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International Outlook

Continued from page 13

the underlying economies varied greatly. Germany's export-oriented economy, for example, benefited from the robust emerging-market demand for goods and services, while the U.K.'s economy languished due to high levels of government and consumer debt. "These factors will continue to be substantial headwinds and could worsen this year as cash strapped governments increase taxes to pay down their tremendous debt levels," says Dean Tenerelli, manager of the European Stock Fund.

Mr. Tenerelli is also concerned that European stock markets could be adversely affected as central banks retract excess liquidity from the economy and interest rates begin to rise.

Nevertheless, he believes that Europe's economic recovery will broaden. "The continuation of the low interest rate environment will support equities in the short term," he says. "And even though we expect a modest, gradual economic recovery, companies' cost reductions and lean inventories will result in expanding profit margins and earnings as soon as we see any return to top line revenue growth."

Mr. Mills notes that European stocks offer historically low valuations as well as attractive dividend yields. "Many companies used the crisis as an opportunity to undertake fundamental restructuring and permanent cost-cutting," he says. "When the global expansion hits its stride and corporate revenues return to healthy levels, earnings should be quite strong."

In emerging Europe, Russia was one of the top-performing markets last year. Despite several risks, including an economy heavily dependent on the energy sector, weak corporate governance, and the potential for undue government influence in

economic and corporate matters, managers believe the economy should recover rapidly this year.

Leigh Innes, manager of the Emerging Europe & Mediterranean Fund, believes the economy continues to offer significant long-term potential, citing the country's huge natural resources and an expected rise in consumer activity.

Latin America

In Latin America, rising disposable incomes and consumer spending are also expected to underpin long-term economic growth. Despite their recent upswing, market valuations in the region remain reasonable relative to their historical levels, and growth opportunities are still significantly greater than in developed markets, according to Jose Costa Buck, manager of the Latin America Fund.

"Brazil may be the strongest emerging market economy outside of China," he says. "It is not reliant on exports and has been somewhat insulated from the global economic downturn. It also has huge currency reserves that were accumulated during the recent boom years. Over the long term, we expect Brazil's domestic economy to drive an increasing share of the country's economic growth."

Japan

With its economy inhibited by the strength of the yen and the restraints put on its stimulus by the high level of government debt, Japan has continued to lag the rebound in equity markets.

"We remain cautious about the Japanese market in the short term," says Campbell Gunn, manager of the Japan Fund. "A historic change in the ruling party has introduced an element of uncertainty, and the Bank of Japan currently projects gross domestic product growth of only 1% for the next five years. Although export volumes have recovered in line with the world trade cycle, their effect has been muted. The strong yen has weighed on margins, causing corporate profits to rise only modestly."

Despite a daunting list of challenges, Mr. Gunn says "Japan remains the home of many world-leading companies that merit consideration in diversified portfolios."

While international investing can provide diversification and attractive investment opportunities, investors should also realize that funds that invest overseas are generally more risky than funds that invest only in U.S. assets due to factors such as currency risk and political and economic uncertainty abroad. These risks are heightened for funds investing in emerging markets. 🌐

International Market Valuations Attractive Relative to U.S.

As of December 31, 2009

	Europe	Japan	Emerging Markets	U.S.
Price/Book*	1.73	1.20	2.15	2.21
Price/Earnings**	12.78	19.95	10.19	14.42
Dividend Yield, %	3.25	1.69	2.05	1.90
Return on Equity, %	9.29	-3.42	10.45	7.73

* Price/Book, Dividend Yield, and Return on Equity are based on 12-months trailing data.

** Price/Earnings is based on 12-months projected earnings. Data based on MSCI indices for these regions.

Sources: MSCI and FactSet.

Revisiting Asset Allocation in Wake of Financial Crisis

In the aftermath of the historic bear market from October 2007 to March 2009, diversification—one of the most fundamental tenets of investing—has come under scrutiny as Treasury bonds were virtually the only asset to sidestep that market maelstrom.

Some financial advisors, revisiting their asset allocation models, have also questioned the viability of placing as much emphasis on equities, even for long-term investors.

The sharp rebound in the financial markets in 2009, however, has tempered the diversification debate. And a T. Rowe Price review of performance during the recent bear market and over long time periods upholds the merits of broadly diversifying a portfolio and the importance of equities for long-term investors.

An Unusual Time

Historically, bonds have had a relatively low correlation with stocks, meaning they tend to move in the same direction but not nearly to the same degree. Over most of the last decade—an unusually turbulent one

for equities—bonds and stocks have actually had a negative correlation, moving in opposite directions. While bonds typically lag stocks over long-term periods, their low correlation with stocks provides diversification and typically helps mitigate the impact of periodic stock market swoons, including the last one.

“If you just owned stocks in 2008, you really took a dive, but if you diversified into bonds, you protected your downside quite a bit,” says Ned Notzon, chairman of T. Rowe Price’s Asset Allocation Committee. “Those who say diversification didn’t work should also remember that diversification is a long-term concept.”

Although high-grade corporate bonds in 2008 had a negative return and suffered their worst year since 1974, Treasury bonds surged as the financial crisis sent investors scurrying for safety. The S&P 500 Stock Index declined 37% in 2008, but a portfolio of 80% stocks and 20% intermediate-term government bonds would have fallen 28.6%. A portfolio of 60% stocks, 30% bonds, and 10%

cash (Treasury bills) would have declined 20.4%.

As these returns indicate, however, diversification cannot assure a profit or protect against a loss in down markets. Indeed, it was surprising to see almost all markets around the world decline, albeit to varying degrees, when equities collapsed in 2008.

“Even if you are well diversified, there are times when you are going to take a torpedo,” says Brian Rogers, the firm’s chairman and chief investment officer. “There are no free lunches in investing, so you have to diversify with a reasonable time horizon to cope with short-term periods when almost all assets are moving in the same direction.”

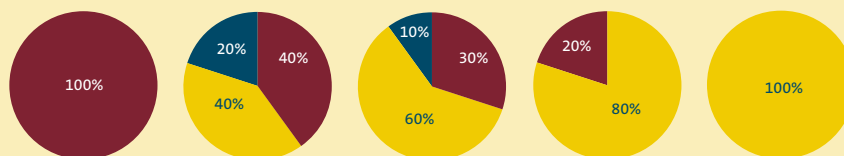
Rich Whitney, director of T. Rowe Price’s Asset Allocation Group, adds, “The market in 2008 was unusual because we really did come to the precipice. The viability of our financial system was under threat. This wasn’t just a bear market. This was a bear market where we almost came apart. So only assets that were not perceived to have risk, such as

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Performance of Various Portfolio Strategies

December 31, 1949, to December 31, 2009

■ Cash
■ Stocks
■ Bonds



	100% Bonds	20% Cash / 40% Stocks / 40% Bonds	10% Cash / 30% Stocks / 60% Bonds	20% Cash / 80% Stocks	100% Stocks
Return for Best Year	29.1%	22.5%	30.5%	41.3%	52.6%
Return for Worst Year	-5.1	-11.5	-20.4	-28.6	-37.0
Average Annual Nominal Return	6.1	8.1	9.2	10.2	11.0
Number of Down Years	8	11	12	14	14
Average Loss (in Down Years)	-1.6	-3.0	-6.4	-8.8	-12.5
Annualized Standard Deviation	6.4	7.5	10.8	14.4	18.0
Average Annual Real (Inflation-Adjusted) Return	2.4	4.3	5.4	6.5	7.3

These portfolios combine stability, income, and growth investments to represent a range of potential risk/reward profiles. For each allocation model, historical data are shown to represent how the portfolios would have fared in the past. Figures include changes in principal value and reinvested dividends and assume the portfolios are rebalanced every year. Stocks are represented by the S&P 500 Stock Index, bonds by the U.S. Intermediate Government Bond Index, and cash by U.S. 30-day Treasury bills.

