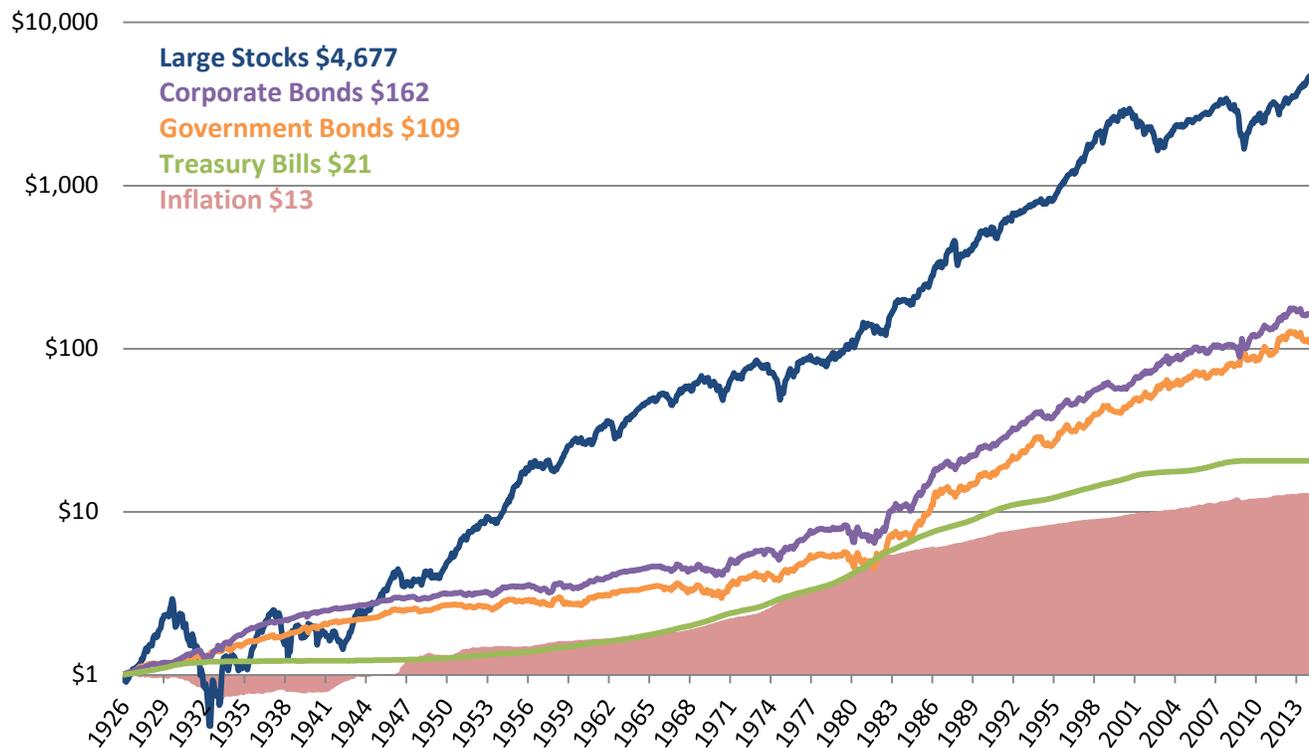


# Why invest in stocks?

2014

Why should someone invest in stocks? Because historically, stocks have performed well when compared to other financial assets, and have typically outpaced inflation. These characteristics should allow patient stock investors to build wealth over time. Keep in mind that past performance is not a guarantee of future results.

Figure 1 – Hypothetical investment in the U.S. capital markets 1926-2013



Sources: Ibbotson Associates, Wells Fargo Advisors. Past performance is no guarantee of future results. Hypothetical value of \$1 invested at the beginning of 1926. Assumes reinvestment of income and no transaction costs or taxes that would be applicable to an actual investment. This information is hypothetical and is provided for illustrative purposes only. It is not intended to represent any specific return, yield, or investment, nor is it indicative of future results. An index is not managed and you cannot invest directly in an index. Treasury bills and government bonds, unlike stocks and corporate bonds, are guaranteed by the U.S. government and if held to maturity, offer a fixed rate of return and fixed principal value. Yield and market value of bonds will fluctuate prior to maturity. The principal value of an investment in stocks fluctuates with changes in market conditions. Large stocks are represented by the Standard & Poor's 90 index from 1926 through February 1957 and the S&P 500 index thereafter. Corporate bonds are represented by the Ibbotson Long-Term Corporate Bond Index. Government bonds are represented by the 20-year U.S. government bond and Treasury bills by the 30-day U.S. Treasury bill. Inflation is measured by the Consumer Price Index, which measures changes in the price level of a market basket of consumer goods and services.

