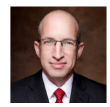
Getting the Most Out of Your U.S. Equity Allocation

A dynamic, diversified exposure could be the answer

July 2020



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KEY INSIGHTS

- The size of the U.S. equity market means that it typically represents a significant allocation in global equity portfolios.
- A key challenge for investors in U.S. equities is how to dynamically allocate across varying styles and market capitalizations as market conditions evolve.
- A U.S. Equity All-Cap Solution can help to address this challenge—by actively allocating across the U.S. equity investment style and market cap spectrum.

Within many portfolios, U.S. equities constitute a relatively large proportion of the investments. This is because their collective weight represents over 50% in global market cap-weighted indices, such as the MSCI All Country World Index (ACWI). A key challenge for investors in U.S. equities is how to allocate across varying styles and market capitalizations, as well as monitoring and dynamically alternating those allocations as market conditions evolve.

In this paper, we propose a solution to help address these demands. A U.S. Equity All-Cap Solution actively allocates across three active U.S. equity strategies, covering a spectrum of investment styles (growth and value) and market capitalizations (large-, mid-, and small-cap) within the U.S. equity universe. It builds a transparent allocation to U.S. equities that has the potential to benefit from security selection within the underlying strategies—as well as tactical asset allocation (TAA)—and risk mitigation through active management and diversification.

We believe such a solution is ideal for investors seeking a transparent and liquid investment solution for exposure to U.S. equities, combining a range of specialist styles and market capitalizations with potential alpha generation in each underlying strategy's universe.

The Importance of U.S. Equity Benchmark Selection

The choice of benchmark for U.S. equities defines the investment universe. With thousands of listed companies in the U.S. equity market, we believe that broader indices offer greater potential to identify opportunities and generate alpha. Further, the choice of index or indices also governs the potential to build a diverse portfolio that takes advantage of variations in performance of different styles, such as growth and value, over time.

…actively balancing and blending growth and value styles through investment cycles can help improve diversification of the portfolio.

A common choice for investors is the S&P 500 Index, representing the 500 largest U.S. companies in terms of market capitalization. It captures approximately 80% of available market value and is often considered the bellwether for the U.S. economy. However, the universe of U.S. equities is much broader than this. The S&P 500 excludes companies with small and mid-size (SMID) market capitalizations. Excluding this segment of the market from a portfolio could be a missed opportunity for gaining market exposure to U.S. SMID companies and alpha generation.

The Russell 3000 Index provides a far broader opportunity set, measuring the performance of the 3,000 largest publicly held U.S. companies in terms of market capitalization. It represents approximately 98% of the U.S. public equity market. Meanwhile, the Russell 1000 Index measures the performance of the 1,000 largest corporations within the Russell 3000 universe, and the Russell 2500 Index measures the performance of the 2,500 smallest companies in the universe, representing the SMID-cap segment of the market.

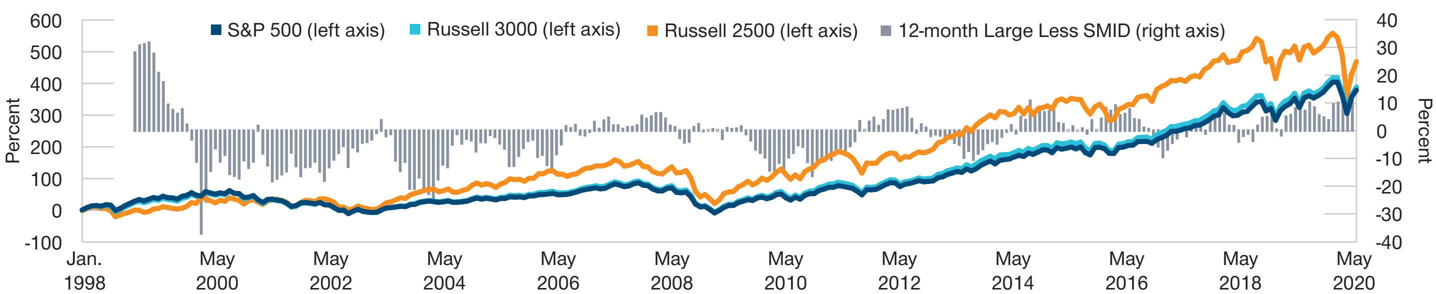
Figure 1 compares the cumulative total return of the S&P 500, Russell 3000, and Russell 2500 indices over time. While the Russell 2500 outperformed its two peers, it experienced larger drawdowns in times of market stress, such as the 2008 global financial crisis and the 2020 coronavirus crisis. While the performance of the S&P 500 and the Russell 3000 was similar over the period, this reflects only the passive performance of the indices. It does not account for the potential benefits from active management within each index. Since the universe of the Russell 3000 is broader than the S&P 500, we believe a skilled active manager has more opportunities to add alpha from its wider investment opportunity set while staying within the benchmark.

