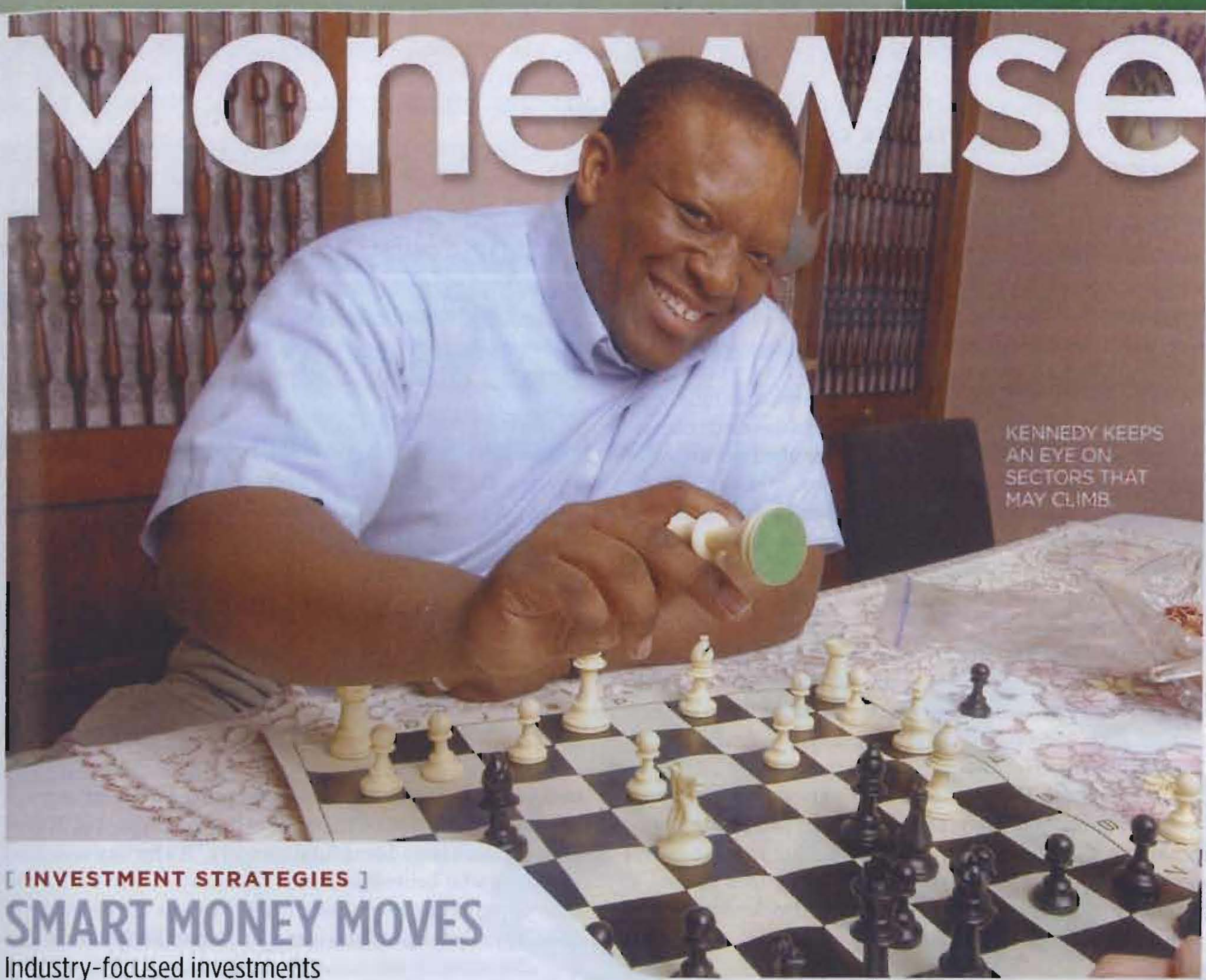
Moneywise



KENNEDY KEEPS AN EYE ON SECTORS THAT MAY CLIMB

[INVESTMENT STRATEGIES]

SMART MONEY MOVES

Industry-focused investments can help you profit in a slowing economy

EDWIN KENNEDY IS NO BUY-AND-HOLD INVESTOR. HE'S always scouting for opportunities to boost the upside potential of his $150,000 stock and mutual fund portfolio. Recently, the Valley Stream, New York, resident shopped for stock in, of all places, the housing sector. Headlines about overflowing supply and plummeting prices drove many investors away from the industry, but Kennedy, who is married and the father of four, wasn't fazed. "Whatever happens, people are still going to need homes," says the 42-year-old New York state court police officer.

It's true that home builders had a rough 2007: The S&P Homebuilding Index dropped 47.6% for the year. But a look at more recent figures suggests that Kennedy may be on to something. Through mid-March of this year, the index was up 2.5% while the S&P 500 was down 12%. Yet, in the end, Kennedy opted not to buy because of the volatility in the housing market. "The housing sector hasn't bottomed out yet," he says.

Kennedy was informally using sector rotation, an approach many professional investors employ to gain an edge. By anticipating the ups and downs of sectors such as energy, housing, and retail, they shift capital every few months out of stocks whose momentum is expiring and into other stocks whose run—they hope—is imminent.

