Investing in Industry-Focused Stock Funds

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Like a lens, an industry-focused stock fund zooms in on a specific business segment of the economy, giving you exposure to advances being made in that industry. Unlike broadly diversified stock funds, which may invest in hundreds of stocks across many sectors, industry-focused stock funds may invest in less than 100 issues—perhaps as few as 30 to 50—in a single sector. As a result, the risks of industry-focused stock funds are greater since they are so concentrated, but so is the potential for higher returns compared with broader stock funds.

If you're considering adding an industry-focused fund to your portfolio, you'll need information on what these funds are, how they work, and their risks. You will also need to understand how you can use industry-focused stock funds in a diversified portfolio to help you meet your financial goals.

Look past the name

Nearly every major industry, from utilities to telecommunications, is targeted by industry-focused funds. But before you can consider investing, you'll need to look carefully at how a fund defines its sector and what it invests in. There is no universally accepted breakdown of sectors followed by the investment community. Rating agencies and other companies tracking the financial markets usually have their own definitions of what constitutes an industry.

Even funds that focus on the same sector may do so in different ways. For example, one company's health care fund may include biotechnology stocks, while another may exclude biotechs in favor of pharmaceuticals. Check a fund's prospectus and most recent shareholder report to determine its specific focus. Most industry funds measure their performance against an index that is used as a

Table I: Industry-Focused Funds Investment Potential Versus Risks

Sector	Investment Potential	Possible Risks
Financial Services	Forms the core of global business activity. Has evolved to offer a wide array of growth opportunities.	May be hurt when interest rates rise sharply and is vulnerable to rapidly rising inflation.
Health/Biotechnology	Consistent (and rising) demand for health care makes some areas of this sector highly defensive, while other segments can generate tremendous opportunity through development of new drugs or processes.	Is often dependent on government funding and regulation and is vulnerable to liability lawsuits and competition from generic products.
Natural Resources	Benefits directly from rising global demand for limited resources. Often considered a strong hedge against inflation.	As a commodity, subject to speculation and related volatility. Tends to perform poorly during weak economic periods.
Real Estate	Provides diversification because many stock and bond portfolios have limited exposure to real estate.	Tends to fare poorly in negative economic environments, and changes in tax laws or rising interest rates could cause a decline.
Science and Technology	Source of major innovations that generate enormous public interest.	Companies that do not quickly generate earnings are often punished by investors.

benchmark; knowing how the benchmark is structured can also clarify a fund's strategy.

Table I Continued

Sector	Investment Potential	Possible Risks
Telecommunications	Critical industry worldwide that generates significant regular revenues.	Subject to rapid obsolescence of their products and services, lack of investor or consumer acceptance, an unfavorable regulatory environment, intense competition, and a dependency on patent and copyright protection.
Utilities	Utilities can generate high income. Often considered a defensive investment during times of economic or market instability.	Income can help reduce volatility in this sector. However, long-term growth potential is also muted.

The benefits

Industry-focused funds give you an opportunity to take advantage of conditions that may benefit a given sector of the economy. For example, the explosion of the Internet in the 1990s generated significant gains across the tech sector, and tech-related funds benefitted. In the early 2000s, sharp increases in oil prices led to major advances in many oil-related stock prices.

Investing some of your assets in an industry-focused fund may also broaden your entire portfolio's diversification. Investing in a fund focused on sectors that are underrepresented in your core equity funds can increase your overall diversification and thus reduce your risk of having too many funds in too few industries. Of course, diversification cannot assure a profit or protect against loss in a declining market.