According to the fundamental law of active management,[1] risk-adjusted return (information ratio) is a function of skill (the correlation between investment decisions and results) and breadth (the number of independent investment decisions). A wide universe of 3,000 securities offers much more breadth than a universe of 500 securities and so elevates the potential for greater alpha generation from talented managers.

To demonstrate the potential of style diversification from index selection,

Cumulative Total Return of the S&P 500, Russell 3000, and Russell 2500 Indices

(Fig. 1) A broader opportunity set can offer greater potential to generate alpha



Past performance is not a reliable indicator of future performance.

As of May 31, 2020.

Sources: Standard and Poor's S&P 500, FTSE/Russell, Russell 3000, and Russell 2500 (see Additional Disclosures); analysis by T. Rowe Price.

January 1998 through May 2020 monthly performance returns are in U.S. dollars. The 12-month large less SMID is the difference in total return between the S&P 500 and the Russell 2500 over a 12-month rolling period, calculated each month.

[1] Grinold, Richard, 1989. "The Fundamental Law of Active Management." Journal of Portfolio Management 15(3).

Figure 2 shows the cumulative and relative total returns of growth and value stocks in the U.S., as represented by the Russell 1000 Value and the Russell 1000 Growth indices. The relative performance clearly oscillates, with each style displaying periods of strength at different stages of the market cycle. Each should, therefore, be considered as a distinct sub-asset class given the variations in performance.

This subcategorization is further justified by distinctive characteristics and sector composition within each index. For example, the Russell 1000 Growth includes a nearly 35% greater weighting in the information technology sector than the Russell 1000 Value, while the Russell 1000 Value includes nearly 20% more in financials and 5% more in the energy sector than the Russell 1000 Growth. Therefore, actively balancing and blending growth and value styles through investment cycles can help improve diversification of the portfolio.

Monitored and Managed Benchmark Exposure Through Tactical Asset Allocation (TAA)

While benchmark selection is important in the U.S. equity space, it is also vital that the allocation to those benchmarks is monitored and managed over time. Introducing a layer of TAA actively changes the allocation to assets, such as growth and value or SMID and large-cap, based on analysis and views of their expected future relative performance. If TAA within a U.S. equity allocation is skillfully employed, it can deliver an additional source of return beyond those derived from exposure to the equity market, as well as alpha from security selection.

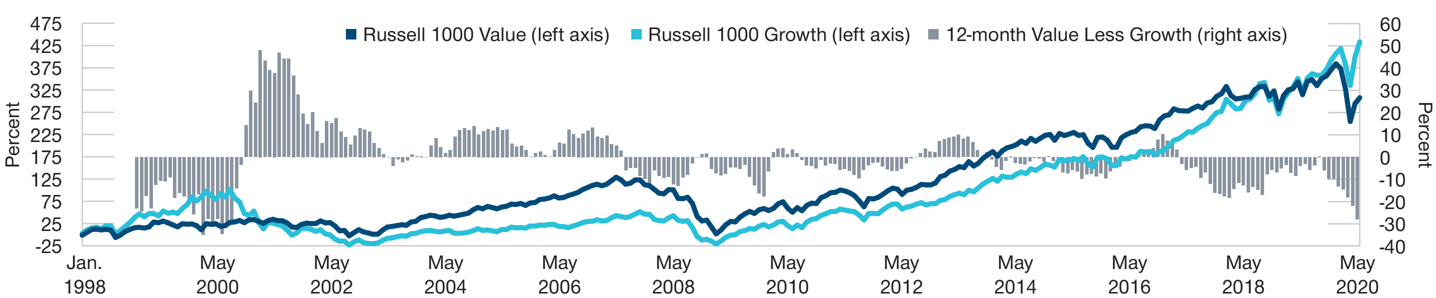
The TAA process can be anchored in fundamental research that assesses valuations, the macroeconomic backdrop, market sentiment, technical factors, as well as corporate fundamentals, and can potentially take advantage of the typically long cycles of styles and market cap sizes. For example, like any asset, styles and sizes go through cycles of richness or cheapness. Reducing exposure to expensive assets and adding to cheap ones introduces a healthy process of taking profits when asset prices appreciate—selling high—and buying when prices are low.