Please see page 9 for Disclaimers

**In this report, we will examine the following:**

- the record of long-term returns of key asset classes, in both nominal and real (inflation-adjusted) terms,
- the volatility of stocks versus other asset classes,
- the total return potential of dividend paying stocks,
- strategies for reducing a portfolio's risk, and
- investment ideas for the stock investor.

**What is “common stock”?**

Common stock is a type of security that represents an ownership, or equity interest, in a company. It typically carries voting rights that give holders the right to elect a company's board of directors and vote on other aspects of corporate policy. It is a residual claim on the company's earnings and assets after creditors are repaid.

Some people avoid buying common stock because they think the market is too risky or that stocks should be bought only with money that can be lost without resulting in undue financial strain. Although it is true that an investment in stocks carries the risk of principal loss, what we are talking about in this report is prudent, long-term investing; not speculating in the hot concept du jour, or in a stock for which little or nothing is known about the underlying company.

The prudent investor buys stock in high quality companies and participates in any earnings remaining after the fixed claims of other securities. In exchange for taking on a higher level of downside risk compared to a fixed income investment, a shareholder should have greater opportunity for capital appreciation given the stock's potential to reflect the growth of the company's earnings.

Figure 1 depicts the hypothetical outcome of one dollar invested in each of several different financial asset classes in 1926 and held through 2013. All income is reinvested in this illustration; in other words, dividends received purchase more shares of stock and interest payments from bonds purchase more bonds. The study shows that stocks have significantly outperformed both corporate and government bonds and T-bills over the 88-year period. What investors may not appreciate when looking at Figure 1 is how dramatically stocks have outperformed other asset classes over this period, as

Figure 1 uses a logarithmic scale for the vertical axis in order to fit the graph on a single page.

Many investors, worried about day-to-day volatility, shun stocks and stay with historically more conservative fixed-income investments. Of course, fixed-income investments can and should have a place in a well-diversified portfolio. Government bonds and Treasury bills are guaranteed by the U.S. government, and if held to maturity, offer a fixed rate of return and principal value. Yet, as illustrated in Figure 1, history has shown that over time fixed-income investments have significantly underperformed equity investments.

**Inflation takes its toll**

There are two primary risks to one's investments: volatility and inflation. Volatility is the near-term risk that price fluctuations could result in selling an asset at a lower price than what one paid for it. Inflation is the longer term risk that investment returns will not keep up with the rising cost of living.