Source: T. Rowe Price Associates. Data supplied by Ibbotson Associates.

Asset Allocation

Continued from page 15

the dollar and U.S. Treasuries, were not hammered.

“What diversification does is smooth out risks that are specific to one market or another,” Mr. Whitney says. “But in an environment like 2008, where the viability of most investments is threatened and investors do not want any risk or uncertainty, correlations [among asset classes] are stronger and you can’t diversify away risk.”

The Equity Equation

Another result of the financial crisis has been greater skepticism over how much emphasis investors should place on stocks in their portfolios. However, stocks have consistently provided superior returns and a better hedge against inflation compared with other asset classes over long-term investment periods. This is because stock returns over time typically reflect growth in corporate earnings, which is linked to growth in the economy and inflation.

In determining how much of their investment portfolio should be invested in stocks, bonds, and other assets, “investors have to balance their needs for short-term stability and long-term growth depending on their time horizon,” says Stuart Ritter, a T. Rowe Price financial planner. “As your time horizon shrinks, you should move toward more short-term stability. Those two goals are trade-offs—the more long-term growth potential you have, the less short-term stability and vice versa.”

Mr. Ritter says that for investors saving for a long-term goal, such as their retirement or a college education for their children, “their biggest risk is inflation—not short-term market volatility or even suffering a loss in any one year. That means having most of their money in stocks for long-term growth potential.”

From 1950 through December 2009, for example, stocks (the S&P 500 Index) provided a real (inflation-adjusted) annualized return of 7.3% compared with 2.4% for intermediate-term U.S. government bonds and about 1% for 30-day Treasury bills.

T. Rowe Price also examined returns for these asset classes over various rolling investment periods (on a monthly basis) since 1950.

Stocks outpaced inflation in every one of the 480 different 20-year periods from January 1950 through November 2009, while long-term corporate and government bonds lagged inflation in 29% and 40% of the periods, respectively.

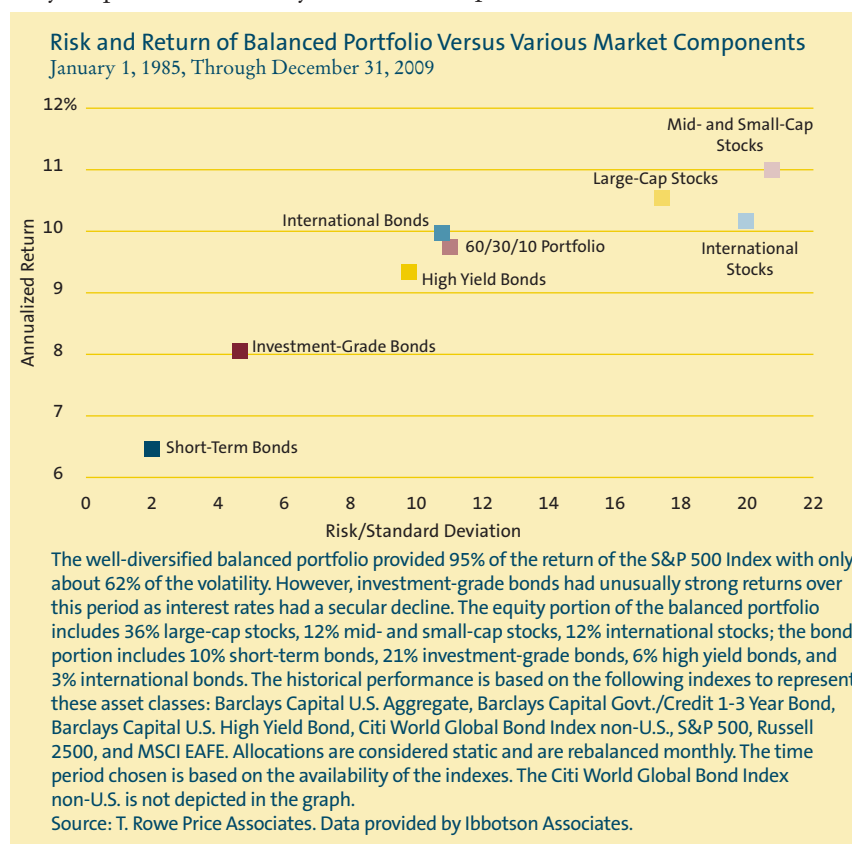
Stocks outperformed bonds in almost all of the rolling 15- and 20-year investment periods. In terms of nominal returns, stocks’ worst annualized return over the 20-year periods was 6.4% for the 20-year period ended May 1979.

The greater a portfolio’s exposure to stocks, the greater its annualized return would have been over time. However, more aggressive portfolios have tended to suffer more years with losses, steeper average losses in those down years, and greater volatility.

Despite this superior long-term performance for equities, T. Rowe Price managers suggest that even long-term investors maintain some exposure to bonds to help them weather periods when stocks plunge in value.

It’s also noteworthy that since January 1950 through December 2009, a portfolio of 80% stocks and 20% bonds would have achieved about 93% of the return of an all-stock portfolio with only 80% of the volatility.

A well-diversified strategy also could help investors avoid the urge to significantly reduce their equity exposure in bear markets.



“If you move out of stocks in a market downturn, you should realize that your potential long-term return goes down,” Mr. Ritter says.

Allocating Across Asset Classes

T. Rowe Price managers also suggest that investors consider diversifying across different subsectors of the stock and bond markets. Mr. Notzon says that the equity portion of the firm’s asset allocation portfolios is generally invested 80% in U.S. stocks and 20% in foreign stocks, with moderate exposure to emerging markets. For the domestic equity part, about 80% is allocated to large-cap stocks with the balance split between small- and mid-cap stocks.

The fixed income part of the portfolio typically invests 70% in investment-grade bonds, 10% in high yield bonds, and the other 20% roughly split between emerging market and international bonds. The managers make modest, gradual tactical shifts in these allocations as market conditions change.

“One advantage of including these other sectors is higher potential returns,” Mr. Notzon says. “For example, we think emerging market stocks will have higher long-term returns than international developed markets or U.S. stocks over the next five to 10 years. Another potential advantage is a dampening of volatility if the riskier asset is not very highly correlated with the others. You could add up to 30% in international stocks, for instance, and still reduce volatility while potentially enhancing your return over most longer time periods.”

It also may be possible to achieve a return comparable to that of the stock market but with considerably less risk, as the chart on page 16 illustrates.

“Adding modest exposure to nonfinancial assets such as real estate and natural resources as inflation hedges can further enhance diversification,” Mr. Notzon says. “Real estate generally has longer cycles than the financial cycle so it can provide a long-term dampening effect. In the short term, real estate investments trusts (REITs) behave more like stocks, but over longer periods they behave more like real estate. Correlations are relatively low between REITs and the stock market, so it tends to be a good diversifier.”

