



### IN THIS ISSUE

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### ARE BONDS THE ANSWER?


With the stock markets of the world so unsettled, many plan participants are considering moving their assets to fixed income investments. The question is: “Are fixed income investments really as safe as they appear?”

Most investment advisors expect that bonds (fixed income) will outperform “cash” this year, but they caution that a rise in interest rates could cause declines in principal values, thereby undermining total returns

The most important issue for plan participants who favor fixed income investments to focus on in

the coming months is likely to be the potential for rising interest rates. The chart below will give you some idea of how the various bond maturities might be affected when interest rates begin to increase. In reading the table below, remember that 100 basis points (bps) is equal to 1%.

To combat the financial crisis, the Federal Reserve has kept the federal funds rate (a key determinant for short-term rates) near 0% and made massive investments in mortgage-backed, agency, and Treasury securities. As that liquidity surge is gradually withdrawn, it could lead to higher

Treasury yields (as bond prices decline), borrowing costs for corporations, and mortgage rates. Many analysts believe that rising interest rates will be a multiyear process and involve both rate increases and “quantitative easing” (purchase of asset securities), which will be difficult to navigate without disrupting fixed income markets. The general consensus is that rates will begin to increase in the fourth quarter of 2010 or the first quarter of 2011 (about ½% to ¾% initially) with the Federal funds rate peaking at 4% over the next two to three years. 

**How Rising Interest Rates Affect Bond Prices**  
Change in Principal Value of Bonds With \$1,000 Face Value

Bond Maturity	Coupon	Rates Increase By:				
		25 Basis Points	50 Basis Points	75 Basis Points	100 Basis Points	200 Basis Points
2 Years	1.02%	-0.49%	-0.98%	-1.47%	-1.95%	-3.85%
5 Years	2.54	-1.16	-2.30	-3.43	-4.54	-8.84
10 Years	3.83	-2.04	-4.02	-5.96	-7.84	-14.89
30 Years	4.71	-3.88	-7.53	-10.94	-14.13	-24.55

Coupons reflect yields on Treasury securities as of 3/31/10. Price changes are apart from fluctuations caused by other market conditions or factors. One hundred basis points equal one percentage point. The table may not be representative of price changes for mortgage-backed securities because of prepayments. This is an illustration and does not represent expected yields or share price changes of any T. Rowe Price fund. Price declines from rising rates are also reflected in total returns shown in the chart on page 9.

Source: T. Rowe Price


**RISKS FOR FIXED INCOME INVESTORS**

Bond prices and interest rates tend to move in opposite directions, so as rates rise, the prices of outstanding bonds fall, potentially more than offsetting the interest income earned.

Investors usually obtain higher yields on longer-term bond issues, but the volatility of bond prices typically increases with the length of their maturity or duration, which reflects a bond or fixed income

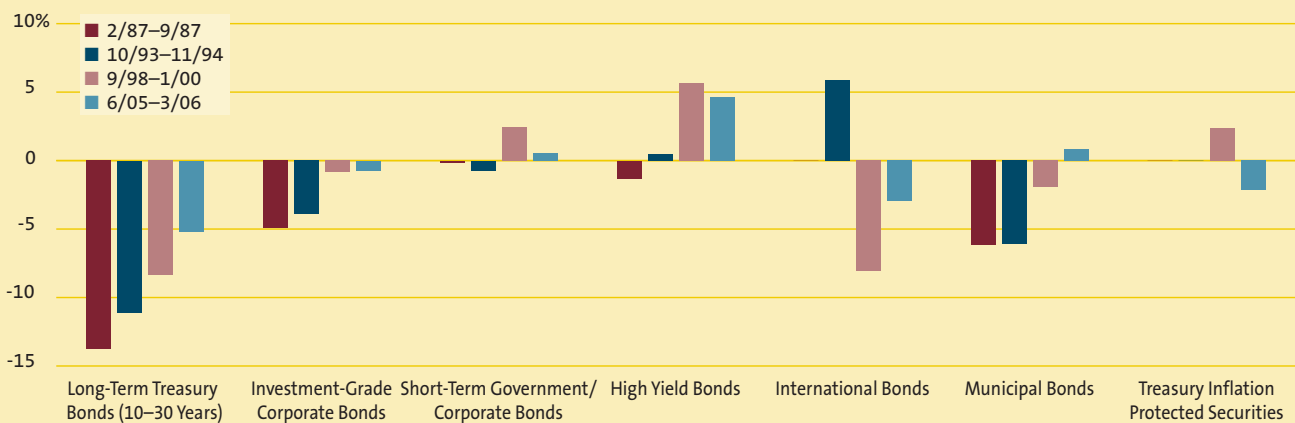
mutual fund’s portfolio’s sensitivity to interest rate changes. A bond or bond fund with a five-year duration, for example, would fall about 5% in price in response to a one-percentage-point increase in interest rates, and vice versa.