There are multiple approaches to sector rotation. Some investors focus on the predictable boom-and-bust cycles of the economy. At various stages, different sectors seem to regularly thrive. For instance, when the economy is expected to slow down, it's time to consider moving into relative safe havens such as healthcare and consumer staples, which are less exposed to downturns in consumer spending. Conversely, as a weak economy seems poised to strengthen, investors may want to look into sectors that would benefit from an uptick in corporate spending and manufacturing, such as chemical companies.

ONE STOCK AT A TIME

Such investors aim to buy stocks in the right industries, ahead of turns in the business cycle, and then watch them appreciate. Gains are maximized, of course, if investors can buy the stocks just before their sectors come back into favor—when the stocks are still bargains. Others base their decisions to buy or sell on isolated factors such as the earnings growth momentum of the companies in a given sector.

These varied approaches aim to beat a buy-and-hold strategy—which often loses money in a bear market. After all, a few strong sectors can be found even in a flagging market. Wall

[INVESTMENT STRATEGIES CONT.]

Street professionals have used sector rotation for decades, but with the proliferation of inexpensive online research and brokerage accounts, it's possible for do-it-yourselfers to follow suit; however, it demands that investors be particularly proactive in monitoring their investments.

Picking individual stocks is the most time-consuming approach to sector rotation. Do-it-yourself investors must analyze business cycles and then take the time to research numerous companies in order to maintain diversified portfolios of stocks in at least half a dozen industries, says Sam Subramanian, chief investment officer of Houston-based AlphaProfit Investments L.L.C., and publisher of *AlphaProfit Sector Investors' Newsletter*. "If you're holding six or seven industries, that's a fair amount of diversification," Subramanian says. "Don't do just two or three groups."

Sector investing should be viewed as a complement to your core portfolio offerings of more diversified funds. Education and guidance are readily available; for instance, if you click on the "Stocks" tab on Morningstar.com, you'll find a link to obtain stock performance data by industry or by sector. You can obtain return figures for various time periods going back the last five years. The myriad features at Yahoo Finance's stock research center (***http://biz.yahoo.com/r/***) include a tool that sorts sectors according to a variety of factors, including market capitalization, dividend yield, and P/E ratio.

THE FUND ROUTE

You can take easier routes into sector rotation—thanks to an increasing number of mutual funds and exchange-traded funds that provide exposure to specific sectors. For instance, Fidelity Investments offers 41 select funds which focus on sectors as broad as consumer staples and as specialized as air transportation. ProFunds, Rydex, T. Rowe Price, and Vanguard are also known for sector funds. And exchange-traded funds—mutual funds that can be traded like stocks and often group companies of the same industry—are an increasingly popular way to invest in sectors.

Sector ETFs, including Barclays Global Investors' iShares and State Street Global Advisors' SPDRs, are popular because they can be bought and traded quickly in response to market changes—without the redemption fee that many mutual funds charge. What's more, sector ETFs do not require minimum investments. But it's possible to build a diversified portfolio of ETFs with as little as $6,000, says Subramanian, adding that having at least $1,000 in each fund helps mitigate the sting of brokerage fees.

There are still simpler ways to play the rotation game: Use single funds that do the work for you, such as the **Claymore/Zacks Sector Rotation ETF (XRO)** or **Rydex Sector Rotation C (RYISX)**. The Rydex mutual fund ranks 67 industries according to price momentum, and invests in those that are top ranked. As of mid-March, the fund posted a 5-year average annualized return of 14.1%, earning it a spot in the top 10% of Morningstar's large-blend fund category. "It's for buy-and-hold investors who believe in sector rotation but don't have the time or expertise to evaluate market trends at the industry level," says Rydex portfolio manager Adrian Bachman, whose firm also offers 18 individual sector funds.

INDUSTRY INSIGHT

How various segments of the market have fared

Industry	Total Return (%) 3-Month	1-Year	5-Year
Biotechnology	-0.8	13.3	26.5
Chemicals	0.1	27.3	21.9
Drugs	-10.8	-1.5	6.1
Gold & Silver	35.5	71.0	31.2
Homebuilding	2.7	-41.9	2.5
Household & Personal Products	-7.8	7.9	12.3
Oil & Gas	2.4	38.0	32.1
Regional Banks	-3.7	-21.5	6.7
Restaurants	-10.3	4.7	22.4
Semiconductor Equipment	-9.2	10.9	15.9

SOURCE: MORNINGSTAR. DATA AS OF 3/14/08

Bachman is the first to admit that sector rotation funds are somewhat more volatile than the market overall, because of the nature of sector investing. Many investors use it as the third leg of an investment stool that includes growth and value components, having it account for no more than 20% to 30% of equity portfolios.

Sector investing has its drawbacks. Unlike the buy-and-hold approach, it requires frequent buying and selling, which means additional brokerage fees and a bigger capital gains tax hit. Rydex Sector Rotation, for example, trades out of one industry and into another as much as four times a month, according to Bachman. Of course, housing the sector rotation within a tax-sheltered vehicle such as an Individual Retirement Account negates the tax hit.

What's more, if you're doing the job yourself, it requires a steely discipline that's not as needed in the buy-and-hold approach. Successful investors must actively research and cull those sectors facing the economy's headwinds, and snap up those with more promise. "If you do that, and you are more right than wrong, you increase your probability of beating the market over a longer time horizon," Subramanian says.

—Steve Garmhausen