Investing in Health Care Stocks

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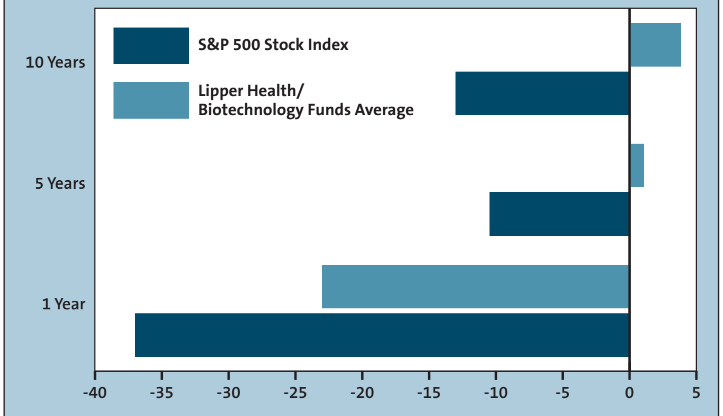
The increasing ability of modern medicine to ease our afflictions and prolong life is driving unprecedented growth in the health care industry. In the U.S., annual spending on health care is in the trillions, with no slowdown in sight. An expanding over-60 population, which uses more health care products and services than previous generations, fuels this rising demand, while rapid advances in science and technology create exciting investment possibilities.

If investing in health care stocks interests you, you'll need some information about what these securities are and how they behave. You also will need to understand how health care stocks can be used appropriately in a diversified portfolio designed to help you meet your financial goals.

Chart I: Health Care Versus the Market

Lipper Health/Biotechnology Funds Average and the S&P 500 Stock Index

Annualized Returns for Periods Ended 12/31/08



This chart is for illustrative purposes only and is not intended to represent the performance of any T. Rowe Price fund. Past performance cannot guarantee future results.

It is not possible to invest directly in an index.

Source: Lipper Inc.

A healthy opportunity

Health care stocks exist at the nexus of two complementary trends. On one hand, as the baby boomer generation ages, national usage rates for heath care products and services are rising. At the same time, tremendous strides are being made in medical therapies—for instance, minimally invasive surgical techniques for implanting heart valves and bypass grafts, even using robotics, have become alternatives to open heart surgery. Molecular biology and genomics (the study of genes) are holding out the promise of more effective treatment for such intractable illnesses as cancer and AIDS.

The changes in medicine are not limited to the laboratory and the operating room. Technology, in the form of health care data management, is playing a pivotal role in transforming the health care industry. Likewise, insurance and managed care facilities are developing mechanisms to deliver health care more effectively and at a lower cost. With so much productive change occurring at one time, the health care industry offers investors a compelling investment opportunity.

Taking the pulse of health care stocks

Most health care stocks fall into one of two broad categories. The first includes companies seeking high growth through new technology or innovation and generally includes companies in biotechnology and life sciences, as well as certain product and device or health care service firms. These are considered aggressive growth stocks, among the riskier but potentially more rewarding types of equity investments, and they share aggressive growth stock characteristics:

- The potential for rapidly rising earnings.

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■ Premium valuations, as measured by price-to-earnings (P/E) ratios or other valuation measurements.

■ Low dividends, since earnings typically are invested in the company to support research and development or new growth opportunities.

■ High volatility. Since investors pay relatively high prices on the expectation that earnings will increase rapidly, these stocks are often punished severely when earnings are disappointing. But they may handsomely reward investors when they meet or exceed earnings targets.

The second category of health care stocks includes most major pharmaceutical companies as well as some service firms. These firms have a more defensive growth profile:

■ Earnings growth expectations are more modest but also expected to be more consistent from quarter to quarter. Drugs, for example, are needed regardless of the economic or market environment.

■ Some companies with very high rates of cash flow may offer attractive dividends.

■ Volatility is muted by their more modest earnings expectations and the existence of dividends. In fact, in times of volatility for the broad market, investors may flock to these more defensive companies because their earnings are more likely to remain stable.

Chart II: The Ups and Downs of Health Care Stocks

Annual Results for the Lipper Health/Biotechnology Funds Average

This chart is for illustrative purposes only and is not intended to represent the performance of any specific security. Past performance cannot guarantee future results.

Source: Lipper Inc.

No pain, no gain

Health care stocks are often subject to the powerful influence of government intervention. It can come in many varieties, ranging from presidential efforts to revamp the entire health care system to federal and state laws that alter Medicare reimbursement rules. Sometimes, government decisions can pick up the market, as when President Bush signed into law a 2003 bill providing a drug benefit for Medicare recipients. However, adverse developments can wreak havoc on health care stocks as an entire group.

Health care stocks face several other challenges that are specific to their industry:

■ Many companies rely on patents or exclusive rights to develop and market a product. When these rights expire, the companies can face intense competition from low-cost, generic versions of their products, potentially eroding their profitability.

■ Pharmaceutical and other health care companies are susceptible to product liability lawsuits. The mere threat of a lawsuit, and the ensuing media attention, can throw these stocks into a swoon.

■ Safety is a paramount consideration in this industry. Any reported concerns about a previously approved drug's safety can depress sales for an entire category of health care products or services.

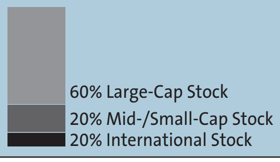
■ The rapid pace of technological achievement and the race to unveil new products is an everyday reality in health care. Investors closely watch the ability of these companies to create new products, secure regulatory approval, generate customer demand, and continue to increase earnings. A disappointment on any one of these fronts can result in a significant decline in a company's stock price.

Fitting health care 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.

If you are a disciplined long-term investor, health care stocks may be a good addition to the aggressive part of your equity portfolio. For example, of the equity portion of a well-diversified portfolio, 20% might be in health care (see Chart III). (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.)

Chart III: Suggested Portfolio Diversification—Equity



If your portfolio includes individual stocks, we also suggest that you have no more than 5% to 10% of your portfolio in any single health care company. Before you invest in an individual stock in this volatile arena, keep in mind that you may already have exposure to a particular company through your mutual fund holdings.

The best way to manage the volatility of health care stocks is through diversification. Diversification cannot assure a profit or protect against loss in a declining market. However, diversification can help manage everyday volatility because your portfolio is spread among investments with different risk and return characteristics. One of the easiest ways to diversify is to purchase shares of a health care mutual fund, which buys stocks of many different firms. The greater the number and variety of holdings within the portfolio, the smaller the impact on the fund's share price if a particular holding performs badly.

You may also want to choose a mutual fund that interprets "health care" broadly, instead of focusing just on hot industries such as biotechnology and pharmaceuticals. By casting a wider net to include areas like environmental services, alternative site care delivery, and health food retailers, a broader-based fund should achieve greater diversification and therefore less volatility.

Insights reports provide background information on many aspects of investing. *For more information on any T. Rowe Price fund, 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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