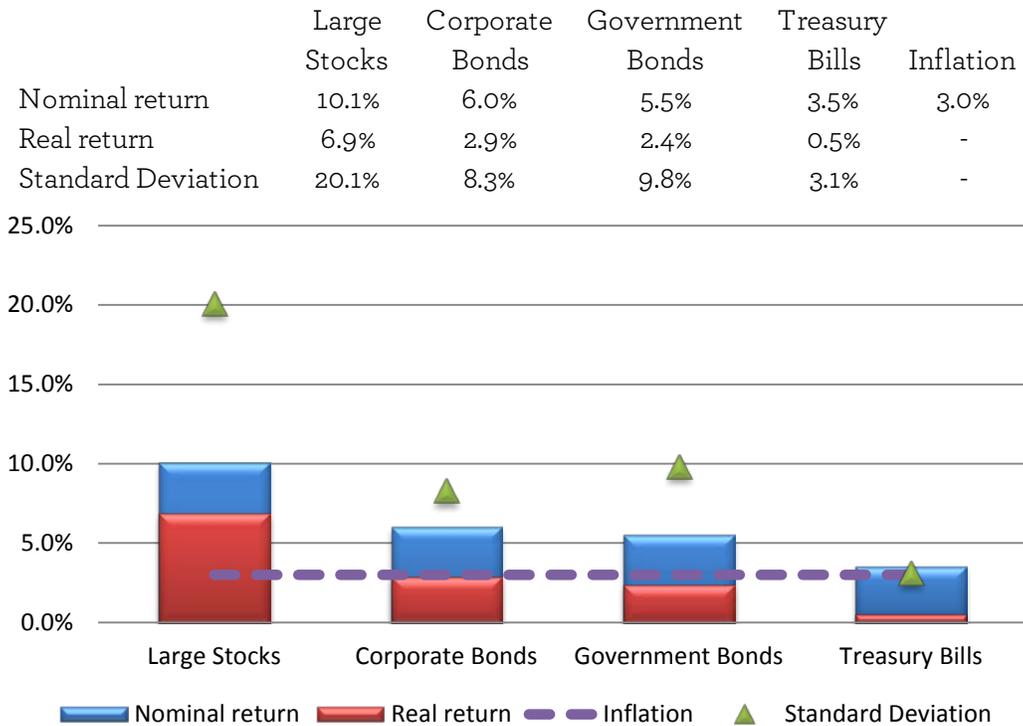
As shown in Figure 2, fixed-income investments have not done a good job historically of outpacing inflation. If investors own only bonds and Treasury bills, it could be difficult over time to maintain the manner in which they have become accustomed to living, i.e., because of inflation investors run the risk of outliving their assets. Historically, only stocks have provided a noteworthy return over time after taking into account the eroding effects of inflation.

**What about the volatility?**

As shown in Figure 2, since 1926, the average annual standard deviation (a common statistical measure used to measure the volatility of investment returns) of stocks has been 20%, 8% for long-term corporate bonds, 10% for long-term government bonds, and 3% for T-bills. The stock investor historically has had to tolerate more than twice the volatility of the long-term bond investor.

Some investors are not able to tolerate an investment that can deviate as much as plus or minus 20% a year or more on average. It is important that an investor know and understand his tolerance for volatility well enough to determine the amount of risk that can be assumed. A risk-averse investor

**Figure 2 – Summary of returns (1926-2013)**



Sources: Ibbotson Associates, Wells Fargo Advisors. Please see the bottom of page 1 for descriptions and disclaimers. Figures shown are hypothetical and for illustrative purposes only. They assume that \$1 was invested in 1926.

must also understand that he cannot expect the kinds of returns that only more volatile investments like stocks typically offer.

Over long periods of time, stock prices tend to move in recognition of the underlying company’s growth potential. In the short term, emotional factors such as fear and greed can cause stock prices to bounce around, sometimes dramatically.

How can we apply this notion of volatility (i.e., risk) and return to an individual stock? Suppose a company is expected to increase earnings 10% per year. All other things equal, a company with 10% annual earnings growth should, maybe not every year, but over time have a stock that offers roughly 10% average annual price appreciation. With historical data from Figure 2 in mind, an investor must be able to tolerate about twice as much in the way of annual volatility (measured by standard deviation) as return. So, an investor must be able to tolerate a drop in stock price of about 20% for the potential to earn that anticipated 10% annual return.

**How can you deal with volatility?**

- Diversify. Owning stocks from several different market sectors, with different investment characteristics, is a strategy designed to smooth out the performance of the entire investment portfolio over the long run. (*Diversification does not guarantee a profit or protect against loss.*)
- Stick with good quality companies, with measurable fundamentals, so that you can determine reasonable expectations for their shares.
- Understand what is realistic in the way of expected return and volatility.
- If you get meaningful profits, lock some in along the way.

Don’t be scared out of the market by big daily point moves. As illustrated in Figure 1, the long-term trend of stock prices has been up. Stocks are financial assets that give investors the potential to keep up with inflation and build wealth over time. To participate in the stock market, it is necessary to understand and accept the inherent risks (i.e.,

volatility) that inevitably follow. But, if you own stock in companies that you know and understand, with products and services that are in demand and are likely to stay in demand in the future, then short-term stock market volatility should not deter you from participating in the company's long-term growth potential.

