



Euro Corporate Bond: Generating Alpha in Changing Markets

Portfolio Manager David Stanley stays ahead with a flexible, long-term approach.

May 2019

KEY INSIGHTS

- The Euro Corporate Bond Strategy targets diverse alpha sources and has achieved positive results in a wide range of market environments.
- The strategy's strong performance over a 10-year period stems from balancing long-term conviction with a flexible approach to shifting conditions.
- We have found alpha opportunities despite the European Central Bank's market intervention. These are expected to increase as central banks unwind accommodative policies.
- Despite modest yields, euro corporate bonds are attractive relative to ultralow, and in some cases negative, government yields.



David Stanley
Portfolio Manager

European corporate bond markets have seen sovereign debt crises, regulatory changes, and central bank interventions over the past decade. Through this changing backdrop, the Euro Corporate Bond Strategy has managed to deliver consistent outperformance against the index. Portfolio Manager David Stanley discusses how he has approached investing in investment-grade corporate markets and what he sees in store for the asset class going forward.

Q. Describe the investment strategy of euro corporate bond.

We aim for consistent alpha through fundamental research. Our performance has been positive over the past 10 years by applying the following core tenets.

 We seek diversified sources of alpha. Our extensive research resources provide us with many investment opportunities. We strive to understand the correlations between our different positions, conscious that these can change over time and are dependent on the market environment. By maintaining a portfolio that is not dominated by any one sector, geographic region, rating, and obviously issuer, alpha is therefore driven by many factors, which can help keep the volatility of performance low.

 We are not beta "junkies." We are paid to make active decisions against the benchmark, but this is not a case of always being high beta. In 2018, for example, we outperformed despite spreads moving wider. Rather than

(Fig. 1) Generating Positive Alpha

ECB's total returns, alpha, and peer rankings

As of March 31, 2019

T. Rowe Price Funds SICAV—Euro Corporate Bond Fund	1 Year	3 Years	5 Years	10 Years
Morningstar Peer Group Ranking (I share class)	28	20	14	7
Gross Alpha, Annualized, (Basis Points)	-5	73	59	194
Net Alpha, Annualized, (Basis Points), I share class	-31	29	14	128
Total Return, Gross, Annualized (%)	2.26	2.90	3.44	7.36
Total Return, Net, Annualized (%), I share class	2.00	2.46	2.99	6.70

Past performance is not a reliable indicator of future performance.

Alpha defined as relative performance versus Bloomberg Barclays Euro-Aggregate Corporate Index hedged to euros.

Source for 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, taxes, and other locally applied costs have not been deducted, and, if applicable, they will reduce the performance figures.

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**EUR 2.05
trillion**

European corporate
bond market size

chasing or avoiding risk, we are assessing where we are compensated for taking it, and again this can apply at the sector, issuer, and issue levels.

 We are very conscious of the asymmetric nature of the asset class. The downside in investing in investment grade is clearly more than the upside. It is therefore important that we understand and assess the risks that we are taking when buying a corporate bond. We believe that long-term success comes more through avoiding underperforming credits, rather than chasing the highest returns.

 Yield and rolldown are key to adding value. Out-yielding the benchmark will, over the long term, generate excess returns. However, a higher yield implies higher risk, but we prefer to seek high information ratio opportunities, assessing carry opportunities relative to risk and volatility.