Blending Styles and Market Capitalization Sizes

How can investors gain access to the range of market cap and style opportunities in U.S. equities? We believe an all-cap solution could be an ideal way to build a simple and transparent allocation to enhance the alpha opportunity set and potential diversification benefits. This approach combines three specialist T. Rowe Price

Cumulative and Relative Total Return of Growth and Value

(Fig. 2) Actively blending style exposures can improve portfolio diversification



Past performance is not a reliable indicator of future performance.

As of May 31, 2020.

Sources: FTSE/Russell, Russell 1000 Value, and Russell 1000 Growth (see Additional Disclosures); analysis by T. Rowe Price.

January 1998 through May 2020 monthly performance returns are in U.S. dollars. The 12-month value less growth is the difference in total return between the Russell 1000 Value and the Russell 1000 Growth over a 12-month rolling period, calculated each month.

> Lowly correlated alphas mean the return profile would be smoother, as alphas are produced at different times...

U.S. equity strategies to build exposure to securities across the market cap range and balance the allocation to growth and value styles.

The approach breaks down the U.S. equity universe into large-cap and SMID-cap, and further distinguishes the large-cap section into growth and value. In this way, it constructs a representation of the entire universe of publicly traded companies in the U.S.—a true all-cap, style-balanced, solution.

In our solution, about 70% of the Russell 3000 universe is large-caps, 15% mid-caps, and 15% small-caps. Our U.S. Equity All-Cap Solution uses a SMID-cap strategy benchmarked against the Russell 2500 Index and splits the large-cap exposure evenly across two strategies: one benchmarked against the Russell 1000 Growth Index and a second benchmarked against the Russell 1000 Value Index.

As illustrated in Figure 3, since the universe of the Russell 1000 dips into mid-caps, and there is some mid-cap overlap between the large-cap and mid-cap strategies, we structurally overweight large-caps by 10%. This effectively outsources some of the allocation decision between small- and mid-caps to the bottom-up security selection of the SMID specialists, allowing them to choose among the best investment opportunities in the SMID universe.

U.S. Equity All-Cap Solution—Diversification Across Market Capitalization

Compared with a basic allocation to the Russell 3000, our approach aims to deliver a more diversified exposure to investment styles and market cap ranges. Figure 4 shows the market cap weights of the Russell 3000 Index on the left and strategic weights in our U.S. Equity All-Cap Solution on the right. The solution more effectively diversifies the U.S. equity exposure across styles (growth and value) and market cap size (large-cap and SMID-cap).

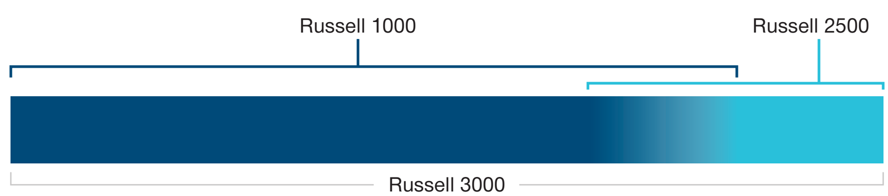
How We Build Diversification Through Portfolio Construction

When constructing a portfolio consisting of several strategies, diversification is crucial. One level of diversification is achieved through blending sub-asset classes with imperfect correlation. The Russell 1000 Growth, Russell 1000 Value, and Russell 2500 indices are highly, but not perfectly, correlated. Imperfect correlation adds diversification benefits, helping to mitigate risk.

