

Investing in Industry-Focused Stock Funds

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Like a magnifying glass, an industry-focused stock fund zooms in on a specific business segment of the economy. 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. Naturally, the magnitude of risk is greater since industry-focused funds are so concentrated, but so is the potential for higher returns compared with broader stock funds.

Industry-focused stock funds may be good choices for mutual fund investors who want more aggressive investments but may not want to spend time analyzing and tracking individual securities or entire industries. In this Insights report, we'll take a closer look at industry-focused funds, why you may want to add them to your portfolio, and what you should know about the risks.

Q. In what sectors do industry-focused stock funds invest?

A. Nearly every major industry, from utilities to telecommunications, is likely to be targeted by one or more industry-focused funds, but there is no universally accepted breakdown of sectors followed by the investment community. Rating agencies and other companies that track 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. Some may have a narrower objective than others. For example, one company's health care fund may include biotechnology stocks, while another may exclude them. You should check a fund's profile or prospectus and most recent shareholder report to see how focused a fund is.

Q. Why invest in industry-focused stock funds?

A. One reason to invest in an industry-focused fund is the opportunity for high returns. When a particular stock sector is performing well, possibly because of some catalyst, funds that focus on that sector are likely to show strong returns. For example, natural resources stocks surged along with the price of oil in recent years, so those stocks were above-average performers for the three-year period ended December 31, 2007.

Various Stock Sectors (Lipper Averages) vs. the S&P 500
Annualized Returns for Periods Ended 12/31/07

	1 year	3 years	5 years	10 years
Financial Services Funds	-13.17%	2.56%	10.14%	6.52%
Health/Biotechnology Funds	8.80	7.37	12.29	9.12
Natural Resources Funds	39.63	30.86	30.82	16.54
Real Estate Funds	-14.81	7.48	17.71	10.45
Science & Technology Funds	14.92	8.98	16.12	7.12
Telecommunication Funds	10.97	12.79	19.52	6.70
Utility Funds	19.53	19.14	21.05	9.33
S&P 500 Index	5.49	8.62	12.83	5.91

Sources: T. Rowe Price and Lipper Inc. The industry returns listed here are averages of mutual funds that invest in different sectors as tracked by Lipper and are not representative of the performance of any T. Rowe Price fund. The S&P 500 tracks the stocks of 500 U.S. companies. It is not possible to invest directly in an index.

As shown in the table on the previous page, several Lipper categories performed much better than the broad-based S&P 500 Index over different time periods, but some performed worse. Notice, also, the disparity of returns between sectors.

While it may be tempting to invest only in sectors with the highest returns, keep in mind that those sectors tend to be the most volatile. Investor sentiment could change swiftly, and out-of-favor sectors may suddenly become market darlings. Therefore, if you invest in industry-focused funds, you should make sure the core of your portfolio remains broadly diversified across many industries. That way, you can participate in the gains made by the leading sectors and avoid having too many assets in the laggards.

Another reason to invest some of your assets in an industry-focused fund is that it may broaden your entire portfolio's diversification. If certain sectors enjoy an extended period of gains, you may discover that broad domestic stock funds have higher exposure to these areas and lower allocations to sectors that have lagged. 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 eggs in too few baskets. Of course, diversification cannot assure a profit or protect against loss in a declining market.

Q. What are the risks?

A. As with all stock funds, industry-focused funds entail market risk—the possibility that falling stock prices may cause your investment to decline in value. The risk, however, is magnified for two reasons:

- Such funds often have a relatively small number of holdings, so 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.
- Industry-focused funds generally are required to stay invested in a chosen industry, whereas general stock funds have more flexibility.

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 have struggled recently, as troubles in the housing sector and slowing economic growth have begun to have an impact on commercial real estate.

Because sectors can swing in and out of favor, industry-focused stock funds are among the most volatile. But 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.

Q. How can these risks be managed?

A. You can take measures to reduce your risk and still benefit from the growth potential of an industry-specific stock fund.

Invest only a portion of your portfolio in industry-focused funds. You should keep most of your assets in core funds with broad diversification. Using industry-focused funds in tandem with broader-based funds can help you strategically increase exposure to industries you want to emphasize in your portfolio.

For example, you may want to increase your exposure to technology stocks, but also wish to maintain broad diversification in a large-cap growth fund that has only a modest allocation to the tech sector. In this situation, you could make a new investment in a technology fund or shift a small portion of your large-cap fund assets into a technology fund.

Consider dollar cost averaging. To reduce the risk of investing all your money at a market high, you could invest gradually in industry-focused stock funds by using dollar cost averaging—the process of investing a fixed sum on a regular basis, such as monthly or every payday. This way, you will purchase more shares when the fund's price declines and fewer shares when the price increases.

Of course, dollar cost averaging cannot assure a profit or protect against loss in a declining

market. Since such a plan involves continuous investment in securities regardless of fluctuating price levels, investors should consider their financial ability to continue purchases through periods of both high and low price levels.

Check how your holdings respond to economic developments. If your portfolio emphasizes stocks that perform well during an economic expansion, you may want to consider industry-focused funds targeting sectors that fare better during an economic downturn, and vice versa. For example, retail stocks may struggle if consumer spending dips, but pharmaceutical stocks may perform relatively well because consumer demand for medication should not be affected by slower economic growth.


Consider undervalued sectors. Don't overlook stock sectors that have recently been out of favor. Investing in an undervalued industry can help limit your downside because prices of stocks in that industry are already low. Shifts in investor sentiment often occur without warning, and sectors that have been shunned may suddenly become popular.

In addition, if your portfolio emphasizes growth stocks or growth funds, adding a fund focused on an undervalued industry to your portfolio may help increase your diversification. However, there is the possibility that an undervalued sector could remain out of favor for an extended period.

■ A Final Word

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 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 risk.

Insights reports provide background information on many aspects of investing. *For more information on any T. Rowe Price fund, including investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing, call 1-800-638-5660 to request a fund profile or prospectus.* T. Rowe Price Investment Services, Inc., Distributor.

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