Q. What have been the main changes in the market in the past 10 years?

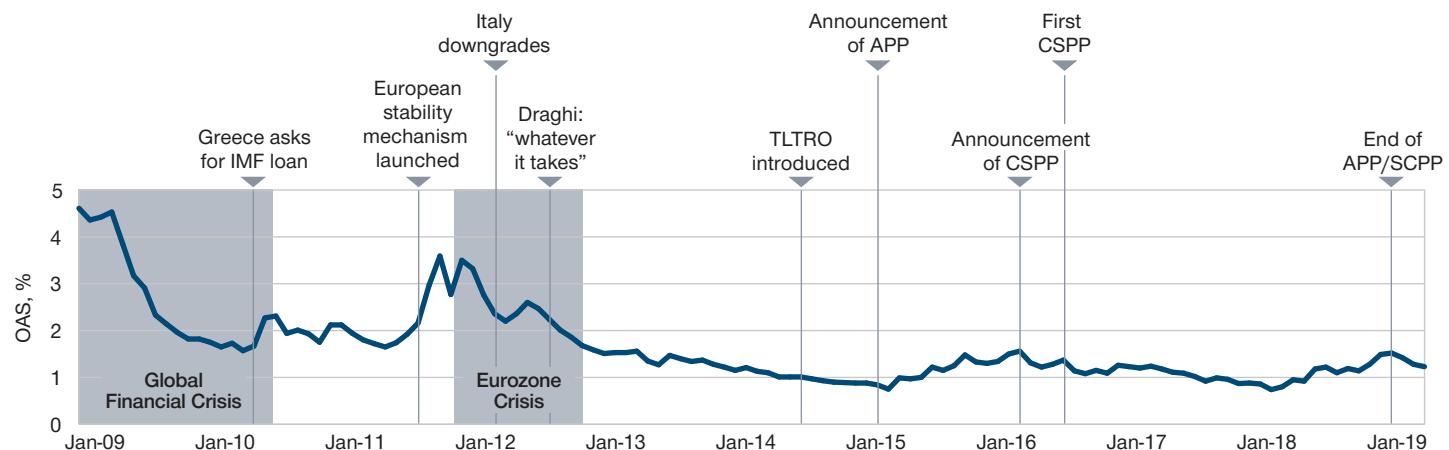
One of the things that makes this job so interesting is that the market is constantly evolving and the drivers of performance, such as technical factors or domicile of issuer (particularly during the euro sovereign crisis), can change in importance.

One of these is the introduction of new debt classes, such as non-preferred senior bonds, within the banking sector. Although they have senior in the title, the name obscures the risks as the bonds fall between "senior" unsecured debt and subordinated debt. While their uniqueness initially offered attractive value as an asset class as a whole, they have subsequently provided many relative value opportunities on an issuer-specific basis.

(Fig. 2) An Eventful 10 Years in European Corporate Markets

European corporate bond spreads and major market events

As of March 31, 2019



OAS: Option-Adjusted Spread of Bloomberg Barclays Euro-Aggregate Corporate Bond Index, IMF: International Monetary Fund, TLTRO: Targeted Long-Term Refinancing Operation, APP: Asset Purchase Program, CSPP: Corporate Sector Purchase Program.
Source: Bloomberg Index Services Limited. Analysis by T. Rowe Price.

One aspect of the market that has taken a while to get used to has been the emergence of negative-yielding corporate bonds, following multiple European Central Bank (ECB) cuts of its deposit facility to -0.4%. The concept of buying a corporate bond that is guaranteed to lose money if held to maturity is clearly not appealing, and something that I have resisted. However, some short-dated, high-quality holdings have seen their yield drift into negative territory. They have not become automatic sells, as the negative cost of holding cash can be higher.

A concerning feature of the last 10 years has been the decreasing and erratic liquidity of the euro-denominated investment-grade market. This is partly the result of regulatory demands on the banks that have significantly shrunk their inventory, diminishing their market-making role. Similarly, it appears many market participants have been taking increasingly short-term views, further accentuating

price swings on market-moving news. While frustrating, we continue to see these as providing investment opportunities where we can benefit from the ability to take a slightly longer-term view.

Q. How did the ECB's quantitative easing impact markets in the past decade, and how did you adapt?

The ECB's monthly corporate sector purchase program (CSPP) had two strong effects on the market. The first was to trigger a dramatic tightening in investment-grade spreads, for corporates that were both eligible and noneligible for inclusion in the program. The second was to cause a reduction in the dispersion of spreads, and hence relative value opportunities.