### Think total return – Don't forget about dividends!

Total return is calculated as the sum of a stock's price appreciation plus dividend income received. Historically, about 45% of the roughly 10% average annual total return from stocks has come from dividends and 55% has come from price appreciation. For instance, over the 88-year period depicted in Figure 1, large stocks generated a total return of 10.1% per year on average, and approximately 5.8% per year on a price only basis.

What is not readily apparent in Figure 1 is the fact that capital appreciation alone led the dollar invested in stocks in 1926 to grow to only \$145 by the end of 2013, an average compound annual return of roughly 5.8%, as noted above. The remainder of the \$4,677 total return was achieved by collecting the dividends paid, purchasing more shares of stock, and enjoying the benefits of compounding growth. In absolute dollars then, 3% of the total return came from capital appreciation (\$145), while 97% came from dividends and dividend reinvestment ( $\$4,677 - \$145 = \$4,532$ ).

$$\text{Total Return (\%)} = \text{Change in Price (\%)} + \text{Dividend Yield (\%)}$$

### The compounding power of dividend reinvestment

A stock investor can potentially benefit in two ways from the growth potential of a company. A company can reinvest all or some portion of its earnings back into the company to develop its growth opportunities. This can result in potentially higher earnings. Then, if the company pays out to shareholders a portion of its earnings as dividends, the growing company may be able to increase the amount of dividends it pays out as its earnings grow. If the disciplined shareholder then reinvests those dividends in more shares of stock, the total return from that investment may well exceed the return from one where dividends are harvested and spent.

For example, a \$10,000 investment in the S&P 500 on the last day of 1993, with all dividends reinvested and held until the last day of 2013 could have grown to \$58,325, as shown in Figure 3. The same investment *without* reinvesting dividends might have grown to only \$39,693. The power of compounding growth is not well understood by most people. It takes time to see its effects, but investors with the discipline to exercise such patience have the potential to be well rewarded.

Ask your financial advisor about dividend reinvestment, an automatic service that allows you to take full advantage of the compounding growth potential of your dividend income.

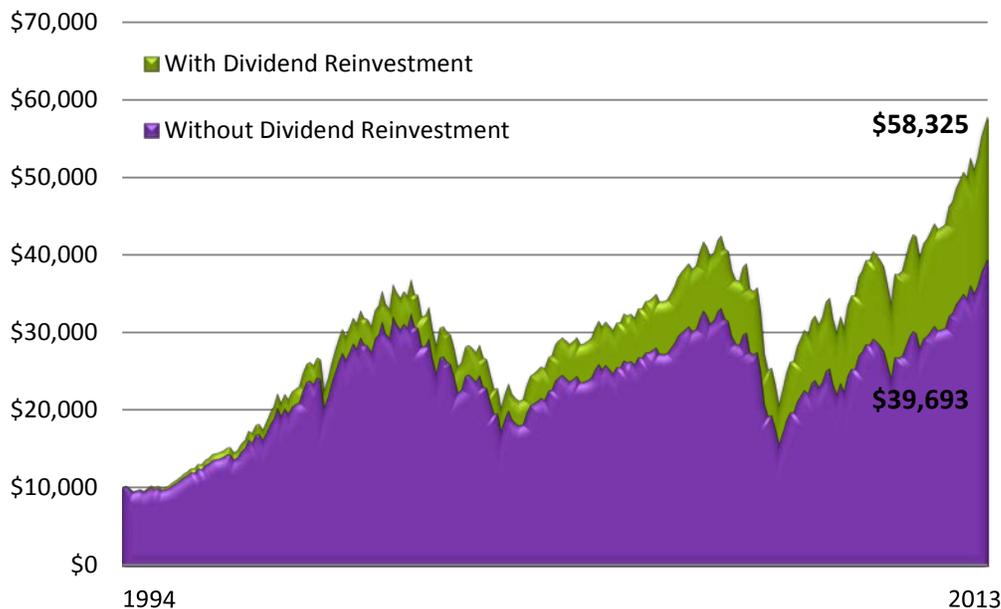
### Estimating total return

When determining whether or not to buy stock, investors typically make assumptions about the company's growth potential. An analyst's job, in part, is to make growth projections specific to each company they follow. For some companies, the most important factor is earnings growth; for other companies, cash flow or dividends could be the critical factor to determine their growth rate. Regardless, history has shown that over long periods of time stock prices tend to move in recognition of growth. Therefore, when estimating what an investment could return to an investor, it is often useful to look at the analyst's projected growth rate—be it earnings, cash flow, or dividend growth.