If the yield on a 30-year Treasury bond with a \$1,000 par value rises from 4.7% to 5.5%, for example, the price of the outstanding bond would drop 11.6% to \$883. Yet, a

doubling in short-term rates from 1% to 2% would only cut the principal value of a two-year note with a \$1,000 par value to \$980, a decline of less than 2%. It is important to note, however that different sectors of the bond market tend to be more sensitive to rate changes than others, depending on their durations and credit quality, as you can see from the chart below. 

**Bond Market Performance During Periods of Rising Rates**

Total Return




Source: T. Rowe Price. Data based on various Barclays Capital bond indices.

**FIXED INCOME STRATEGY**

With possible rate increases on the horizon, investors should review their fixed income strategies. Those with shorter-term horizons, say five years to retirement or less, might consider focusing on intermediate-term bond funds in their retirement accounts to provide a buffer against interest rate increases.

Longer-term investors who invest in bond mutual funds, mainly to diversify their portfolios, may be better off by making only modest adjustments, if any, in their current strategies.

While these investors could incur a loss of principal value in the next year or two, that

loss could be more than offset by the additional income earned from reinvesting bond fund distributions at higher interest rate levels. 

We would encourage plan participants to consider the dividends that are being paid by equity mutual funds, prior to investing. Investing some of your retirement assets in equity mutual funds that hold companies that pay dividends and have the financial strength to consistently increase those dividends, historically, have provided stellar investment results. But after last year, yield-oriented equity investors may wonder if this strategy remains as viable now.

Over the long haul, dividends have proved to be an important source of equity returns. Since 1925, reinvested dividends have accounted for almost 44% of the total return of the S&P 500 Index. Dividend-paying stocks in the S&P 500 outperformed non-dividend payers in every bear market since 1973, but tended to lag in bull markets as you can see on the chart to the right.

Despite occasional setbacks, many companies that pay dividends have steadily increased them over time, providing a growing level of

**DIVIDEND PAYING STOCKS**

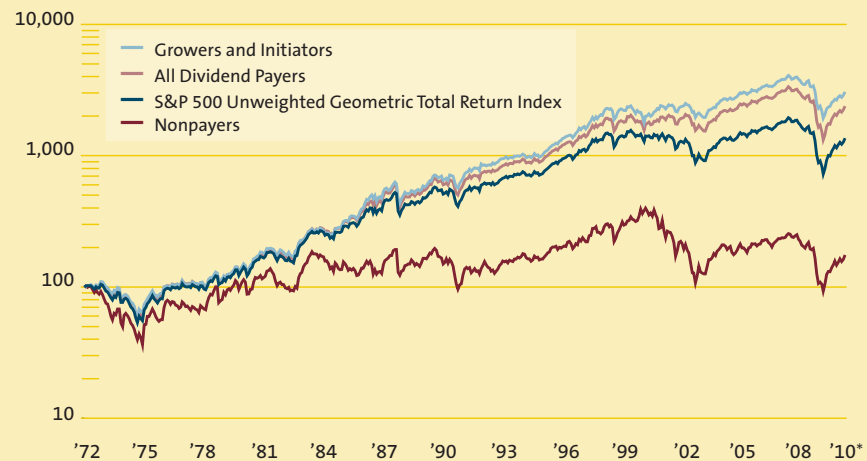
income that has maintained its purchasing power. From 1980 through 2009, dividends on stocks in the S&P 500 grew at an annual compound rate of 4.7% compared with the 3.7% annual inflation rate. Many investment advisors believe that a mutual fund of high-quality companies that yields around 3% and is growing that dividend should be attractive to plan participants

In a study that tracked two portfolios over the past 25 years; one of the top 50% of dividend payers in the S&P 500, and the other of the S&P 500 Long-Term Government Bond Index, some interesting

results were determined. The study assumed all interest and dividend payments were taken in cash each year.