The presence of a large price-insensitive buyer of bonds clearly had a very distorting impact on the market that could not be ignored. Inclusion or exclusion mattered, but not to the extent that it overruled corporate fundamentals. It was important, therefore, that our analysts maintained



Investment-grade bonds should always, and usually do, play a role in fixed income portfolios, irrespective of market conditions.

— David Stanley
Portfolio Manager

their bottom-up, fundamental focus, but as portfolio manager, I remained very aware of the technical impact of inclusion that had to be considered, when assessing relative valuation.

Q. What have been the keys to your performance and alpha generation over the last 10 years?

First, I have the benefit of being able to draw on the resources of an excellent research platform. Our analysts are crucial to providing multiple investment opportunities and helping avoid the deteriorating credits, unless we are adequately compensated.

I think consistency of performance requires diversification, as mentioned above, but also a flexible approach. Drivers of performance can change in importance, and these must be recognized and incorporated into the decision-making process. At the same time, however, they should not be at the expense of fundamental credit analysis.

Flexibility also does not prevent us from maintaining high-conviction, long-term views to generate alpha. For example, we identified many compelling opportunities in the banking sector during the European sovereign crisis. These incurred short-term losses after purchase but contributed significantly to performance over the subsequent months.

Finally, a focus on risk management is key and an integral part of the portfolio construction process. This takes on many forms, including diversification, quantitatively monitoring the sources of risk and alpha, and management of liquidity risk. Last but not least, and probably the hardest, is maintaining a disciplined approach, such as not becoming too attached to individual positions. This can involve the hard decision to sell underperforming positions and “move on.”

Q. What is your current market outlook?

We have a cautious outlook on the euro corporate market following the dramatic tightening of spreads in the first quarter of this year. They responded to central bank action as the Fed signaled a reversal in monetary policy stance and the ECB, following a series of weak economic data, signaled that rates would remain at current levels at least until the end of 2019 and a readiness to take further action if needed. The risk-on tone and declining government yields led to very strong demand for spread products.

The current low-growth, low-inflation, low-volatility environment is a good one for investment-grade credit, and it is possible that spreads could tighten further. However, we believe that the tightening potential is limited, and the market is vulnerable to either a further slowdown or pickup in global economic growth. The former could start to have a negative effect on corporate fundamentals, while a bounce-back in economic data, particularly in the U.S., could lead to a reversal in the currently benign interest rate expectations and risk sentiment.

Therefore, we prefer to continue to avoid taking significant market directional “bets” in the portfolio, with a preference for taking idiosyncratic and relative value positions.

Q. What role should euro investment-grade bonds have in investors' portfolios going forward?

Income and diversification are the two main benefits of investing in the asset class. Subsequently, investment-grade bonds should always, and usually do, play a role in fixed income portfolios, irrespective of market conditions. While yields are currently low on an absolute basis, a portfolio of diversified

corporates still provides incremental yield with modest additional risk, compared with low and, in many cases, negative-yielding government bonds and cash.

Euro corporate bonds also contain many alpha opportunities for active managers. With the end of the ECB's

corporate sector purchases, we expect greater spread dispersion going forward. This is likely to lead to a commensurate increase in volatility. However, this is not something to fear, as with volatility comes opportunity—so bring it on!

WHAT WE'RE WATCHING NEXT

We believe the economic outlook will increasingly drive market direction. Despite the data disappointments in early 2019, we see the potential for the eurozone economy to improve. The ECB's accommodative stance, domestic wage growth, and looser fiscal policies in some countries should help growth stabilize. Signs that stimulus measures in China are filtering through to the economy there also form another tailwind. However, risks such as Brexit and global trade protectionism could negatively impact sentiment.

(Fig. 3) Performance

Euro Corporate Bond Composite.