But, looking only at the growth rate could be misleading. For instance, suppose an investor bought stock in a company that paid a \$1.00 dividend, and the stock's price rose from \$40 to \$50 during the year. The investor's total return would have been 27.5% ( $\$50$  ending stock price + \$1 dividend [i.e., \$51], minus \$40 beginning stock price, divided by \$40 beginning stock price = 27.5%). If the investor calculated only the percentage change in price movement  $\{(\$50 - \$40) / \$40 = 25\%$ , she would have understated her increase in wealth by 2.5%, the dividend yield when the investment was purchased. In other words, it is important to consider the entire change in value, or total return— income received as well as change in price.

$$\text{Projected Total Return (\%)} = \text{Estimated Growth Rate (\%)} + \text{Yield (\%)}$$

**Figure 3 – Hypothetical \$10,000 invested in the S&P 500 (1994-2013)**



Sources: FactSet, Wells Fargo Advisors. This information is hypothetical and is provided for illustrative purposes only. It is not intended to represent any specific return, yield, or investment, nor is it indicative of future results. Hypothetical results do not reflect the impact of fees, expenses or taxes applicable to an actual investment. The Index is unmanaged and not available for direct investments.

Consider this example:

Suppose a company pays an annual dividend of \$1.00 per share. If the stock is trading at a price of \$40, the current yield is 2.5% (\$1.00 divided by \$40 = 2.5%). Analysts project that the company should be able to increase its dividend 5% per year. If the company does, in fact, raise its dividend the next year to \$1.05 per share, and the share price adjusts (higher) to maintain a yield of 2.5% on the increased dividend, the stock would trade at \$42 (\$1.05 divided by 2.5% = \$42), all else being equal.

Our illustration is purposefully simplistic. The yield and estimated growth rate are only two of a large number of factors that determine a stock’s market price.

This exercise of using dividend growth estimates to determine where we think a stock’s price could go over time is very similar to one in which analysts are making earnings per share (EPS) estimates and examining price/earnings (P/E) ratios to gauge a stock’s upside potential. For example, suppose a company is expected to earn \$5 per share this year (2014), \$6 per share in 2015 and \$7 per share in 2016. If the shares are currently trading at \$50, the P/E

ratio is 10 times (\$50 stock price divided by \$5 estimated earnings per share). If P/E multiples remain stable, by the year 2016 when this company is expected to earn \$7 per share, the shares could be trading at \$70 (\$7 EPS estimate multiplied by 10 times P/E multiple). If all this comes to pass, the shares would have increased 40%  $\{(\$70 - \$50) / \$50 = 40\}$ , or an average 20% per year, in line with the roughly 20% per year increase in earnings.

Over long periods of time, stock prices tend to move in recognition of growth— be it cash flow, earnings or dividend growth, or some combination thereof.

**Building wealth requires patience**

Investors are typically concerned about the volatility of stocks and the possible risk to investment principal along the way. Accumulating shares at regular intervals (e.g., monthly) over time, with the same dollar amount each time, as opposed to the outright purchase of an entire position, is one way of potentially reducing some of the risks of incorrectly timing a purchase decision. This practice, known as dollar cost averaging, can help reduce the need for accurate market timing. *(Dollar cost averaging does not ensure a profit or protect against a loss in a*

*declining market. You should consider your financial and emotional ability to continue the program in both up and down markets).*

Figure 4 illustrates how difficult it is to time market fluctuations correctly, and therefore why patience is so essential to long-term investment success. We examined what would have happened if an investor had been out of the market during some of the best-performing days over the last 20 years. The average compound annual total return received by an investor in the S&P 500, with dividends reinvested over the entire 20-year period from 1994 through 2013, could have been 9.2%. Had that investor missed the 10 and 20 days that the S&P 500 turned in its highest returns during that period, the average compound annual total returns might have been just 5.5% and 3.0%, respectively. Missing the market's best 30 and 40 days, the investor might have only received an average compound annual total return of 0.9% and -1.0%, respectively.