Converging Correlations

Some critics also contend that the case for diversification has been undermined in recent years as market sectors and asset classes have become more correlated, especially during market downturns.

For example, in the 1990s U.S. and international stocks had a correlation of 0.40 (a correlation of 1.0 means assets always move in the same direction but not to the same degree, while a correlation of 0 means they tend to be uncorrelated). This correlation has moved up sharply since 1997, and for the five-year period ended December 31, 2009, it measured 0.90.

In 2008, foreign markets on average plunged even more than the U.S. market, but over the past decade, adding foreign stocks to a U.S. equity portfolio significantly improved performance, though it also increased volatility.

“There is a big difference between short-term correlation and long-term correlation, but it is undoubtedly true that in the short run assets are much more correlated today than they used to be,” Mr. Whitney observes. “I think that’s because we have a more global economy and because information and news events ripple

through the markets much more quickly. Individuals, corporations, and governments can react very fast.

“But that does not necessarily mean that in the long run assets are much more correlated than they used to be. Countries have different demographics and economies, and you expect those differences to be reflected in different returns from the markets.”

So investors are cautioned not to judge the merits of diversification based just on their investment experience and market performance in recent years.

“Being diversified may not have saved you [from incurring a loss in ’08], but that doesn’t mean the concept doesn’t work,” Mr. Whitney says. “If you are trying to protect against a potential end-of-world scenario, you won’t have much success diversifying across different asset classes. If you are trying to diversify against the more normal type of cyclical behavior that we see across markets, diversification remains a viable strategy. I don’t think there is anything in financial markets that works 100% of the time.”

Pursuing a Diversified Strategy

T. Rowe Price offers a range of funds that provide professional management of the asset allocation process, broad diversification among sectors within asset classes, and regular rebalancing of assets to maintain a consistent risk profile. The firm’s Retirement Funds also adjust their asset allocation strategy to become more conservative over time.

For those who prefer to manage their own portfolios, the firm also offers several tools on its Web site, including the Morningstar Portfolio X-Ray® and the Morningstar Asset Allocator®. Investors can get recommendations on their current strategy via Account Access and general portfolio planning information at troweprice.com/allocationplanning.

Investing Through Peaks and Valleys

Studies by Morningstar and other independent researchers have shown that individual investors' average returns over time have tended to lag those of the mutual funds in which they have invested.

The reason: the tendency of many investors to move in and out of funds, too often at the wrong times, with negative consequences.

"Most investors would agree that it's most desirable to buy low and sell high," says Judith Ward, a T. Rowe Price financial planner. "This may sound simple, but it isn't easy for investors to achieve that timing as markets rise and fall."

The past year—with the sharp fall in global markets suddenly reversing course into a steep recovery—is only the latest period when many equity investors may have found their long-term investment plans challenged by their emotions.

"Given the turmoil at the beginning of 2009, many investors doubtless were tempted to change their investment strategies by reducing their exposure to stocks and stock funds," Ms. Ward says.

Her advice: Determine your investment goals and an appropriate long-term investing strategy to reach those goals. And then resist the temptations to deviate from that long-term plan.

Finally, review the plan regularly but not so often that you are frequently tinkering with it—let alone attempting to time your stock market investments.

Two Investors

To underscore her point, Ms. Ward compared two hypothetical investors who each had \$10,000 in stocks (as represented by the S&P 500 Index) at the end of 2006. Over the next

three years, each investor added \$100 a month to his account.

The only difference between the two was that after October 2008—when the S&P 500 had fallen 36% over the past 12 months—the second investor capitulated, moving all of his portfolio to cash and investing all subsequent additions into cash.

Meanwhile, the first investor continued adding \$100 a month to stocks as the market rose until the fall of 2007, fell until March 2009, and then rose again from there.

Both investors had balances of more than \$12,000 by October 2007. But then the stock market began its decline. By early February 2009, the second investor looked like he had made a good move by bailing out of the market. His account had \$9,043 in it, versus just \$6,959 for the investor who had continued purchasing stocks.

But then the market recovery took off, and by July of last year the investor who had stayed the course with stocks was ahead again—a lead that would widen as the year went on.

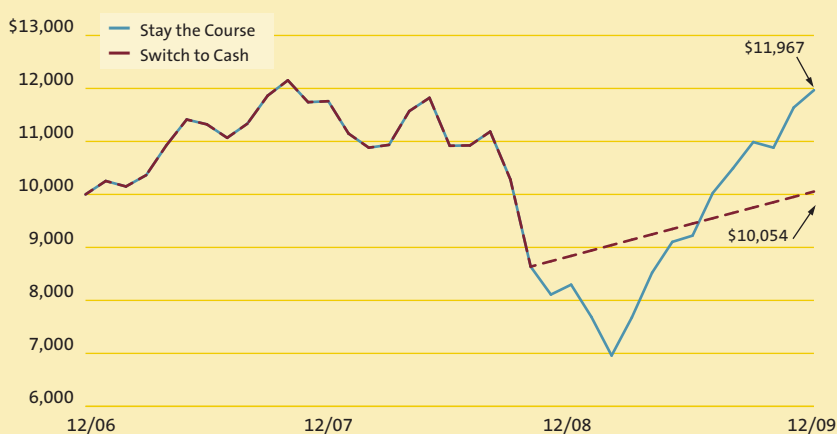
Of course, given the scale of the historic market downturn during this period, even this more disciplined investor still had less in his account at the end of 2009 than the \$13,600 (\$10,000 plus 36 monthly additions of \$100) he had invested.

At the same time, his account totaled almost \$2,000 more at year-end than that of the investor who had fled to cash in late 2008.

"Regular contributions cannot assure a profit or protect against loss in a declining market," Ms. Ward says. "But over the long haul, it can help you weather market storms, build a solid foundation for your investment goals, and take advantage of downturns to buy at lower prices." 🐼

Staying Invested Versus Fleeing to Cash

Two investors each had \$10,000 in the stock market at the end of 2006 and added \$100 a month more in stocks during 2007 and 2008. Both remained 100% invested in stocks through October 2008, until one investor (marked in red) switched his account and all subsequent contributions to cash. The other investor (marked in blue) stuck with stocks and suffered much greater losses as the market downturn continued, but he then quickly recovered and ended up with a higher account balance by the end of 2009.



Note: Investment returns of stocks are represented by the S&P 500 Index and of cash by the 90-day U.S. Treasury bills. It is not possible to invest directly in an index.

Stocks Rally as Economy Emerges From Recession

U.S. stocks advanced strongly in the fourth quarter, extending the remarkable rally that started in March and capping the best year for domestic equities since 2003. Major stock indexes reached their highest levels of the year in December as the economy seemed to be emerging from the longest and deepest recession since the Great Depression, corporate earnings were generally better than expected, and Federal Reserve officials stated that they intend to keep short-term interest rates low for some time.