Another level of diversification is the correlation among the alphas of the different underlying strategies and between these alphas and the equity market. Lowly correlated alphas mean the return profile would be smoother, as alphas are produced at different times, as illustrated in Figure 5. As each of the underlying strategies is managed by a different portfolio manager with a

Illustrative Market Caps of Russell 3000, Russell 1000, and Russell 2500

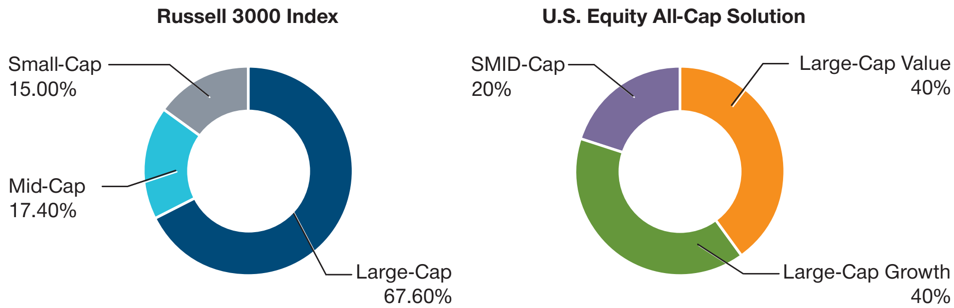
(Fig. 3) U.S. Equity All-Cap Solution adjusts for overlap between indices



For illustrative purposes only. Not shown to scale.
Source: T. Rowe Price.

Comparative Market Cap Weightings

(Fig. 4) Potential for improved diversity across style and market cap



As of March 31, 2020.
Sources: T. Rowe Price and FTSE/Russell. Russell 3000 Index (see Additional Disclosures).

different style, yet benefiting from our global research platform, the respective alphas are indeed imperfectly correlated.

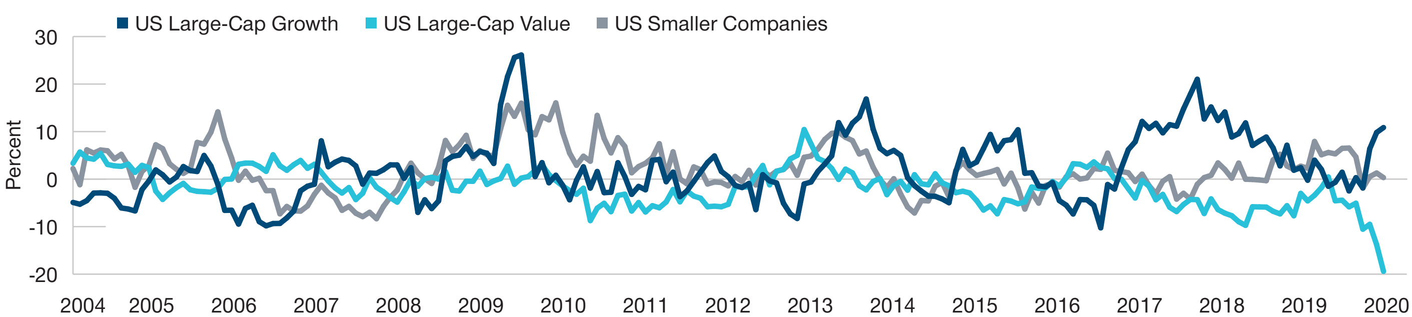
Low correlation between alpha and beta means that alpha is an independent source of return, adding important diversification benefits. Figure 6 shows the correlation matrix among the alphas of the underlying strategies, as well as with the U.S. Equity All-Cap Solution benchmark.[2] A correlation below 0.70 is considered advantageous for diversification.

The Power of Active Security Selection and TAA in U.S. Equities

Our U.S. Equity All-Cap Solution builds a diversified profile of U.S. equity exposure, benefiting from T. Rowe Price's active management in both security selection and TAA.

Rolling 12-Month Alpha of Underlying T. Rowe Price U.S. Equity Strategies, Relative to the Russell 3000

(Fig. 5) Imperfect correlation of strategy alphas can provide a smoother return profile



Past performance is not a reliable indicator of future performance.
As of May 31, 2020.
Sources: FTSE/Russell and Russell 3000 (see Additional Disclosures); analysis by T. Rowe Price. July 2004 to May 2020 monthly performance returns in U.S. dollars. US Large-cap growth: T. Rowe Price Funds SICAV US Large Cap Growth Equity Fund—Class I. US Large-cap value: T. Rowe Price Funds SICAV US Large Cap Value Equity Fund—Class I. US Smaller Companies: T. Rowe Price Funds SICAV US Smaller Companies Equity Fund—Class I. Alpha: Relative performance of each SICAV sub-fund compared with Russell 3000.
Source of fund performance: T. Rowe Price. Fund performance is calculated using the official net asset value with dividends reinvested, if any. The value of the investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the fund and the subscription currency, if different. Sales charges (up to a maximum of 5% for the A Class), taxes, and other locally applied costs have not been deducted, and, if applicable, they will reduce the performance figures.