It requires patience to buy and hold. But that strategy, when devoted to stocks of good quality companies, has frequently yielded results superior to one of trading in and out of the market.

**Think long-term**

Figure 5 helps to put into perspective how seldom large company stocks (represented by the S&P 500) have generated negative returns during various holding periods. For example, since 1926 there have been only 12 five-year periods (out of 84 total, or just 14%) in which the S&P 500 had a negative total return, or lost an investor money; most of which occurred in the 1930's (4) and in the past ten years (5).

Most investors who have built significant wealth by participating in the stock market have achieved this success over years and years of patient investing. The stock market provides a way to own a piece of the companies that provide our goods and services, and a way to participate in the decisions managements make about these companies. Just as companies do not prosper overnight, most stocks do not go up dramatically and create significant investment value overnight either. Investors often like to get paid while waiting for the market to reflect a company's growth. Fortunately for such investors, many companies pay shareholders a portion of their earnings, usually quarterly, in the form of dividends.

**Figure 4 - Market timing: the risk of missing major opportunities**



*Sources: FactSet, Wells Fargo Advisors. This information is hypothetical and for illustrative purposes only. It is not intended to represent any specific return, yield, or investment, nor is it indicative of future results. Hypothetical results do not reflect the impact of any fees, expenses or taxes applicable to an actual investment. The Index is unmanaged and not available for direct investments.*

**Figure 5 – Summary of returns for different holding periods (nominal terms 1926-2013)**

	Number of Periods	Times Equities Outperformed		Times Equities Had Negative Returns	
		Number	Percent	Number	Percent
1 Year	88	54	61%	24	27%
5 Years	84	59	70%	12	14%
10 Years	79	60	76%	4	5%
15 Years	74	63	85%	0	0%
20 Years	69	62	90%	0	0%

Sources: Ibbotson Associates, Wells Fargo Advisors. Please see the bottom of page 1 for descriptions and disclaimers. Past performance is no guarantee of future results.

**Figure 6 – Diversification guidelines**

A properly diversified equity portfolio should include:

- A minimum of 20 to 30 stocks
- Representation from at least six to eight sectors with different investment characteristics
- No more than 20 percent of the total portfolio value in any one sector
- No more than 10 percent of the total portfolio value in any one stock
- A minimum of approximately 3% to 4% of the total portfolio value in each security.

*Diversification cannot eliminate the risk of fluctuating prices and uncertain returns.*

**Stocks that can potentially stand the test of time**

We think that to be successful in the stock market it makes sense to emulate the techniques of great investors, such as Warren Buffett and John Templeton, by adhering to a formula of:

- selecting good quality companies with solid prospects for future growth,
- accumulating shares over several weeks, months or years according to a disciplined, regular schedule- adding to positions if the shares pull back and provide an attractive buying opportunity, and
- patiently holding the shares year after year, monitoring the company's progress, selling only if something of a materially negative, and presumably permanent nature occurs at a company.

We believe diversification is also critical to modifying portfolio risk over time. Figure 6 provides some guidelines that should help investors who wish to build a well-diversified portfolio of common

stocks. In addition to stocks, a well-constructed portfolio may also contain other asset classes.

**What stocks should I buy?**

The first step in any investment-planning process is one of self-examination. Defining one's financial goals, and how much risk can be tolerated along the way, is crucial at the outset. Once an investor has determined if the primary investment objective is for income, growth, or some combination; he or she can evaluate the risk that accompanies owning particular stocks.

Stocks included in several Wells Fargo Advisors investment strategies presented in Figure 7 may be suitable for an investor's temperament or comfort level. Our *DSIP List (Diversified Stock Income Plan)* and *Core List*, in particular, identify stocks we consider appropriate for long-term investors. Investors desiring more information on specific companies should contact their financial advisor, who can help determine which stocks may be appropriate additions to their portfolio.