EQUITY REVIEW

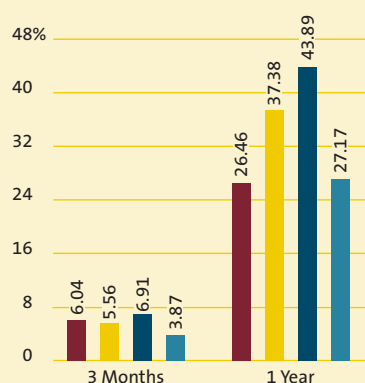
Emerging Markets and Large-Cap Domestic Growth Stocks Lead

Large-cap shares outperformed their smaller peers. As measured by various Russell indexes, growth stocks outpaced value across all market capitalizations, particularly among large-caps. Since reaching their lows in early March, most major U.S. stock indexes have jumped roughly 60% to 80% through the end of December.

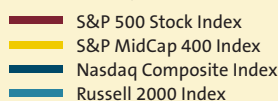
In the U.S. stock market, as measured by the Wilshire 5000 Total Market Index, most major sectors produced solid gains. Shares of information technology companies fared best in the quarter and for the entire year, helped by aggressive cost-cutting, cash-rich balance sheets, and better-than-expected revenues. Materials stocks climbed with commodity prices, while consumer discretionary shares rose in anticipation of increased consumer spending. Financials declined as some investors locked in earlier gains and several major companies issued new shares to raise capital or repay money borrowed from the federal government.

Non-U.S. stocks produced mostly positive returns. Developed European and Asian markets generally rose, but shares in Greece tumbled due to the government's growing fiscal problems. Japanese stocks declined as a late-period U.S. dollar rebound versus the yen reduced returns in dollar terms. Emerging markets significantly outperformed developed markets, led by shares in Latin America.

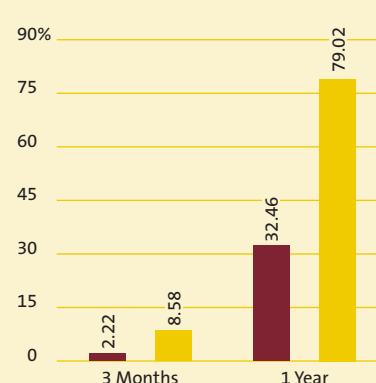
U.S. Stock Market Performance



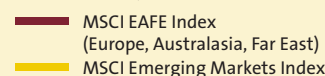
Total Returns for Periods Ended December 31, 2009



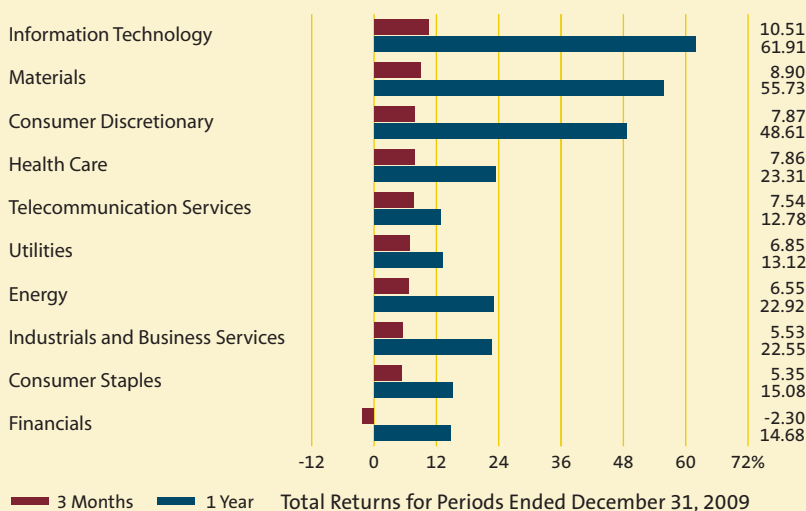
International Stock Market Performance



Total Returns for Periods Ended December 31, 2009



Performance of Wilshire 5000 Series



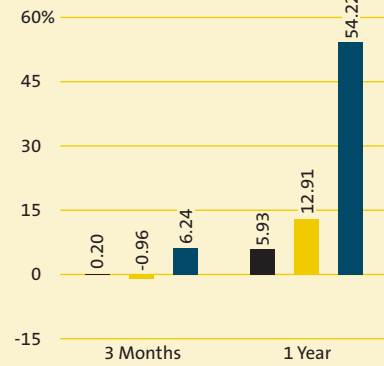
Total Returns for Periods Ended December 31, 2009 Ranked by Highest to Lowest Quarterly Return

Bonds Produce Mixed Returns as Treasury Rates Rise

Domestic bond returns in the last three months were mixed as money market yields remained close to 0%, but longer-term Treasury yields increased amid signs of an economic recovery and heavy new issuance. High yield bonds produced strong returns, capping their best year in history. Investment-grade corporate bonds and asset-backed securities—which are backed by credit card, auto loan, or other debt payments—produced milder gains. Agency mortgage-backed securities were flat, but municipal bonds fell slightly. U.S. Treasury bond prices declined, particularly longer-term issues.

Non-U.S. bond returns were also mixed in the fourth quarter. Emerging markets bonds rose moderately, but high-quality bonds issued in developed countries declined in U.S. dollar terms as a strengthening dollar reduced returns to U.S. investors.

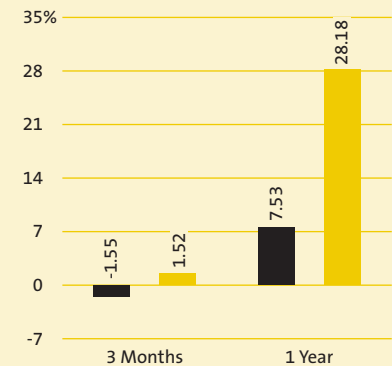
U.S. Bond Market Performance



Total Returns for Periods Ended December 31, 2009

- Barclays Capital U.S. Aggregate Index
- Barclays Capital Municipal Bond Index
- Credit Suisse High Yield Index