[2] 40% Russell 1000 Growth, 40% Russell 1000 Value, and 20% Russell 2500.

...active investing can offer potential alpha generation, putting the investment to work and making it count.

Alpha Correlation Matrix

(Fig. 6) Low-correlation alpha mix has diversification benefits

	U.S. Large-Cap Growth	U.S. Large-Cap Value	U.S. Smaller Companies	Benchmark
U.S. Large-Cap Growth	1.00	–	–	–
U.S. Large-Cap Value	0.18	1.00	–	–
U.S. Smaller Companies	0.46	0.23	1.00	–
Benchmark	0.29	0.15	0.39	1.00

Past performance is not a reliable indicator of future performance.
As of May 31, 2020.
Sources: FTSE/Russell, Russell 1000 Value, Russell 1000 Growth, Russell 2500, and Russell 3000 (see Additional Disclosures); analysis by T. Rowe Price. August 2003 to May 2020 monthly performance returns are in U.S. dollars.
Benchmark: 40% Russell 1000 Value, 40% Russell 1000 Growth, and 20% Russell 2500.

We believe that an active approach is beneficial to investing in U.S. equities. Many investors face the dilemma of choosing between passive and active approaches for U.S. equities. While passive may cost less than active and is potentially easier to govern, active investing can offer potential alpha generation, putting the investment to work and making it count. We believe good value for money is not achieved by simply choosing the cheaper option but by accessing investments that offer the highest ratio of potential reward to risks and charges.

In our view, selecting an asset manager with a demonstrated skill in generating alpha from security selection is vital for active management of U.S. equities. Adding even modest alpha on average every year has the potential to compound significantly when the investment horizon is long, helping investors achieve their investment objectives.

In relation to the U.S. Equity All-Cap Solution, three factors drive performance:

1. U.S. equity market exposure. A large portion of the performance is determined by the general performance of the U.S. equity market (beta). Over the last 10 years, the hypothetical beta return of the T. Rowe Price U.S. Equity All-Cap Solution was 12.5% per year.[3]

2. Alpha from security selection. The three underlying investment strategies are managed independently. Over the last 10 years, the hypothetical annualized net of fees alpha from security selection was 0.4% per year.[4]

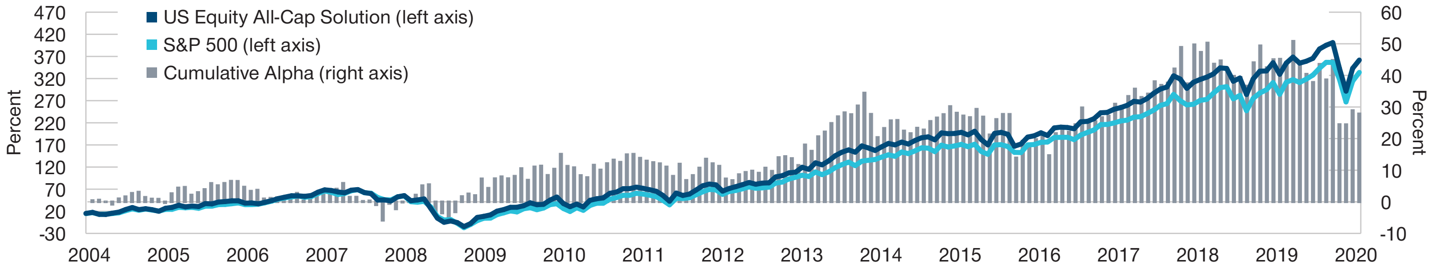
3. Alpha from TAA. T. Rowe Price's Multi-Asset team manages the U.S. Equity All-Cap Solution. The team has more than 25 years of experience designing and managing multi-asset

[3] The information contains a hypothetical analysis, which is shown for illustrative purposes only and is not indicative of realized past or future performance. See the end of the paper for important information. Hypothetical annualized total return based on monthly returns from June 2010 through May 2020, measured in U.S. dollars. The U.S. Equity All-Cap Solution benchmark includes 40% Russell 1000 Value, 40% Russell 1000 Growth, and 20% Russell 2500, assuming monthly rebalancing to the target weights.

