



Complexity Brings Opportunity—Key Dynamics Shaping European Equities

Tobias Mueller sheds light on Europe on his three-year milestone.

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KEY INSIGHTS

- Active management is the best way to navigate the complex European landscape.
- High-quality growth companies that are innovators and/or disruptors often have the potential for durable growth that can persist through economic cycles.
- Environmental, social, and governance (ESG) practices of a company have the potential to enhance the quality of a business and mitigate risks, so we integrate ESG into every stage of our investment process.

Launching a new fund requires a steady nerve at the best of times. But even more so when, in the fund's infancy, the manager must contend with the substantial challenges of a global pandemic, a war at Europe's fringes, and ensuing energy and inflation crises.

Here, Tobias Mueller describes his experience over the first three years of the European Select Strategy and how a laser focus on high-quality companies drives his long-term approach to the portfolio.

What attracted you to managing a European strategy? What have you learned in your first three years as an investment manager?

Europe is an exciting continent for an investor. It is highly diverse but also distinctly complex with different regulations, markets and customs. It requires skill to navigate this complexity, which is now heightened by a war taking place on the border of the European Union.

Some investors damn Europe for lacking in homegrown equivalents to those big U.S. high-tech companies to power economic growth. But there are lots of "hidden winners" that are equally important, and getting an insight into a wide range of these underappreciated high-quality companies is something I find fascinating and rewarding.

On a personal level, it was gratifying and challenging to transition from being an analyst focused on a specific sector to being a portfolio manager looking across the whole investment universe. I found early on as a portfolio manager that selling sometimes tended to be based on quick, often reactive—even emotional—decisions. My mistakes tended to be when I sold out of a holding at the wrong time or not selling when I should have. On the other hand, I believe my best decisions came when I correctly judged a stock had run out of steam after a strong run or when my thesis was broken.



Tobias Mueller

Portfolio Manager, T. Rowe Price European Select Strategy

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I started an investment decisions journal to develop a framework to help improve the process. This has helped me spot trends and patterns in my decision-making. I've also learned from fellow portfolio managers who are good at selling—judging when to make a sale as part of the process of adding value.

Another lesson has been to strike a balance between my research and portfolio management. It is not realistic to conduct in-depth analysis on your own as a portfolio manager. I now rely much more on our large, global platform of talented in-house analysts. Many heads are better than one.

In this period, markets have been roiled by a confluence of extraordinary factors. How have you coped through those tough times when the asset class has been out of favor?

We aim to identify, thoroughly understand, and back high-quality growth companies that are innovators, disruptors, and, as we see it, on the right side of change taking place in industries and sectors. In just two years, we have lived through two extremes: learning how to cope with being on the “right” side and the “wrong” side of the coronavirus pandemic. This has led me to develop more of a perspective on being on the “right side of change.” While the concept is still important, the volatility that we have seen means that we are also more interested in whether the fundamentals of a business are getting better or worse.

I am grateful for our collaborative culture here at T. Rowe Price. Company management is very supportive of portfolio managers and analysts when times are tough, not only when they are good. Managing a portfolio is not all just about the right numbers.

I have also learned to not work 24/7. It is important to reset and establish a balance. Spending time with my family and physical pursuits away from my desk, like paddleboarding and keeping fit, help me stay fresh.

How would you characterize your investment style? What do you look for when selecting a stock for the portfolio? Do you have a preferred valuation framework to assess the attractiveness of an investment?

I want to own quality companies with a potential for durable growth—this has been constant over the past three years. It is also important to identify what is not appreciated by the market, allowing one to invest early in high-quality companies that are likely to prosper or to spot that element in already highly valued firms that are likely to continue to perform strongly.

Otherwise, I would describe myself as flexible about a valuation framework. I tend to rely on a handful of tried and tested Enterprise Value measures, which I think are better suited to evaluating different companies' capital structures. I also use a discounted cash flow model that I apply to analysts' estimates. But I want analysts to guide me on what works best for their sector so as to find companies with the most attractive risk/reward profile, rather than a stock that is just “cheap.”

How do you integrate ESG into your portfolio?