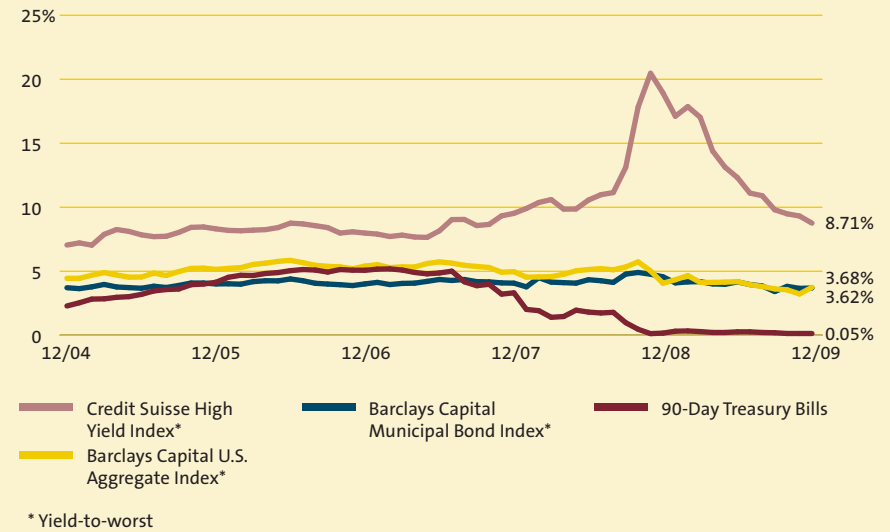
International Bond Market Performance



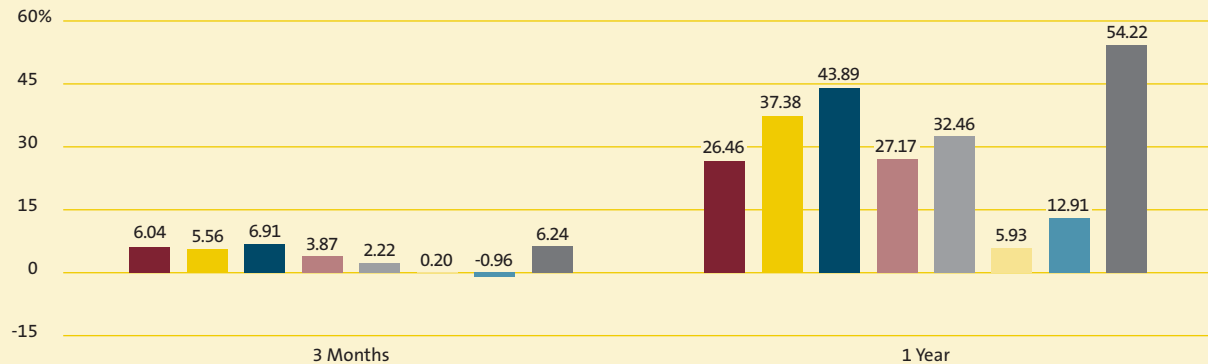
Total Returns for Periods Ended December 31, 2009

- Barclays Capital Global Aggregate ex U.S. Dollar Bond Index
- J.P. Morgan Emerging Markets Bond Index—Global

Trends in Interest Rates



Stock and Bond Market Performance



Total Returns for Periods Ended December 31, 2009

Unlike stocks, U.S. government bonds are guaranteed as to the timely payment of interest and principal.

- S&P 500 Stock Index
- Nasdaq Composite Index
- MSCI EAFE Index
- Barclays Capital Municipal Bond Index
- S&P MidCap 400 Index
- Russell 2000 Index
- Barclays Capital U.S. Aggregate Index
- Credit Suisse High Yield Index

The performance information presented here includes changes in principal value, reinvested dividends, and capital gain distributions. *Current performance may be higher or lower than the quoted past performance, which cannot guarantee future results. Share price, principal value, yield, and return will vary, and you may have a gain or loss when you sell your shares. To obtain the most recent month-end performance, call us at 1-800-225-5132 or visit our Web site. The performance information shown does not reflect the deduction of redemption fees (if applicable); if it did, the performance would be lower. Call 1-800-225-5132 to request a prospectus or summary prospectus; each includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing. Summary prospectuses are not yet available for all funds.* Funds are placed in alphabetical order in each category. To learn more about each fund's objective and risk/reward potential, visit troweprice.com/mutualfunds. There is no assurance past trends will continue.

STOCK FUNDS	Ticker Symbol	3 Months	1 Year	3 Years	5 Years	10 Years or Since Inception	Inception Date	Redemption Fee	Redemption Fee Period	Expense Ratio	Expense Ratio As of Date
DOMESTIC											
Blue Chip Growth*	TRBCX	7.70%	42.57%	-2.58%	1.45%	-0.38%	6/30/93			0.80%	12/31/08
Capital Appreciation	PRWCX	4.98	33.05	0.44	4.40	9.28	6/30/86			0.74	12/31/08
Capital Opportunity	PRCOX	5.94	29.28	-4.63	0.99	0.02	11/30/94			0.79	12/31/08
Diversified Mid-Cap Growth*	PRDMX	5.67	45.30	-2.13	2.26	4.08	12/31/03			1.23	12/31/08
Diversified Small-Cap Growth	PRDSX	5.64	37.98	-1.31	1.88	0.18	6/30/97	1.0%	90 days	1.38	12/31/08
Dividend Growth	PRDGX	5.55	26.15	-3.40	1.64	2.77	12/30/92			0.73	12/31/08
Equity Income	PRFDX	5.35	25.62	-5.88	0.70	4.13	10/31/85			0.71	12/31/08
Equity Index 500	PREIX	6.00	26.33	-5.79	0.19	-1.19	3/30/90	0.5	90 days	0.37	12/31/08
Extended Equity Market Index	PEMXX	4.98	36.69	-4.36	2.17	1.65	1/30/98	0.5	90 days	0.41	12/31/08
Financial Services	PRISX	-0.06	28.44	-11.30	-3.18	4.50	9/30/96			1.00	12/31/08
Growth & Income	PRGIX	5.65	30.57	-4.18	0.65	1.77	12/21/82			0.73	12/31/08
Growth Stock*	PRGFX	9.15	43.25	-2.99	2.10	1.12	4/11/50			0.73	12/31/08
Health Sciences	PRHSX	6.17	32.17	3.79	6.82	8.64	12/29/95			0.86	12/31/08
Media & Telecommunications+*	PRMTX	8.77	68.52	3.20	10.79	5.08	10/13/93			0.90	12/31/08
Mid-Cap Growth*	RPMGX	4.87	45.44	1.05	4.82	5.67	6/30/92			0.83	12/31/08
Mid-Cap Value*	TRMCX	5.07	46.68	-1.17	4.57	10.54	6/28/96			0.83	12/31/08
New America Growth*	PRWAX	6.09	49.33	1.57	3.23	-0.08	9/30/85			0.91	12/31/08
New Era*	PRNEX	7.24	49.36	1.54	9.73	11.51	1/20/69			0.66	12/31/08
New Horizons*	PRNHX	5.07	43.87	-2.19	2.37	3.31	6/3/60			0.84	12/31/08
Real Estate	TRREX	8.85	31.65	-13.32	0.40	11.03	10/31/97	1.0	90 days	0.75	12/31/08
Science & Technology*	PRSCX	5.89	67.83	1.81	2.98	-8.55	9/30/87			1.00	12/31/08
Small-Cap Stock	OTCFX	4.96	38.46	-3.21	2.09	6.41	6/1/56			0.93	12/31/08
Small-Cap Value	PRSVX	5.14	26.88	-3.29	2.72	10.90	6/30/88	1.0	90 days	0.92	12/31/08
Tax-Efficient Equity+**											
Returns before taxes	PREFX	6.91	41.73	-3.14	0.62	1.21	12/29/00	1.0	365 days	1.46	2/28/09
Returns after taxes on distributions		—	41.73	-3.14	0.62	1.21	12/29/00				
Returns after taxes on distributions and sale of fund shares		—	27.12	-2.66	0.53	1.03	12/29/00				
Total Equity Market Index	POMIX	5.87	28.76	-5.21	0.88	-0.36	1/30/98	0.5	90 days	0.40	12/31/08
U.S. Large-Cap Core	TRULX	6.12	—	—	—	20.55	6/26/09			3.89	6/26/09
Value	TRVLX	4.68	37.15	-5.93	1.17	4.54	9/30/94			0.90	12/31/08

* Investors should note that the fund's short-term performance is highly unusual and unlikely to be sustained.

