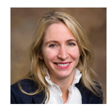
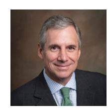
Betting on Secular Change Is Not Just for Growth Investors

Disruption creates risks and opportunities for value strategies.

August 2020



Heather McPherson
Co-Portfolio Manager, U.S. Large-Cap Value Equity Strategy



John Linehan
Portfolio Manager, U.S. Large-Cap Equity Income Strategy

KEY INSIGHTS

- Value stocks have come under pressure as economic uncertainty prompts investors to shorten their time horizon, pile into secular winners, and avoid cyclicals.
- We believe our rigorous fundamental research gives us an edge in identifying where the market's misunderstanding of secular risks could create opportunity.
- We are looking for the most compellingly valued stocks relative to their long-term prospects.

Widespread innovation and the resulting disruptions to many industries are big reasons why value stocks have lagged over the past decade and a half. But a deep understanding of an investment's secular risks, along with a disciplined valuation focus, can give skilled investors an edge in exploiting opportunities created by market dislocations.

The challenges facing value stocks intensified during the first half of the year. In certain sectors, the economic damage stemming from the coronavirus pandemic heaped cyclical pressures on top of long-standing secular headwinds, many of which stem from technological innovation. The global health crisis also accelerated the adoption of disruptive technologies—such as e-commerce, streaming media, and cloud-based software that supports remote work. Fear and uncertainty have also meant that investors have favored well-understood growth stories during the recovery rally without regard to valuation.

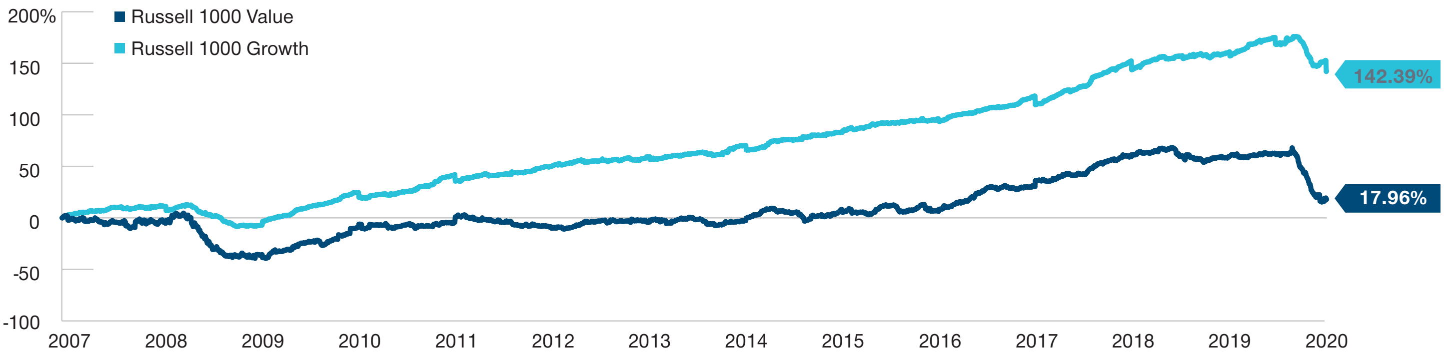
Near-term headwinds aside, we believe that leveraging our rigorous fundamental research, valuation discipline, and longer time horizon can help us to find investments that offer more ways to outperform than simply betting on a broad-based rotation into value stocks.

Innovation and the Growth-Value Disparity

Value's extended run of relative underperformance since 2005 has coincided with a period of widespread innovation that has disrupted some industries by siphoning off profit pools or introducing deflationary pressures that compress profit margins. Companies that find themselves on the wrong side of innovation have seen their valuation multiples shrink and, in the worst cases, have priced in legitimate existential risks.

Divergent Fundamentals

(Fig. 1) Free cash flow growth for large-cap growth and value stocks



Past performance is not a reliable indicator of future performance.

June 1, 2007, to June 30, 2020.

> But fundamentals have mattered less to growth's outperformance since the onset of the coronavirus pandemic.

The disparate fortunes of the disruptors and the disrupted help to explain the wide gap in free cash flow growth between value and growth stocks in the Russell 1000 Index. For much of the period, the leading mega-cap growth stocks have earned their relative outperformance.

Economic Uncertainty Amplifies Pressure

But fundamentals have mattered less to growth's outperformance since the onset of the coronavirus pandemic. The market's myopic focus on secular growth and an extreme aversion to cyclical risks have contributed to the narrowing in market leadership.