As of March 31, 2019, figures are calculated in euros.

	Annualized					
	Three Months	One Year	Three Years	Five Years	Ten Years	Fifteen Years
Euro Corporate Bond Composite (Gross of Fees) [†]	2.98%	2.26%	2.90%	3.44%	7.36%	4.53%
Euro Corporate Bond Composite (Net of Fees) [†]	2.90	1.96	2.59	3.13	7.04	4.22
Bloomberg Barclays Euro-Aggregate: Corporates Bond Index [†]	3.19	2.31	2.17	2.85	5.42	3.89
Value Add (Gross of Fees) [‡]	-0.21	-0.05	0.73	0.59	1.94	0.64

Past performance is not a reliable indicator of future performance.

Gross performance returns are presented before management and all other fees, where applicable, but after trading expenses. Net of fees performance reflects the deduction of the highest applicable management fee that would be charged based on the fee schedule contained within this material, without the benefit of breakpoints. Gross and net performance returns reflect the reinvestment of dividends and are net of all non-reclaimable withholding taxes on dividends, interest income, and capital gains.

^{*}The Value Added row is shown as Euro Corporate Bond Composite (Gross of Fees) minus the benchmark in the previous row.

[†]Valuations and performance are computed in U.S. dollars and converted to the currency shown. When converting U.S. dollar composite returns, benchmarks, dispersion, and/or asset data, the same exchange rate source is used consistently. Total returns in non-U.S. dollar currencies are calculated by adjusting U.S. dollar performance by the percent change in the U.S. dollar/foreign currency exchange rate (as determined by an independent third party) for the time periods selected.

Source for Bloomberg Barclays index data: Bloomberg Index Services Ltd. Copyright© 2019, Bloomberg Index Services Ltd. Used with permission.

GIPS® Disclosure

Euro Corporate Bond Composite.

Period Ended March 31, 2019

Figures Are Shown in Euros

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	YTD 2019
Gross Annual Returns (%)	27.00	6.28	0.86	17.19	3.26	8.55	0.75	5.37	3.63	-1.11	2.98
Net Annual Returns (%) ¹	26.63	5.96	0.56	16.85	2.95	8.23	0.45	5.06	3.32	-1.41	2.90
Bloomberg Barclays Euro-Aggregate: Corporates Bond Index (%)	15.71	4.75	1.49	13.59	2.37	8.39	-0.56	4.73	2.41	-1.25	3.19
Composite 3-Yr. St. Dev.	8.36	8.54	7.12	5.36	5.38	3.46	3.42	3.16	3.20	2.41	2.32
Bloomberg Barclays Euro-Aggregate: Corporates Bond Index 3-Yr St. Dev.	4.88	5.05	4.59	4.17	4.22	2.93	2.95	2.75	2.82	2.11	2.18
Composite Dispersion	N/A										
Comp. Assets (Millions)	21.1	22.4	20.8	83.6	84.8	98.5	100.3	113.8	118.7	119.7	155.3
# of Accts. in Comp.	1	1	1	1	1	1	1	1	1	1	1
Total Firm Assets (Billions)	275.4	361.5	379.8	439.8	505.3	619.5	711.0	774.8	833.0	962.3	973.6

¹Reflects deduction of highest applicable fee schedule without benefit of breakpoints. Investment return and principal value will vary. Past performance is not a reliable indicator of future performance. Monthly composite performance is available upon request. **See below for further information related to net of fee calculations.**