† Formerly the closed-end New Age Media Fund. Converted to open-end status on 7/28/97 and operates under a different expense structure. †† The returns presented reflect the return before taxes; the return after taxes on dividends and capital gain distributions; and the return after taxes on dividends, capital gain distributions, and gains (or losses) from redemptions of shares held for 1-, 5-, and 10-year or since-inception periods, as applicable. After-tax returns reflect the highest federal income tax rate but exclude state and local taxes. The after-tax returns reflect the rates applicable to ordinary and qualified dividends and capital gains effective in 2003. During periods when a fund incurs a loss, the post-liquidation after-tax return may exceed the fund's other returns because the loss generates a tax benefit that is factored into the result. An investor's actual after-tax return will likely differ from those shown and depend on his or her tax situation. Past before- and after-tax returns do not necessarily indicate future performance.

BENCH-MARKS	DOMESTIC STOCK	3 Months	1 Year	3 Years	5 Years	10 Years or Since Inception
S&P 500 Index		6.04%	26.46%	-5.63%	0.42%	-0.95%
S&P MidCap 400 Index		5.56	37.38	-1.83	3.27	6.36
Nasdaq Composite Index		6.91	43.89	-2.06	0.85	-5.67
Russell 2000 Index		3.87	27.17	-6.07	0.51	3.51
Lipper Indexes						
Large-Cap Core Funds		5.52	28.15	-4.91	0.61	-1.20
Equity Income Funds		5.58	23.85	-6.25	0.63	2.25
Small-Cap Core Funds		4.49	34.50	-4.06	1.55	5.24

	Ticker Symbol	3 Months	1 Year	3 Years	5 Years	10 Years or Since Inception	Inception Date	Redemption Fee	Redemption Fee Period	Expense Ratio	Expense Ratio As of Date	
STOCK FUNDS	INTERNATIONAL/GLOBAL											
	Africa & Middle East	TRAMX	-5.15%	22.08%	—	—	-12.41%	9/4/07	2.0%	90 days	1.32%	10/31/08
	Emerging Europe & Mediterranean*	TREMx	10.65	125.13	-11.40%	8.30%	9.81	8/31/00	2.0	90 days	◆	10/31/08
	Emerging Markets Stock*	PRMSX	8.16	85.07	1.44	13.84	9.34	3/31/95	2.0	90 days	1.24	10/31/08
	European Stock	PRESX	0.85	34.40	-4.23	4.71	1.89	2/28/90	2.0	90 days	1.01	10/31/08
	Global Large-Cap Stock*	RPSEX	4.62	49.59	—	—	65.74	10/27/08	2.0	90 days	▲	10/31/08
	Global Real Estate	TRGRX	4.76	33.62	—	—	36.53	10/27/08	2.0	90 days	‡	12/31/08
	Global Stock*	PRGSX	6.41	44.77	-6.88	3.96	1.09	12/29/95	2.0	90 days	0.87	10/31/08
	Global Technology*	PRGTX	6.22	80.28	4.60	6.91	-2.81	9/29/00			1.32	12/31/08
	International Discovery*	PRIDX	3.39	55.69	-3.14	8.21	4.92	12/30/88	2.0	90 days	1.24	10/31/08
	International Equity Index	PIEQX	1.60	30.42	-5.74	3.71	3.33	11/30/00	2.0	90 days	0.50	10/31/08
	International Growth & Income	TRIGX	1.69	34.39	-6.97	3.90	3.77	12/21/98	2.0	90 days	0.90	10/31/08
	International Stock*	PRITX	5.33	52.20	-3.54	4.47	-0.16	5/9/80	2.0	90 days	0.87	10/31/08
	Japan	PRJPX	-1.66	0.84	-13.22	-2.90	-6.44	12/30/91	2.0	90 days	1.07	10/31/08
	Latin America*	PRLAX	13.76	114.36	12.25	27.91	18.43	12/29/93	2.0	90 days	1.22	10/31/08
	New Asia*	PRASX	10.85	102.76	9.58	17.76	8.82	9/28/90	2.0	90 days	0.96	10/31/08
	Overseas Stock	TROsx	2.75	36.70	-6.33	—	-6.32	12/29/06	2.0	90 days	0.93	10/31/08
BENCH-MARKS	INTERNATIONAL/GLOBAL STOCK											
	MSCI EAFE Index		2.22%	32.46%	-5.57%	4.02%	1.58%					
	Lipper Averages											
	Emerging Markets Funds		7.59	75.74	2.00	13.17	9.40					
	International Large-Cap Growth Funds		4.37	33.44	-5.32	4.21	0.43					
	International Small-/Mid-Cap Growth Funds		4.00	51.61	-6.68	5.33	2.29					
BOND FUNDS	DOMESTIC TAX-FREE*											
	California Tax-Free Bond	PRXCX	-0.99%	14.85%	3.34%	3.67%	5.20%	9/15/86			0.52%	2/28/09
	Georgia Tax-Free Bond	GTFBX	-0.83	14.68	3.46	3.57	5.19	3/31/93			0.62	2/28/09
	Maryland Short-Term Tax-Free Bond	PRMDX	0.45	3.76	3.62	2.92	3.25	1/29/93			0.58	2/28/09
	Maryland Tax-Free Bond	MDXBX	-0.22	17.98	3.91	3.92	5.35	3/31/87			0.47	2/28/09
	New Jersey Tax-Free Bond	NJTFX	-0.75	14.40	3.36	3.62	5.29	4/30/91			0.56	2/28/09
	New York Tax-Free Bond	PRNYX	-0.73	14.52	3.52	3.74	5.37	8/28/86			0.54	2/28/09
	Summit Municipal Income	PRINX	-0.60	18.70	3.52	4.07	5.75	10/29/93			0.50	10/31/08
	Summit Municipal Intermediate	PRSMX	-0.43	10.79	4.80	4.16	5.12	10/29/93			0.50	10/31/08
	Tax-Free High Yield	PRFHx	-0.24	31.41	0.65	2.98	4.76	3/1/85			0.71	2/28/09
	Tax-Free Income	PRTAX	-0.78	16.09	3.78	4.03	5.51	10/26/76			0.53	2/28/09
	Tax-Free Short-Intermediate	PRFSX	0.52	7.23	4.68	3.64	4.12	12/23/83			0.51	2/28/09
	Virginia Tax-Free Bond	PRVAX	-0.74	14.39	4.00	3.96	5.50	4/30/91			0.50	2/28/09

◆ Note about the Emerging Europe & Mediterranean Fund's expense ratio: The fund's expense ratio as of its fiscal year ended 10/31/08 was 1.32%. Recent market declines have led to lower net assets in the fund, thereby increasing its expense ratio to 1.98% as of 3/31/09. To protect the interests of shareholders, T. Rowe Price International will waive its fees and bear any expenses that would cause the fund's net expense ratio to exceed 2.00% effective May 1, 2009. This contractual expense limitation expires on 2/28/11.

▲ Note about the Global Large-Cap Stock Fund's expense ratio: To limit this fund's expenses during its initial period of operations, T. Rowe Price International will waive its fees and bear any expenses that would cause the fund's net expense ratio to exceed 1.00%. As of its fiscal year ended 10/31/08, the Global Large-Cap Stock Fund's gross and net expense ratios were 4.43% and 1.00%, respectively. The fund operates under a 1.00% contractual expense limitation that expires on 2/28/11.