[4] The information contains a hypothetical analysis, which is shown for illustrative purposes only and is not indicative of realized past or future performance. See the end of the paper for important information. Hypothetical annualized performance calculated using the official net asset values of Class I of the underlying SICAV sub-funds with distributions reinvested from June 2010 to May 2020, measured in U.S. dollars. The solution includes 40% T. Rowe Price Funds SICAV US Large Cap Growth Equity Fund—Class I, 40% T. Rowe Price Funds SICAV US Large Cap Value Equity Fund—Class I, and 20% T. Rowe Price Funds SICAV US Smaller Companies Equity Fund—Class I. Alpha is relative performance in excess of the U.S. Equity All-Cap Solution benchmark.

Cumulative Hypothetical Total Return and Alpha

(Fig. 7) The simulated U.S. Equity All-Cap Solution outperformed, net of fees



The information contains a hypothetical analysis, which is shown for illustrative purposes only and is not indicative of realized past or future performance. See the end of the paper for important information.

As of May 31, 2020.

Sources: Standard and Poor's S&P 500 (see Additional Disclosures); analysis by T. Rowe Price. May 2004 to May 2020 monthly performance returns are in U.S. dollars. U.S. Equity All-Cap Solution: 40% T. Rowe Price Funds SICAV US Large Cap Growth Equity Fund—Class I, 40% T. Rowe Price Funds SICAV US Large Cap Value Equity Fund—Class I, and 20% T. Rowe Price Funds SICAV US Smaller Companies Equity Fund—Class I (assuming monthly rebalancing to target weights). Cumulative alpha: Cumulative difference in hypothetical total return of U.S. Equity All-Cap Solution and S&P 500.

portfolios. TAA decisions include overweighting and underweighting styles and market cap sizes.

While, historically, the main driver of hypothetical performance has been market returns (beta), this could change going forward. As U.S. equity markets are not cheap at present, future beta returns may be modest compared with those in the past. Under these circumstances, the excess returns achieved from security selection and TAA could become more important factors for performance.

Hypothetical Simulated Performance for a U.S. Equity All-Cap Solution

The desired outcome of an active investment strategy is excess return, net of fees, above the comparative benchmark. Figure 7 shows the simulated cumulative total return of the U.S. Equity All-Cap Solution, using the active underlying strategies, compared with the S&P 500 Index. The U.S. Equity All-Cap Solution outperformed the index, net of fees, which included alpha from security selection of the actual track record of the underlying strategies.

Accessing the U.S. Equity All-Cap Solution With T. Rowe Price

Our U.S. Equity All-Cap Solution can be readily implemented using three underlying active equity strategies offered by T. Rowe Price: (1) US Large-Cap Growth, (2) US Large-Cap Value, and (3) US Smaller Companies. All three are available as UCITS-compliant SICAVs or OEICs or as a separately managed account (SMA). While environmental, social and governance factors are imbedded in our investment management process, in the case of SMAs, we can apply additional sustainable investing exclusions (e.g., tobacco and controversial weapons).

We believe using a single skilled asset management firm to manage the underlying strategies, as well as the allocation among them, can offer economies of scale and governance benefits. It helps to reduce monitoring costs and ease governance burdens compared with using multiple managers for each asset. Ultimately, active returns should be measured net of all costs, not just explicit management fees.

Our capabilities in managing U.S. equities and multi-asset strategies are significant. T. Rowe Price manages over USD 600 billion across a range of active U.S. equity strategies, spanning a range of styles and market caps.[5] Our multi-asset team manages strategies totaling over USD 300 billion.[6]

Conclusion

U.S. equities are typically a significant portion of most investment portfolios, which potentially gives investors added impetus to make the most of their allocation to this asset class. The U.S. equity market is enormous, and investors can benefit from tapping the broad range of opportunities, diversifying across investment styles and market capitalization sizes. We believe the skilled and experienced team at T. Rowe Price can add value through both security selection and TAA across investment styles and market capitalization ranges.

[5] The total U.S. equity strategies assets managed by T. Rowe Price Associates, Inc. and its investment advisory affiliates. As of June30, 2020.
[6] The combined multi-asset portfolios managed by T. Rowe Price Associates, Inc. and its investment advisory affiliates. This figure includes assets that are held outside of T. Rowe Price, but where T. Rowe Price influences trade decisions. As of June 30, 2020.