T. Rowe Price (TRP) has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®). TRP has been independently verified for the 22-year period ended June 30, 2018 by KPMG LLP. The verification report is available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation. TRP is a U.S. investment management firm with various investment advisers registered with the U.S. Securities and Exchange Commission, the U.K. Financial Conduct Authority, and other regulatory bodies in various countries and holds itself out as such to potential clients for GIPS purposes. TRP further defines itself under GIPS as a discretionary investment manager providing services primarily to institutional clients with regard to various mandates, which include U.S., international, and global strategies but excluding the services of the Private Asset Management group. The minimum asset level for equity portfolios to be included in composites is \$5 million and prior to January 2002 the minimum was \$1 million. The minimum asset level for fixed income and asset allocation portfolios to be included in composites is \$10 million; prior to October 2004 the minimum was \$5 million; and prior to January 2002 the minimum was \$1 million. Valuations and performance are computed in U.S. dollars and converted to Euro. When converting U.S. dollar composite returns, benchmarks, dispersion and asset data, the same exchange rate source is used consistently. Total returns in non-U.S. dollar currencies are calculated by adjusting U.S. dollar performance by the percent change in the U.S. dollar/foreign currency exchange rate (as determined by an independent third party) for the time periods selected.

Gross performance returns are presented before management and all other fees, where applicable, but after trading expenses. Net of fees performance reflects the deduction of the highest applicable management fee that would be charged based on the fee schedule appropriate to you for this mandate, without the benefit of breakpoints. Gross and net performance returns are net of nonreclaimable withholding taxes on dividends, interest income, and capital gains. Effective June 30, 2013, portfolio valuation and assets under management are calculated based on the closing price of the security in its respective market. Previously portfolios holding international securities may have been adjusted for after-market events. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Dispersion is measured by the standard deviation across asset-weighted portfolio returns represented within a composite for the full year. Dispersion is not calculated for the composites in which there are five or fewer portfolios.

Some portfolios may trade futures, options, and other potentially high-risk derivatives which generally represent less than 10% of a portfolio.

Benchmarks are taken from published sources and may have different calculation methodologies, pricing times, and foreign exchange sources from the composite. Composite policy requires the temporary removal of any portfolio incurring a client initiated significant cash inflow or outflow greater than or equal to 15% of portfolio assets. The temporary removal of such an account occurs at the beginning of the measurement period in which the significant cash flow occurs and the account re-enters the composite on the last day of the current month after the cash flow. Additional information regarding the treatment of significant cash flows is available upon request.

The firm's list of composite descriptions and/or a presentation that adheres to the GIPS® standards are available upon request.

Fee Schedule

Euro Corporate Bond Composite. The Euro Corporate Bond Composite seeks current income and capital appreciation primarily through investment in corporate fixed income securities denominated in euros. The strategy may invest in preferred stock and other transferable debt securities, including those issued by the governments of countries participating in the euro. (Created June 2001)

First 40 million (EUR)	30 basis points
Next 40 million (EUR)	25 basis points
Above 80 million (EUR)	22.5 basis points on all assets ¹
Above 200 million (EUR)	20 basis points on all assets ¹
Minimum separate account size	40 million (EUR)

¹A transitional credit is applied to the fee schedule as assets approach or fall below the breakpoint.

Risks—the following risks are materially relevant to the portfolio:

Country risk (Russia and Ukraine)—in these countries, risks associated with custody, counterparties and market volatility are higher than in developed countries.

Credit risk—a bond or money market security could lose value if the issuer's financial health deteriorates.

Default risk—the issuers of certain bonds could become unable to make payments on their bonds.

Derivatives risk—derivatives may result in losses that are significantly greater than the cost of the derivative.

Emerging markets risk—emerging markets are less established than developed markets and therefore involve higher risks.

Interest rate risk—when interest rates rise, bond values generally fall. This risk is generally greater the longer the maturity of a bond investment and the higher its credit quality.

Liquidity risk—any security could become hard to value or to sell at a desired time and price.

Sector concentration risk—the performance of a portfolio that invests a large portion of its assets in a particular economic sector (or, for bond portfolios, a particular market segment), will be more strongly affected by events affecting that sector or segment of the fixed income market.

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.

Counterparty risk—an entity with which the portfolio transacts may not meet its obligations to 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.

INVEST WITH CONFIDENCESM

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

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