‡ Note about the Global Real Estate Fund's expense ratio: To limit the fund's expenses during its initial period of operations, T. Rowe Price will waive its fees and bear any expenses that would cause the fund's net expense ratio to exceed 1.05%. As of its fiscal year ended 12/31/08, the fund's gross and net expense ratios were 4.73% and 1.05%, respectively. The fund operates under a 1.05% contractual expense limitation that expires on 4/30/11.

* Some income from the tax-free funds may be subject to state and local taxes and the federal alternative minimum tax.

All mutual funds are subject to market risk, including possible loss of principal. Funds that invest overseas generally carry more risk than funds that invest strictly in U.S. assets due to factors such as currency risk, geographic risk, and emerging markets risk. Funds that invest in fixed income securities are subject to credit risk and liquidity risk, with high yield securities having a greater risk of default than higher-quality securities.

PERFORMANCE SUMMARY

T. Rowe Price Mutual Funds

Past Quarter, Year, and Average Annual Total Returns
Periods Ended December 31, 2009

BOND FUNDS	DOMESTIC TAXABLE	Ticker Symbol	3 Months	1 Year	3 Years	5 Years	10 Years or Since Inception	Inception Date	Redemption Fee	Redemption Fee Period	Expense Ratio	Expense Ratio As of Date
	Corporate Income	PRPIX	1.71%	22.09%	4.46%	4.16%	6.25%	10/31/95			0.75%	5/31/09
	GNMA**	PRGMX	0.59	6.35	6.17	5.01	5.86	11/26/85			0.66	5/31/09
	High Yield*	PRHYX	5.87	49.14	5.14	5.69	6.55	12/31/84	1.0%	90 days	0.80	5/31/09
	Inflation Protected Bond	PRIPX	2.00	10.43	6.41	4.28	5.51	10/31/02			0.69	5/31/09
	New Income	PRCIX	0.97	12.33	6.60	5.34	6.35	8/31/73			0.71	5/31/09
	Short-Term Bond	PRWBX	0.80	9.00	5.19	4.33	4.89	3/2/84			0.60	5/31/09
	Strategic Income	PRSNX	2.07	19.87	—	—	22.67	12/15/08			1.51	5/31/09
	Summit GNMA**	PRSUX	0.31	5.77	6.22	5.07	5.90	10/29/93			0.60	10/31/08
	U.S. Bond Index	PBDIX	0.23	6.63	6.28	4.97	5.76	11/30/00	0.5	90 days	0.30	10/31/08
	U.S. Treasury Intermediate**	PRTIX	-0.98	-1.37	7.35	5.18	6.00	9/29/89			0.52	5/31/09
	U.S. Treasury Long-Term**	PRULX	-4.98	-10.90	6.50	5.17	7.05	9/29/89			0.58	5/31/09

** The market value of shares is not guaranteed by the U.S. government.

BENCH-MARKS	DOMESTIC BOND					
	Barclays Capital U.S. Aggregate Index	0.20%	5.93%	6.04%	4.97%	6.33%
	Barclays Capital Municipal Bond	-0.96	12.91	4.41	4.32	5.75
	Credit Suisse First Boston High Yield Index	6.24	54.22	5.33	5.99	7.08
	Lipper Averages					
	Short Investment-Grade Debt	1.12	9.61	3.00	3.02	3.88
	Corporate Debt Funds A Rated	1.20	15.18	3.94	3.47	5.45
	GNMA	0.73	8.01	6.46	5.07	5.70
	High Current Yield	5.61	46.41	3.08	4.36	4.80
	Short Municipal Debt	0.42	5.26	2.79	2.53	3.20
	Intermediate Municipal Debt	-0.71	10.75	3.88	3.39	4.60
	General Municipal Debt	-1.27	16.85	2.32	2.91	4.59

BOND FUNDS	INTERNATIONAL/GLOBAL	Ticker Symbol	3 Months	1 Year	3 Years	5 Years	10 Years or Since Inception	Inception Date	Redemption Fee	Redemption Fee Period	Expense Ratio	Expense Ratio As of Date
	Emerging Markets Bond	PREMX	1.77%	34.93%	5.52%	8.95%	11.85%	(12/94)	2.0%	90 days	0.98%	12/31/08
	International Bond	RPIBX	-1.30	8.38	6.67	3.69	6.10	(9/86)	2.0	90 days	0.81	12/31/08

BENCH-MARKS	INTERNATIONAL/GLOBAL BOND					
	Barclays Capital Global Aggregate ex U.S. Dollar Bond Index	-1.55%	7.53%	7.62%	4.25%	6.47%
	J.P. Morgan Emerging Markets Bond Index-Global	1.52	28.18	6.66	8.11	10.52
	Lipper Averages					
	Emerging Markets Debt Funds	1.99	32.49	5.37	7.23	11.09
	International Income Funds	-0.62	10.84	6.79	3.90	6.30

MONEY MARKET	TAX-FREE***	Ticker Symbol	7-Day Yield	7-Day Unsubsidized Yield	3 Months	1 Year	3 Years	5 Years	10 Years or Since Inception	Inception Date	Expense Ratio	Expense Ratio As of Date
	California Tax-Free Money	PCTXX	0.01%	-0.22%	0.00%	0.14%	1.62%	1.92%	1.68%	(9/86)	0.63%	2/28/09
	Maryland Tax-Free Money	TMDXX	0.01	-0.14	0.00	0.15	1.70	1.98	1.57	(3/01)	0.54	2/28/09
	New York Tax-Free Money	NYTXX	0.01	-0.20	0.00	0.15	1.66	1.95	1.77	(8/86)	0.61	2/28/09
	Summit Municipal Money Market	TRSXX	0.01	-0.05	0.00	0.24	1.83	2.11	1.97	(10/93)	0.47	10/31/08
	Tax-Exempt Money	PTEXX	0.01	-0.11	0.00	0.15	1.76	2.05	1.88	(4/81)	0.50	2/28/09
	TAXABLE***											
	Prime Reserve	PRRXX	0.01%	-0.15%	0.00%	0.19%	2.52%	2.96%	2.74%	(1/76)	0.60%	5/31/09
	Summit Cash Reserves	TSCXX	0.01	-0.04	0.00	0.30	2.63	3.09	2.89	(10/93)	0.47	10/31/08
	U.S. Treasury Money	PRTXX	0.01	-0.26	0.00	0.05	1.91	2.49	2.44	(6/82)	0.46	5/31/09

An investment in money market funds is not insured or guaranteed by the FDIC or any other government agency. Although the funds seek to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the funds. Money fund yields more closely reflect current earnings than do total returns.

*** In an effort to maintain a zero or positive net yield for the fund, T. Rowe Price has voluntarily waived all or a portion of the management fee it is entitled to receive from the fund. A fee waiver has the effect of increasing the fund's net yield. The 7-day yield without waiver represents what the yield would have been if we were not waiving our management fee. This voluntary waiver is in addition to any contractual expense ratio limitation in effect for the fund and may be amended or terminated at any time without prior notice. Please see the prospectus for more details.