Assuming a \$500,000 initial investment in each portfolio at the end of 1984, the equity index provided total dividend payments of more than \$2.6 million through 2009, or about \$212,000 more than the total interest payments from the bonds. Moreover, in terms of principal value, the original \$500,000 investment in the stock portfolio grew to more than \$2.8 million compared with about \$908,000 in the bond portfolio.

**Dividend-Paying Stocks Have Outperformed Over the Long Term**  
Total Returns Based on S&P 500 Index, Indexed to 100 as of January 31, 1972



Source: Ned Davis Research. \*As of March 31, 2010.

**IT'S NOT TOO LATE TO BUILD A SIZABLE RETIREMENT ACCOUNT**

The earlier, the better is a central axiom of saving for retirement. All else being equal, starting to build a nest egg earlier always beats starting later because of the

potentially profound impact of compounded growth in investments over longer time periods.

Having said that, there is still

hope for those who, for one reason or another, have not been able to start saving for retirement until later in their careers, even well into their 50s.

The message here is that, for those who are approaching retirement and who may have nothing set aside, there still are positive actions they can take today that can make a big difference. If you are willing to really get serious about socking away savings, you can still build up quite a sizable nest egg in just 10 years.

A new study focused on a 55 year old who has no retirement savings and who makes \$80,000 a year. It compared saving just enough (6% of salary) in her 401(k) program to receive her 3% company match with saving the

maximum allowable amount to her 401(k) (\$16,500) each year. It also analyzed the impact of the “catch up” provision that allows those 50 and older to save an additional \$5,500 annually (see chart below).

Just by saving enough to receive the company match led to a nest egg of about \$147,000 after 10 years, the other strategies involving greater 401(k) and catch-up contributions resulted in about \$200,000 to \$300,000 additional savings.

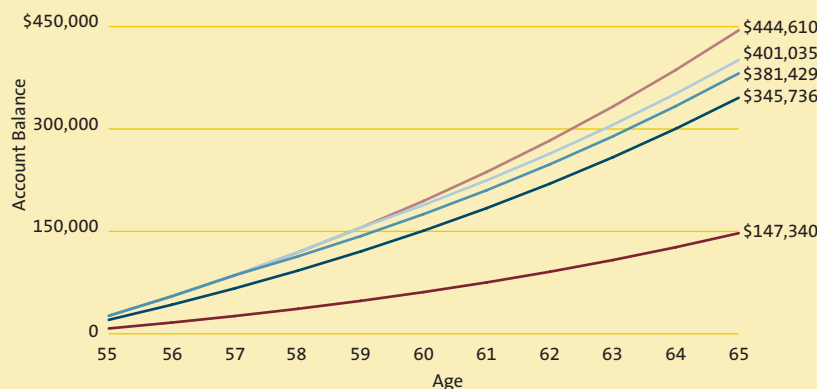
To achieve that, though, this late starter would have to

contribute about 21% to 27.5 % of her salary for the first year, have an 8% return from her investments, and benefit from a 3% contribution from her employer for each of the next 10 years.

There is no such thing as a free lunch and saving that much may be very difficult for many people. Nevertheless, the potential results, as much as half million dollars build up in retirement savings over a decade, are significant enough that it may be well worth making such a strong commitment to your retirement plan. 🐼

### Catch-Up Savings Can Add Up for Late Savers

Five savings strategies for a 55 year old who has no retirement savings, earns \$80,000 a year (which will increase at 3% a year), earns 8% annually on savings, and aims to retire at 65.\*



- Base case: 401(k) contribution of 6% of salary and maximum company match of 3%. Personal savings rate: 6% annually
- Maximum 401(k) contribution of \$16,500. Personal savings rate first year: 20.6%
- Maximum 401(k) contribution of \$16,500 plus maximum catch-up provision contribution of \$5,500 for the first three years for a total of \$22,000 each year, then just the maximum 401(k) contribution of \$16,500 thereafter. Personal savings rate first year: 27.5%
- Maximum 401(k) plus maximum catch-up contributions for the first five years, then just the maximum 401(k) contribution for the last five years. Personal savings rate first year: 27.5%
- Maximum 401(k) plus maximum catch-up contributions for all 10 years. Personal savings rate first year: 27.5%

\*Assumes annual salary increases of 3%, raising the dollar amount of personal savings and company match each year for each strategy. The maximum 401(k) and catch-up provision contributions are capped each year at \$16,500 and \$5,500, respectively.

Company match is 50% of the first 6% of deferred salary, or 3% for salary deferrals of 6% or above. Savings contributions occur at the beginning of each year.

Source: T. Rowe Price

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