Our focus on ESG has intensified over the period. We integrate ESG into every stage of our investment process. We find that companies that are ESG leaders are usually led by forward-thinking managers who are leaders in more than one area—for example, in capital allocation, new product development, or the backward integration of supply chains. The ESG practices of a company can be used as a competitive edge, which enhances the quality of the business. We have also found that sustainable business practices tend to increase the terminal value of a business. And a higher terminal value means a lower cost of capital or a higher multiple on the stock.

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But not everything that shines green turns out to be an ESG winner. We must determine whether a company is greenwashing; that is, claiming a big boost from ESG practices it does not actually perform. So, the analysts also assess whether the ESG benefits will have a material impact on the company's financial model as well.

What have been your biggest investment successes and mistakes, and what lessons have you learned from them?

We have had some notable successes, particularly companies that demonstrate innovation and develop their own intellectual property. ASML Holding,¹ a leader in cutting-edge ultraviolet light technology to make advanced microchips, is a great example. We also own companies whose quality was overlooked by the market. They include Ashtead, a rental equipment company that has experienced stunning growth as companies cut back on capital expenditure, and Teleperformance, which was seen as a low-quality French mid-cap and is now a world leader in outsourced customer experience services management.

As far as missteps are concerned, perhaps I overstayed my welcome in some “COVID winners.” I bought Delivery Hero,¹ an online food company that had performed well, too late and then sold it too low. I also started investing early in Zalando,¹ an online fashion platform, when it was beginning to grow fast, reaped the rewards, but then held on for too long when it underperformed. I think I probably underestimated the exceptional context underpinning the growth and the market fundamentals behind the decline. A couple of other disappointments have also underscored my belief that the quality of the management of a company really matters.

How do you see the market environment going forward?

It seems to me that we could already be in a recession. Many stocks in the consumer discretionary, industrials and business services, and information technology sectors have priced it in, but the market overall has not—earnings expectations will likely have to be revised. The energy situation in Europe is very precarious, and this seems likely to persist over the longer term as countries build necessary infrastructure to secure independence from Russian oil and gas.

We have adjusted our portfolio positions to ride out a downturn, and the question we now face is: Should we take on more risk? Frankly, I would like to see more share market weakness before I do. Perhaps the forthcoming third-quarter earnings season may make clearer the economic pressures that consumers and many companies are suffering.

Are there any themes that you are focusing on that will grow in importance going forward?

The conflict in Ukraine has acted as a catalyst for change, and economies will have to adapt. Energy security is now an issue that will not go away. We are having to adjust our level of consumption and investment in infrastructure and different sources of energy, particularly “clean” energy, as a result. There are complicating stop-gap solutions as well; for example, Germany having to resume coal mining!

The war and its effects on economies and societies has become more dominant as the coronavirus pandemic has begun to recede and supply chain disruptions caused by the pandemic have begun to ease.

¹ The specific securities identified and described do not represent all of the securities purchased, sold, or recommended for the portfolio, and no assumptions should be made that the securities identified and discussed were or will be profitable.

So, our efforts now are geared to getting the right balance in the portfolio as conditions caused by the war and the pandemic appear to normalize. As part of

this process, we are assessing our focus on high-growth areas such as information technology and looking at biologics, which might be a more attractive alternative.

General Portfolio Risks—Equities

Capital risk—The value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the portfolio and the currency in which you subscribed, if different.

Equity risk—In general, equities involve higher risks than bonds or money market instruments.

ESG and Sustainability risk—May result in a material negative impact on the value of an investment and performance of the portfolio.

Geographic concentration risk—To the extent that a portfolio invests a large portion of its assets in a particular geographic area, its performance will be more strongly affected by events within that area.

Hedging risk—A portfolio's attempts to reduce or eliminate certain risks through hedging may not work as intended.

Investment portfolio risk—Investing in portfolios involves certain risks an investor would not face if investing in markets directly.

Management risk—The investment manager or its designees may at times find their obligations to a portfolio to be in conflict with their obligations to other investment portfolios they manage (although in such cases, all portfolios will be dealt with equitably).

Operational risk—Operational failures could lead to disruptions of portfolio operations or financial losses.

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