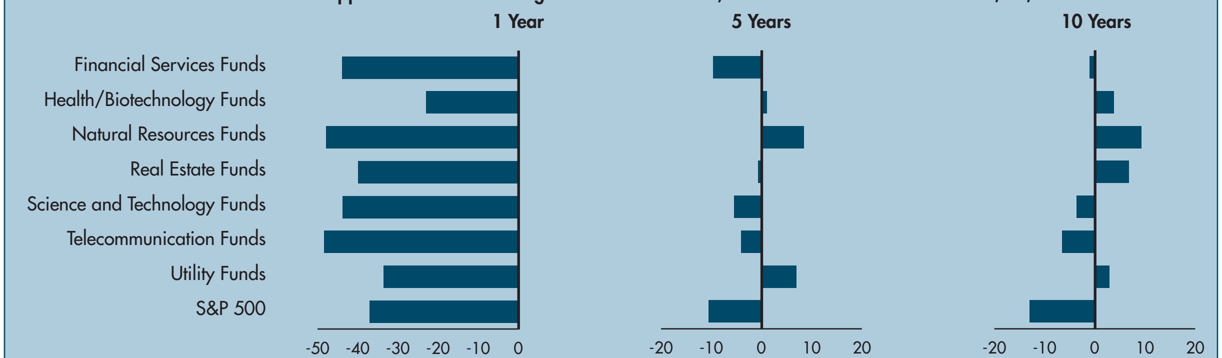
The risks

Industry-focused funds can bring with them high levels of business and sector risk—the possibility that falling stock prices in one area may cause your investment to decline in value. The risk is magnified in these funds because they often have a relatively small number of holdings and are required to stay invested in a chosen industry. The performance of any stock in the portfolio can have a substantial impact on the fund's total return, especially if it represents 5% or more of fund assets.

Therefore, if a particular industry falls out of favor with investors, funds investing exclusively in that sector are likely to show poor performance. For example, real estate funds are likely to continue to struggle as long as slowing economic growth puts a damper on both commercial and residential real estate.

Chart I: Industry Returns Versus the S&P 500

Return of Lipper Mutual Fund Averages for Various Sectors; Annualized for Periods Ended 12/31/08.



Sources: Lipper Inc. and T. Rowe Price

This chart is shown for illustrative purposes only and does not represent the performance of any specific security or mutual fund. *Past performance cannot guarantee future results.* The S&P 500 Stock Index tracks the stocks of 500 U.S. companies. It is not possible to invest directly in an index.

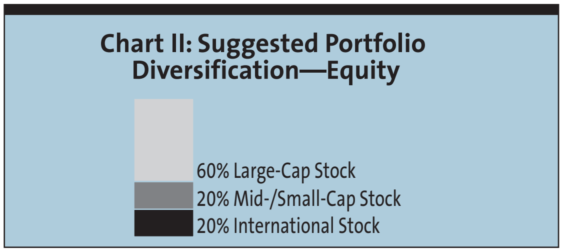
Not all sector funds will have the same degree of volatility. For example, funds that target income-oriented stocks, such as utilities, should be less volatile than funds investing heavily in technology or other high-growth stocks.

Fitting industry-focused stock funds into your portfolio

Before making any investment decision, you need to evaluate your overall financial picture and long-term objectives. To build a portfolio that works for you, we suggest you identify your goals and time horizon, and then determine an appropriate asset allocation.

Industry-focused stock funds can help you easily and instantly increase your portfolio's exposure to certain industries, but, by themselves, they may entail a great degree of business and sector risk. If you invest a portion of your assets in them while maintaining most of your equity assets in broad-based funds, you may be able to enhance your portfolio's long-term performance without a substantial increase in overall business and sector risk.

Of the equity portion of a well-diversified portfolio, 20% might be in mid-cap stocks, small-cap stocks, or other diversifying groups, which may include industry-focused stock funds. (Note that the amount of your portfolio that you should have in equities will vary depending on your time horizon; visit troweprice.com for more information.)



When choosing an industry-focused fund, it can be helpful to select an industry that you already have interest in or knowledge of. But don't overlook stock sectors that have recently been out of favor. While it is true that an undervalued sector could remain out of favor for an extended period, investing in one can help limit your downside and potentially expand your upside because prices of stocks in that industry are already low.

Still, before you make the leap, it's wise to determine just how much of your portfolio is already invested in that sector. You can find out your portfolio's exposure to different market sectors, stock types, sub-asset classes, and global diversification by using the Morningstar Portfolio X-Ray tool. For more information, visit troweprice.com or call 1-800-638-5660.

Insights reports provide background information on many aspects of investing. *Call 1-800-638-5660 to request a prospectus, which includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.* T. Rowe Price Investment Services, Inc., Distributor.

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