**Figure 7 – Wells Fargo Advisors investment strategies**

**DSIP List (Diversified Stock Income Plan):** The DSIP List focuses on companies that we believe will provide consistent annual dividend growth over a long-term investment horizon. Our objective is to provide a broad list of high quality, industry leading companies from which an investor can assemble a well-diversified portfolio. Through consistent dividend growth, our goal is to help investors stay ahead of the wealth eroding effects of inflation.

**Core List:** The Core List is comprised of blue chip, industry-leading companies that we believe can withstand the test of time. The objective is to provide a list of high-quality stocks that can be used to build a well-diversified portfolio or can be used to supplement an existing portfolio.

**High Yield Equity Income List:** The High Yield Equity Income List seeks to emphasize companies with notably higher dividend yields than the broader market (as measured by the S&P 500). Our objective is to offer a list of stocks for investors seeking a higher level of income and willing to accept a higher level of risk.

**Dynamic Growth List:** The Dynamic Growth Equity List focuses on companies that we believe offer above average growth potential and may be on track to become leaders in the markets they serve. Our objective is to offer investors a list of stocks that they can use to help build a well-diversified portfolio or to fill holes in an existing portfolio.

**Focus List:** The Focus List includes 25 stocks and represents a combination of the sector guidance from our Equity Strategy Team and security selection from our Equity Analysts. The objective is to exceed the total return of the S&P 500 over an approximate one-year timeframe.

Please contact your Wells Fargo Advisors financial advisor if you would like more information on any of the investment strategies listed above.

## Disclaimers

- There is no guarantee that dividend-paying stocks will return more than the overall stock market. Dividends are not guaranteed and are subject to change or elimination.
- Stocks offer long-term growth potential, but may fluctuate more and provide less current income than other investments. An investment in the stock market should be made with an understanding of the risks associated with common stocks, including market fluctuations.
- Investing in fixed income securities involves certain risks such as markets risk if sold prior to maturity and credit risk especially if investing in high yield bonds, which have lower ratings and are subject to greater volatility. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline of the value of your investment. All fixed income investments may be worth less than original cost upon redemption or maturity.
- An index is unmanaged and not available for direct investment.
- *S&P 90 Index* - In 1928 Standard & Poor's realized the need to disseminate its market indicator information more frequently. Instead of trying to calculate the 233 Composite on an hourly or even a daily basis, which would have been difficult to do in an era before sophisticated calculators or computers were available, Standard & Poor's created a more manageable subset of stocks. This new index was the first daily, and then the first hourly index published by Standard & Poor's. Comprised of 50 Industrial, 20 Railroad, and 20 Utility stocks, it became known as the S&P 90 Stock Composite Index.
- *S&P 500 Index* is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.
- *Ibbotson U.S. Long-Term Corporate Bond Index* is a market value-weighted index which measures the performance of long-term U.S. corporate bonds. For the period 1926-1945, Standard and Poor's monthly High-Grade Corporate Composite yield data were used, assuming a four percent coupon and a 20-year maturity. The conventional present-value formula for bond price was used for the beginning and end-of-month prices. The monthly income return was assumed to be one-twelfth of the coupon. For the period 1946-1968, Ibbotson and Sinquefeld backdated the Salomon Brothers' Long-Term High-Grade Corporate Bond Index, using Salomon's monthly yield data with a methodology similar to that used for 1969-present. Capital appreciation returns were calculated from yields assuming (at the beginning of each monthly holding period) a 20-year maturity, a bond price equal to APR, and a coupon equal to the beginning-of-period yield. For the period 1969 to present, long-term corporate bond total returns are represented by the Salomon Brothers Long-Term High-Grade Corporate Bond Index. The Index includes nearly all Aaa- and Aa -rated bonds with at least 10 years to maturity. If a bond is downgraded during a particular month, its return is included in the Index for that month before removing it from future portfolios. The Ibbotson U.S. Long-Term Corporate Bond Index includes reinvestment of income.

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