Only one-third of the Russell 1000, for example, outperformed the index over the six months ended June 30, 2020. Or consider that Microsoft, Apple, Amazon.com, Facebook, and Alphabet (Google's parent company) together represented more than 21% of the S&P 500 at the end of June and accounted for 480 basis points of the index's year-to-date return through midyear.

Atypically, value stocks with higher dividend yields have underperformed during this period of risk aversion, likely because extreme economic uncertainty has spurred fears about whether companies would be able to maintain their payouts. In keeping with the market's bias toward the short term, value names exhibiting lower beta—or less volatility relative to the broader market—outperformed despite what we regarded as overly demanding valuations.

The market's embrace of secular growers at any cost and reluctance to take on cyclical exposure help to explain why 92% of the stocks in the Russell 1000 Growth Index outperformed the Russell 1000 Value Index over the trailing 12 months ended June 30. This trend has pushed the valuation gap between growth and value equities to the highest level since the early 2000s.

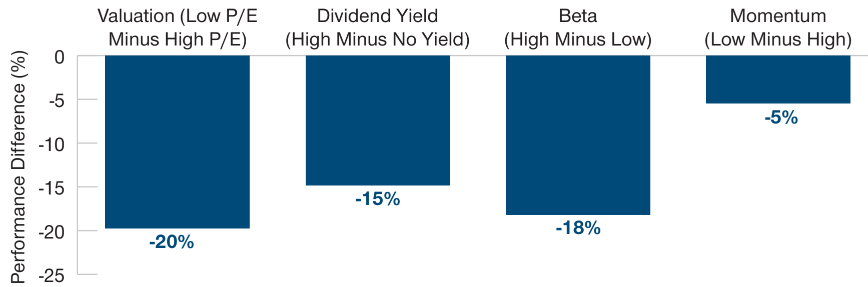
How We Manage Secular Risks

We believe that these excesses eventually will unwind or at least moderate, potentially to the benefit of our portfolio holdings in cyclical sectors. However, we are not trying to call the timing of a turn in the growth-value performance cycle, especially a sustainable reversion.

Instead, we remain focused on finding high-quality companies that we think are trading below their intrinsic value, usually because of some shorter-term dislocation that our rigorous fundamental research suggests could be resolved with time. We are not looking for the cheapest

Low Valuation and High Yield Have Been Headwinds

(Fig. 2) Russell 1000 Value Index Factor Performance[1]



Past performance is not a reliable indicator of future performance. For Illustrative purposes only and not indicative of any specific investment.

December 31, 2019, to July 31, 2020.

Source: T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved.

[1] Relative performance of select factors, or the difference between the top and bottom quintiles. Stocks in the Russell 1000 Value Index are sorted based on each metric noted in the graph and then divided into quintiles. Then the market capitalization-weighted return for each quintile is calculated. The graph isolates the difference in returns between the top and bottom quintiles to capture the relative returns for each factor. P/E is the ratio of a stock's price to the issuer's consensus earnings per share estimate for the next four quarters. Dividend yield is the most recent dividend payment, annualized and divided by the stock price. Beta measures a stock's volatility relative to a benchmark. Here, that benchmark is the Russell 1000 Value Index. Lower-beta stocks exhibit less volatility relative to the benchmark; higher-beta stocks exhibit more volatility. Momentum is a stock's price performance relative to the Russell 1000 Value Index over the trailing nine months.

> "We are not looking for the cheapest stocks; we are looking for the most compellingly valued names relative to their long-term prospects.

stocks; we are looking for the most compellingly valued names relative to their long-term prospects.

One way that we have found attractive investment opportunities is by identifying individual instances where we believe the market misunderstands the potential secular risks a company faces. This approach leverages T. Rowe Price's global research capabilities in equities and fixed income to develop a robust understanding of an individual company and the durability of its business.

Valuation helps to guide where we focus our efforts. For example, we believe that the financials sector contains many cheap stocks because of concerns about economic weakness resulting from the coronavirus pandemic, the implications for banks' credit quality and insurance claims, and the effect of lower interest rates on their financial results.