Appendix

SICAV Performance

Underlying T. Rowe Price Funds SICAV Five Year Performance

Figures are calculated in U.S. Dollars

T. Rowe Price Funds SICAV—US Large Cap Growth Equity Fund (Class I, USD)

Discrete 5-Calendar Year Returns (as of December 31, 2019)	**2015**	**2016**	**2017**	**2018**	**2019**
Fund	10.86%	2.46%	35.86%	3.61%	28.52%
Russell 1000 Growth Net 30% Index	5.19	6.56	29.67	-1.89	35.88

Cumulative 5-year return (as of May 31, 2020)	**5-yr return**
Fund	104.15%
Russell 1000 Growth Net 30% Index	92.74

T. Rowe Price Funds SICAV—US Large Cap Value Equity Fund (Class I, USD)

Discrete 5-Calendar Year Returns (as of December 31, 2019)	**2015**	**2016**	**2017**	**2018**	**2019**
Fund	-4.73%	15.15%	15.78%	-11.13%	25.17%
Russell 1000 Value Net 30% Index	-4.53	16.44	12.85	-8.94	25.56

Cumulative 5-year return (as of May 31, 2020)	**5-yr return**
Fund	12.78%
Russell 1000 Value Net 30% Index	-6.38

T. Rowe Price Funds SICAV—US Smaller Companies Equity Fund (Class I, USD)

Discrete 5-Calendar Year Returns (as of December 31, 2019)	**2015**	**2016**	**2017**	**2018**	**2019**
Fund	-1.40%	14.77%	18.14%	-5.58%	37.55%
Russell 2500 Net 30% Index	-3.31	17.04	16.31	-10.40	27.16

Cumulative 5-year return (as of May 31, 2020)	**5-yr return**
Fund	62.16%
Russell 2500 Net 30% Index	22.78

Past performance is not a reliable indicator of future performance.

Source for Fund performance: T. Rowe Price. Fund performance is calculated using the official NAV with dividends reinvested, if any. The value of the investment will vary and is not guaranteed.

It will be affected by changes in the exchange rate between the base currency of the fund and the subscription currency, if different. Sales charges (up to a maximum of 5% for the A Class), taxes and other locally applied costs have not been deducted and if applicable, they will reduce the performance figures.

Indicative Benchmark Data Source: Russell (see Additional Disclosures). Frank Russell Company ("Russell") is the source and owner of the Russell Index data contained or reflected in these materials and all trademarks and copyrights related thereto.

The indicative benchmark of the fund is not a formal benchmark but is shown for comparison purposes.

Index returns shown with reinvestment of dividends after the deduction of withholding taxes.

Hypothetical Results

The information presented herein is hypothetical in nature and is shown for illustrative and informational purposes only. This material is not intended to forecast or predict future events, but rather to demonstrate T. Rowe Price's capability to manage assets in this style. It does not reflect the actual returns of any portfolio/strategy and is not a reliable indicator of future results. Certain assumptions have been made for modeling purposes and are unlikely to be realized. No representation or warranty is made as to the reasonableness of the assumptions made or that all assumptions used in modeling analysis presented have been stated or fully considered. Changes in the assumptions may have a material impact on the information presented.

Data shown for the US Equity All-Cap model portfolio are as of the dates shown and represent the manager's analysis of the model portfolio as of that date and are subject to change over time. The model portfolio does not reflect the impact that material economic, market, or other factors may have on weighting decisions. If the weightings change, results would be different. Actual results experienced by clients may vary significantly from the hypothetical illustrations shown. The information is not intended as a recommendation to buy or sell any particular security, and there is no guarantee that results shown will be achieved.

U.S. Equity All-Cap Solution—the following risks are materially relevant to the solution:

Small- and Mid-Cap Risk—stocks of small and mid-size companies can be more volatile than stocks of larger companies.

General Portfolio Risks:

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.

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

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Important Information

The Funds are sub-funds of the T. Rowe Price Funds SICAV, a Luxembourg investment company with variable capital which is registered with Commission de Surveillance du Secteur Financier and which qualifies as an undertaking for collective investment in transferable securities ("UCITS"). Full details of the objectives, investment policies and risks are located in the prospectus which is available with the key investor information documents in English and in an official language of the jurisdictions in which the Funds are registered for public sale, together with the articles of incorporation and the annual and semi-annual reports (together "Fund Documents"). Any decision to invest should be made on the basis of the Fund Documents which are available free of charge from the local representative, local information/paying agent or from authorised distributors and via www.troweprice.com.

Please note that the Fund typically has a risk of high volatility.

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