ASSET ALLOCATION	Ticker Symbol	7-Day Yield	3 Months	1 Year	3 Years	5 Years	10 Years or Since Inception	Inception Date	Redemption Fee	Redemption Fee Period	Expense Ratio	Expense Ratio As of Date
Balanced	RPBAX	3.85%	28.28%	-0.53%	3.38%	3.58%	(12/39)				0.69%	12/31/08
Personal Strategy Balanced	TRPBX	4.05	32.61	0.31	3.76	4.81	(7/94)				0.86	5/31/09
Personal Strategy Growth	TRSGX	4.94	37.47	-2.55	2.60	3.84	(7/94)				0.95	5/31/09
Personal Strategy Income	PRSEX	3.05	25.47	2.33	4.32	5.29	(7/94)				0.78	5/31/09
Retirement 2005	TRRFY	3.28	24.55	1.09	3.99	4.64	(2/04)				0.60	5/31/09
Retirement 2010	TRRAX	3.78	27.95	0.00	3.70	8.02	(9/02)				0.64	5/31/09
Retirement 2015	TRRGX	4.23	31.35	-0.72	3.49	4.47	(2/04)				0.69	5/31/09
Retirement 2020	TRRBX	4.70	34.19	-1.60	3.20	8.52	(9/02)				0.73	5/31/09
Retirement 2025	TRRHX	4.96	36.29	-2.28	2.96	4.24	(2/04)				0.76	5/31/09
Retirement 2030	TRRCX	5.26	37.99	-2.84	2.86	8.82	(9/02)				0.78	5/31/09
Retirement 2035	TRRIX	5.47	39.04	-3.18	2.65	3.99	(2/04)				0.79	5/31/09
Retirement 2040	TRRDY	5.47	39.07	-3.17	2.68	8.72	(9/02)				0.79	5/31/09
Retirement 2045	TRRKX	5.51	39.10	-3.13	—	3.23	(5/05)				0.79	5/31/09
Retirement 2050	TRRMX	5.42	38.92	-3.16	—	-3.15	(12/06)				0.79	5/31/09
Retirement 2055	TRRNX	5.43	38.97	-3.19	—	-3.19	(12/06)				0.79	5/31/09
Retirement Income	TRRIX	2.89	22.07	1.86	4.04	6.65	(9/02)				0.58	5/31/09
Spectrum Growth*	PRSGX	6.02	40.94	-3.61	2.67	2.68	(6/90)				0.82	12/31/08
Spectrum Income	RPSIX	2.23	20.29	4.98	5.06	6.68	(6/90)				0.70	12/31/08
Spectrum International*	PSILX	3.85	44.99	-3.47	5.63	1.87	(12/96)	2.0%	90 days		0.98	12/31/08
T. ROWE PRICE NO-LOAD VARIABLE ANNUITY†												
Blue Chip Growth Portfolio*		7.59%	41.45%	-3.21%	0.81%	-0.96%	(12/00)				0.85%	12/31/08
Equity Income Portfolio		5.23	24.93	-6.59	-0.07	3.37	(3/94)				0.85	12/31/08
Equity Index 500 Portfolio		5.83	25.30	-6.53	-0.47	-1.30	(12/00)				0.40	12/31/08
Health Sciences Portfolio		5.94	30.82	2.74	5.75	4.16	(12/00)				0.95	12/31/08
International Stock Portfolio*		5.10	51.61	-4.57	3.51	-1.09	(3/94)				1.05	12/31/08
Limited-Term Bond Portfolio		0.48	7.67	4.49	3.62	4.35	(5/94)				0.70	12/31/08
Mid-Cap Growth Portfolio*		4.71	44.82	0.47	4.18	5.06	(12/96)				0.85	12/31/08
New America Growth Portfolio*		6.04	48.95	1.15	2.80	-0.56	(3/94)				0.85	12/31/08
Personal Strategy Balanced Portfolio		3.92	31.41	-0.65	2.91	4.14	(12/94)				0.90	12/31/08
Prime Reserve Portfolio†		-0.55%	-0.14	-0.21	2.06	2.48	(12/96)				0.57	12/31/08

† The 7-day unsubsidized simple yield for the Prime Reserve Portfolio was -0.58% as of December 31, 2009. In an effort to maintain a zero or positive net yield for the underlying portfolio of the variable annuity subaccount, T. Rowe Price has voluntarily waived all or a portion of the management fee it is entitled to receive from the underlying portfolio. This voluntary waiver is in addition to any contractual expense ratio limitation in effect for the underlying portfolio and may be amended or terminated at any time without prior notice. A fee waiver has the effect of increasing the underlying portfolio's and subaccount's net yield; without it, the underlying portfolio's and subaccount's 7-day yield would have been lower.

Indexes included in this update track the following: S&P 500—500 large-company U.S. stocks; S&P MidCap 400—stocks of 400 mid-size U.S. companies; Nasdaq Composite (principal only)—U.S. stocks traded in the over-the-counter market; Russell 2000—stocks of 2,000 small U.S. companies; Russell 2000 Growth—Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values; Russell 1000 Growth—stocks of the 1,000 largest companies in the Russell 3000 Index with higher price-to-book ratios and higher forecasted growth values; Russell 1000 Value—stocks of the 1,000 largest companies in the Russell 3000 Index with lower price-to-book ratios and lower forecasted growth values; Russell 2000 Value—Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values; MSCI EAFE—the stocks of about 1,000 companies in Europe, Australasia, and the Far East; Barclays Capital U.S. Aggregate—investment-grade corporate and government bonds; Barclays Capital Municipal Bond—tax-free investment-grade U.S. bonds; Credit Suisse High Yield—noninvestment-grade corporate U.S. bonds; Barclays Capital Global Aggregate ex U.S. Dollar Bond Index—tracks investment-grade government, corporate, agency, and mortgage-related bonds in markets outside the U.S.; J.P. Morgan Emerging Markets Bond Index—Global—U.S. dollar-denominated Brady Bonds, Eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities; Lipper averages—all funds in each investment objective category; and Lipper indexes—equally weighted indexes of typically the 30 largest mutual funds within their respective investment objective categories.

‡ A prospectus is available to existing clients who are considering an exchange into a new portfolio. The prospectus includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing. The T. Rowe Price No-Load Variable Annuity is issued by Security Benefit Life Insurance Company (Form V6021). In New York, it is issued by First Security Benefit Life Insurance and Annuity Company of New York, White Plains, New York (FSB201(11-96)). (Security Benefit Life is not licensed in New York and does not solicit business in New York.) The yields and performance figures are based on the AUV of the Variable Annuity subaccounts. Variable Annuity subaccount performance reflects a hypothetical contract and includes the effects of mortality and expense risk charges associated with the T. Rowe Price No-Load Variable Annuity. The inception date relates to the date the portfolios were available as investment options in the Variable Annuity. The Variable Annuity, which has been available since April 1995 and in New York since November 1995, has limitations; contact your representative. It is distributed by T. Rowe Price Investment Services, Inc., T. Rowe Price Insurance Agency, Inc., and T. Rowe Price Insurance Agency of Texas, Inc. The underlying portfolios are managed by T. Rowe Price (T. Rowe Price International for the International Stock Portfolio). The Security Benefit Group of companies and the T. Rowe Price companies are not affiliated. The Variable Annuity may not be available in all states.

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