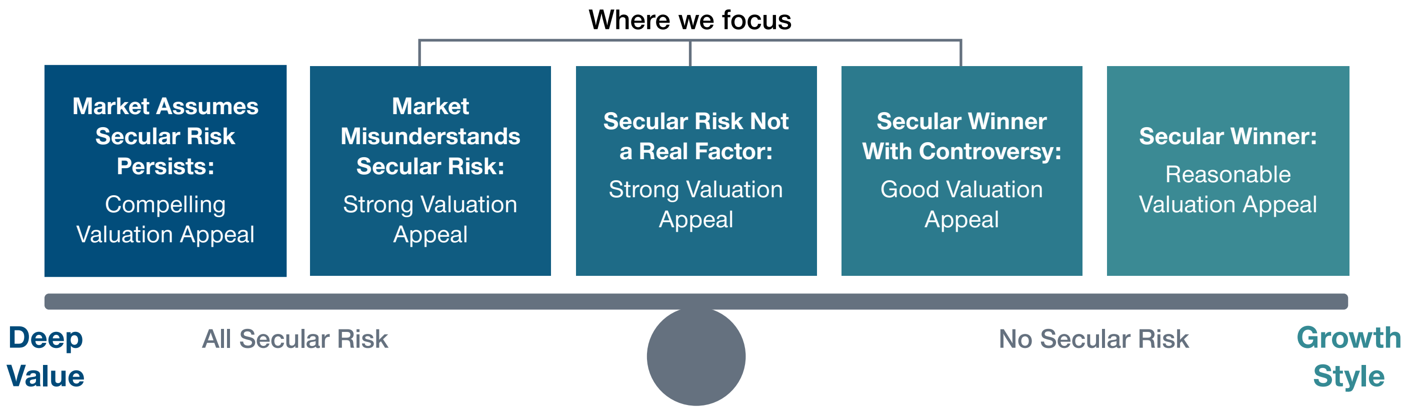
But cheap is not enough. In the financials sector, we focus on names where the potential upside depends on idiosyncratic, company-specific factors—cost reductions, for example, or lower credit risk because of business changes implemented in response to the 2008–2009 financial crisis—that could help a stock to upwardly revalue relative to its peers. Here, the potential catalysts for us to realize value go beyond macro factors, such as an improved outlook for the economy or expectations for an uptick in interest rates. At the same time, we are intensely focused on managing downside and seek risk/reward profiles that appear favorable across a variety of business environments.

We are also finding opportunities in areas where we believe that this market has priced cyclical risks as though they are secular, overlooking the potential for improvement in company and industry fundamentals.

For example, our research has increased our conviction in the potential for cost curves to rise throughout the paper and forest products value chain, supporting product prices and improving profit

Managing Disruption Risk

(Fig. 3) For value investors, balancing secular risk while staying true to style can be challenging.



For illustrative purposes only.

margins in the industry. Among other factors, we see paper-for-plastic substitution in packaging as a longer-term catalyst. Real estate investment trust Weyerhaeuser owns timberlands and operates a wood products business. Although near-term cyclical challenges prompted the company to suspend its dividend, we appreciate the industry's potentially improving demand outlook and possible longer-term tailwinds related to the role timberlands play in pulling carbon from the atmosphere.

We also pursue opportunities to buy secular winners when such companies are facing controversies that create compelling valuations. One such company is Qualcomm. This leading chipmaker could benefit from the global ramp-up in 5G wireless networks but has faced several idiosyncratic challenges in recent years, including legal setbacks that raised questions about its royalty agreements with smartphone handset makers Apple and Samsung Electronics.

In value investing, investment theses take time to come to fruition, resulting in somewhat lumpy gains, barring a broad rotation into inexpensive stocks. We acknowledge that the uncertain macroeconomic environment stemming from the coronavirus could extend some of these timelines. Nevertheless, we are confident that our rigorous fundamental research and longer time horizon should eventually unlock value provided conditions normalize and the market becomes more discriminating.

Key Risks—The following risks are materially relevant to the strategies highlighted in this material: Transactions in securities of foreign currencies may be subject to fluctuations of exchange rates which may affect the value of an investment. The portfolios are subject to the volatility inherent in equity investing, and its value may fluctuate more than a portfolio investing in income-oriented securities. The value approach carries the risk that the market will not recognize a security's true worth for a long time, or that a security judged to be undervalued may actually be appropriately priced.

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.

INVEST WITH CONFIDENCE℠

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

T.RowePrice®

Important Information

This material is being furnished for general informational and/or marketing purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

Australia—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA ex-UK—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

Hong Kong—Issued by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

New Zealand—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

UK—This material is issued and approved by T. Rowe Price International Ltd, 60 Queen Victoria Street, London, EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

ID0003576 (08/2020)
202008-1314602