Here's Why Health Care and Technology Should Be In Most Portfolios

Although it's well known that the odds are against us when trying to do better than the S&P 500, there remains the temptation to be among those who have actually succeeded. Since stock prices over time reflect changes in underlying earnings, it should be rather obvious that the task of coming out ahead will depend on picking sectors that traditionally have grown more rapidly than industry generally.

That eliminates areas such as basic materials, construction, industrial goods, and insurance, which all have cyclical tendencies. It also eliminates consumer staples and utilities, which grow steadily, but slowly.

What's left are financials, health care, and technology, the latter two of which have traditionally been sector standouts. Why include financials? Because in the wake of the 2008-9 credit debacle, the financials have registered exceptional gains.

To put the picture in perspective, I tallied the returns from these three sectors from the market bottom in February, 2009 through June 1st, 2017 and compared the results to the S&P 500. I used the following as proxies for the three sectors: XLF (Financial Select Sector SPDR), PRSHX (T. Rowe Price Health Sciences Fund), and FSPTX (Fidelity Select Technology Portfolio). XLF is a passive exchange-traded fund, while the two mutual funds are actively managed.

As one would expect, the gains over the eight-year period were unusually broad. All three funds greatly outperformed the S&P, but the interim price volatility also varied considerably. So although the returns were better, there was also increased risk.

The top performer over the period was the Fidelity's tech sector fund, which gained 535%, compared with 231% for the S&P, an increase of over 131% above the benchmark. At the same time, the average increase in month-to-month price volatility was 55%. From the standpoint of reward and risk, this is a favorable ratio.

T. Rowe Price's Health Sciences Fund and the Financial Services ETF had almost identical returns, with gains of 478% and 475%, respectively. Those represented increases of 107% and 106%, respectively, above the benchmark. So far, so good, except for the fact that the Price fund's volatility was only 44% above that of the S&P, which is quite good, but XLF's volatility soared to 127% above the S&P, which meant that the increase in risk was significantly greater than the increase in returns. Bottom line: not good.

These numbers represent what took place during a period of exceptional returns since they measured from the bottom of the market crash of 2008-9. Still, they demonstrate using a short time slice that both technology and health care should be considered important components of most portfolios. Even if a period of decades had been used, the result would have been similar.

Although I selected these funds as examples of the kinds of returns that would have been provided by investments in these sectors, there are quite a few others that could have been used. The underlying holdings might have differed, though the end result probably would not have been dramatically different.