



Investing in Sector Funds

Sector funds are mutual funds that focus their equity investments within a specific sector or industry of the economy.

Several investment companies such as Fidelity Investments, ICON Funds, ProFunds, Rydex Investments, and Vanguard Group offer sector- and industry-specific mutual funds.

Some sector funds cover broad sectors, such as information technology or health care. Fidelity Select Technology (NASDAQ: FSPTX) is an example of a sector fund. Other funds focus their investments on an industry group within a sector. Fidelity Select Computers (NASDAQ: FDCPX) for example is an industry group fund.

Some sector funds use margin or leverage to magnify their reward potential. Inverse sector funds invest in financial instruments such as swap agreements that enable fund investors to profit from share price declines.

Buying and Selling Sector Funds

Many sector funds are no load funds, i.e., mutual funds offered without a sales charge. To discourage short-term trading and to protect the interests of long-term shareholders, some mutual fund companies charge a short-term redemption fee if the investor holds sector fund shares for less than

a specified minimum period.

Several sector funds are also available through brokerage firms such as Fidelity Brokerage Services, Charles Schwab, or E*Trade. These firms allow investors to buy or sell sector funds without incurring a transaction fee if the fund shares are held in excess of a specified minimum period.

Rewards of Investing in Sector Funds

Since sector funds focus their investments on a specific sector, they provide investors opportunities to benefit from causal factors affecting specific sectors at a given point.

Examples of such causal factors include:

- Introduction of new products or technologies
- Shifts in consumer demand
- Changes in government regulations or policies
- Transformation of industry structure

When such causal factors work in their favor, sector funds generally help investors earn higher returns than diversified mutual funds. The narrower focus of industry group funds enables them to amplify this benefit even more.

Risks of Investing in Sector Funds

Sector funds vary widely in volatility depending on the diversity and volatility of businesses as well as correlation between stock price movements of companies included in the fund. Sector funds in general tend to be less volatile than industry group funds.

While sector funds may appear to be volatile when evaluated on a stand-alone basis, their impact on portfolio volatility can be quite different. Sectors like energy, for example, often move with little correlation to the overall stock market. Exposure to such sectors can therefore help dampen portfolio volatility.

Using Sector Funds

Prudent investors use sector funds in ways that leverage their return potential while managing portfolio volatility. Sector funds can be used to:

Construct diversified portfolios: A diversified portfolio is constructed from sectors and industry groups with higher expected returns, offering investors the potential to outperform the market averages.

Enhance returns of diversified portfolios: By investing a portion of assets in high-growth sectors like technology or health care or by tactically rotating assets among sectors with high-return potential, investors can boost the returns of their overall portfolio.

Stabilize diversified portfolios: Investors can reduce portfolio volatility by including sector or industry group funds with low volatility or low correlation to overall stock market.

In addition to the above uses, a higher risk tactic is to trade sector funds for short-term profits by taking advantage of opportunities market volatility may create from time-to-time.

Sam Subramanian, AlphaProfit Investments, LLC