# Investing in Natural Resource Stocks

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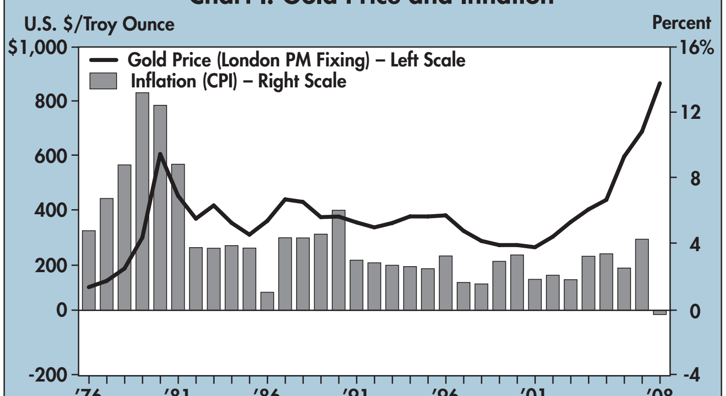
Natural resources have provided some of the world's most lucrative investments, their value derived in large part from their direct role in the long-term rise of living standards. Real assets, especially gold and other precious metals, have often been the first line of defense against the erosion of wealth caused by inflation or debased currencies.

For these reasons and others, natural resource investments should be considered for every well-diversified portfolio. However, they also involve some special risks. A look at their general characteristics, advantages, and disadvantages can help you understand how natural resource stocks work and how they can be used appropriately in a diversified portfolio designed to help you meet your financial goals.

**Chart I: Gold Price and Inflation**




Source: T. Rowe Price; data from *The Wall Street Journal*, Bureau of Labor Statistics, and Haver Analytics.

**Industry characteristics**

The natural resources sector comprises a vast array of industries, such as precious metals, industrial metals, energy, land, and forest products. Most share some distinctive characteristics:

- *Concern with scarcity.* While more of some resources such as gold or oil may be discovered, none can be created. This scarcity imparts a measure of intrinsic value and explains their traditional role as inflation hedges. Even timber, which is a renewable resource in the long term, typically has a fixed supply over shorter periods.
- *Capital intensive.* Finding and developing natural resources requires vast amounts of "real" capital (plants, equipment, technology). Small-scale mining, for instance, is seldom economical. Most resource-based companies are very large and control many phases of production, from raw material to final product.
- *Maturity.* In developed nations, most natural resource industries are relatively mature and likely to grow at average rates based on worldwide economic growth and steady demand for resources. In contrast, natural resource industries in emerging countries may be less mature and companies may be growing rapidly.
- *Demand.* Demand for resources is a constant across nations, but rates of usage are not uniform. In developed countries, consumption may be high but tends to grow at a slower rate than the global average and follows the ups and downs of economic cycles. In developing nations, consumption tends to accelerate as the industrial economy evolves and standards of living rise.

■ *High visibility.* Natural resource-related businesses have always been highly visible. As such, they have often been subject to political scrutiny, the shifting winds of national politics, and international power struggles. In recent decades, the political efforts of the environmental movement have affected the operations of numerous companies.

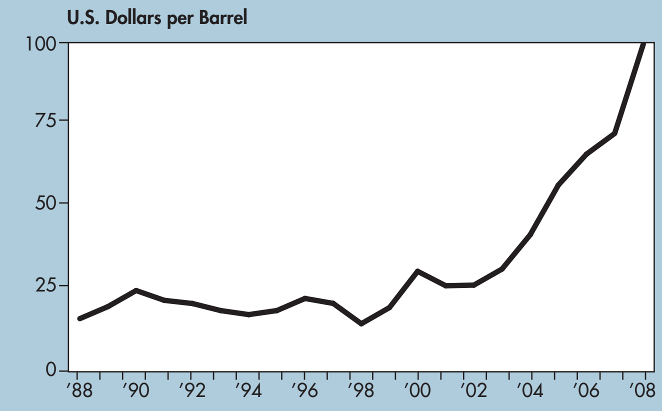
**Investment benefits and risks**

Persistent global demand for resources is just one reason to maintain a stake in the resources industry. Another is the special value associated with resource supply: Often, the value of known reserves and existing development capacity tends to rise over time. This mostly has to do with potential scarcity, but there are other reasons as well—the more promising raw material sites have already been explored; capital costs continue to rise; political problems complicate exploration and development in many countries; and environmental standards are becoming more restrictive and costly, particularly for new ventures.

Resource stocks are also effective as a diversifying component in a broader portfolio, because their performance profiles tend to deviate from that of the broad market. Nonetheless, natural resource investing is not without its risks. These companies are subject to sudden and severe changes in fortune. A major discovery of new resources or the onset of a recession may have an outsized impact. Political risks are often high in this sector, as resource companies can be tempting targets for regulation, taxation, and even nationalizations.

The list of possible risks doesn't end there. Most major resource companies are global entities, and unfavorable currency fluctuations can have a negative impact on their value or their earnings. Resource companies often struggle with the depletion of the resources they are developing. Most of these companies also face more common business risks—limited pricing flexibility in commodity products, environmental concerns, and sporadic labor difficulties, to name a few.

**Chart II: Oil Prices Since 1988**




Source: T. Rowe Price Associates, based on data from Haver Analytics and *The Wall Street Journal.*

**Choosing wisely**

Each natural resource has distinctive characteristics that affect its investment appeal. The challenging aspects of natural resource investing by no means preclude superior results over time, but they do highlight the importance of company selection. Charles M. Ober, a T. Rowe Price portfolio manager who has been specializing in this area for over 20 years, looks for the following characteristics:

■ *Good management.* The most successful will be those that achieve some measure of control over their operating environment. Companies dependent on nonrenewable resources, for example, must look far ahead to secure future supply sources. Good management can create opportunities for growth as well as reduce the impact of the inevitable slowdowns or recessions through product differentiation, diversification, and innovation.

■ *Good cost structures.* Producers with low unit costs should be better able to maintain profits in industries, such as gold mining, where a single company has little control over commodity prices. Likewise, a low-cost producer should be in a better position to increase market share during slow growth periods.

■ *Favorable commodity trends.* While difficult to predict, the likelihood that production can expand and that price increases can be sustained will have a major effect on a company's near- and intermediate-term performance.

- *Strong financial position.* A strong financial position is vital to long-term success in this industry because (1) most real investments take a long time to pay off, (2) capital may be hard to raise from outside sources, and (3) as in any business, a company without heavy fixed obligations has an advantage over those with weaker finances during economic slumps or unexpected business disruptions.

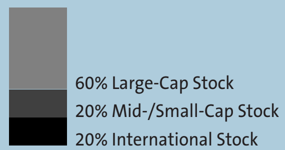
**Fitting natural resource stocks into your portfolio**

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.

Since the earnings of natural resource companies can be irregular because of their sensitivity to business cycles, forces of nature, and politics, careful stock selection from diverse resource industries is necessary to cushion price swings. Combining these stocks with those of companies in the broader economy provides an investor with good appreciation potential as well as some resistance to economic cycles and problems associated with inflation.

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

**Chart III: Suggested Portfolio Diversification—Equity**




We also suggest that you have no more than 5% to 10% of your portfolio in any single natural resource company. Before you invest in a single stock in this sector, keep in mind that you may already have exposure to a particular company through your mutual fund holdings.

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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