Broad Portfolio Diversification Is Key to Moderating Risk

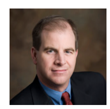
Investing in stable mid-cap growth companies.

March 2019

KEY INSIGHTS

- A well-diversified investment portfolio is one of the best approaches for managing equity risk.
- When investors overreact to short-term market volatility, it can undermine their returns and investment programs.
- Our approach focuses on a broadly diversified portfolio of mid-cap companies with consistent earnings growth and reasonable valuations.

Don Peters
Co-portfolio Manager, T. Rowe Price Diversified Mid-Cap Growth Fund



Don Easley
Co-portfolio Manager, T. Rowe Price Diversified Mid-Cap Growth Fund

Investing in a well-diversified portfolio is, in our view, an effective approach for managing risk and one that can potentially dissuade investors from making sudden allocation shifts. Our objective is to properly manage risk while seeking to outperform our competitors.

To use a baseball analogy, we seek to hit singles and doubles and reduce the likelihood of hitting into double plays. We're not trying to hit three-run homers with lots of double-plays and strikeouts. A diversified strategy can make sense for investors seeking growth while trying to reduce, though not eliminate, volatility. Indeed, it's important to note that periods of volatility can benefit investors in mutual funds by permitting the fund manager to purchase shares of valuable companies at a "discount."

How We Add Value

In managing the Diversified Mid-Cap Growth Fund, we try to add value in several ways:

- First, rather than trying to predict short-term movements in the market, we maintain a nearly fully invested position in stocks. Our cash position is typically only about 20 basis points of assets to take advantage of opportunistic purchases. Many of our competitors' cash positions are often 2% or higher depending on their short-term market expectations. Trying to anticipate short-term swings in the stock market, in our view, has a low probability of long-term success because the manager must be right twice—when to sell and when to reinvest.
- We make very modest sector tilts in the portfolio. Making big bets on one market sector versus another is the first cousin to market timing, so we keep our sector positions in line with those in the Russell Midcap Growth Index. Playing the sector rotation game is extraordinarily challenging. In 2018, the best-performing sectors were technology—a very aggressive sector—

20 basis points

Our typical cash position.

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>
> — **Don Peters**
> *Co-portfolio Manager, T. Rowe Price Diversified Mid-Cap Growth Fund*

and utilities—a very defensive one. That would have been very difficult to predict.

- Stock selection is where we can add the most value, leveraging the insights of our analysts who routinely visit with companies in their industries. This is certainly key to identifying opportunities across the capital structure. Mid-cap companies have more proven business models than smaller companies, but they are not as mature as many large-cap companies, and it's often not clear who the long-term winners will be.

- We invest in a broadly diversified portfolio that typically consists of about 300 companies with proven business models at what we believe are reasonable valuations. Companies that demonstrate consistent earnings growth regardless of economic conditions tend to be more stable than companies whose earnings are more variable.

- We also eliminate those companies that fail to meet our expectations. The higher-quality mid-cap companies are also occasionally acquired by larger companies looking to enhance their growth.

Keeping a Close Eye on Valuation

Finally, we pay close attention to a company's absolute and relative valuation to avoid paying an unreasonable price for expected growth. We do not chase "momentum" stocks whose excessive valuations are unsustainable and likely to decline at some point if growth expectations are lowered.

We also believe our long-term investment horizon creates a strategic advantage. We invest in companies we expect to hold for several years, and our turnover rate is typically far below the average for comparable funds. It is not unusual for our portfolio to hold companies for a decade or longer, though the average holding period is about four years.

Our approach also combines the strengths of quantitative techniques with fundamental research to identify attractively valued companies with developed, stable businesses. Quantitative techniques can enhance portfolio management by analyzing

(Fig. 1) Diversified Mid-Cap Growth Fund

Sector Diversification[1]

As of December 31, 2018

Information Technology	30.08%
Industrials and Business Services	18.53
Consumer Discretionary	15.08
Health Care	13.43
Financials	7.88
Materials	4.28
Consumer Staples	3.45
Real Estate	2.31
Communication Services	2.07
Energy	1.84
Utilities	0.85

[1] Percent of equities.
Source: T. Rowe Price.
T. Rowe Price uses the current MSCI/S&P Global Industry Classification Standard (GICS) for sector and industry reporting. T. Rowe Price will adhere to all updates to GICS for prospective reporting.
Numbers may not total due to rounding.

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(Fig. 2) Diversified Mid-Cap Growth Fund

10 Largest Holdings
As of December 31, 2018

Dollar General	1.0%
Burlington Stores	0.9
Fiserv	0.9
Ross Stores	0.9
ServiceNow	0.9
Microchip Technology	0.9
Hilton Worldwide Holdings	0.9
Workday	0.8
Maxim Integrated Products	0.8
Global Payments	0.8
Top 10 Issuers % of Total Net Assets	**8.9%**

Source: T. Rowe Price.
The information shown does not reflect any exchange-traded funds that may be held in the fund.
Numbers may not total due to rounding.

the trade-offs between risk, return, and transaction costs for each holding. We believe portfolio construction and structure, along with stock selection, are keys to achieving long-term success.

Investors can obtain the benefits of broad diversification by investing in funds that seek to replicate a particular market index, taking a so-called passive investing approach. However, they should compare that with well-diversified, actively managed funds that have achieved superior long-term performance, with comparable or less volatility.

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All funds are subject to market risk, including possible loss of principal. Because the fund invests primarily in securities issued by mid-cap companies, it is likely to be more volatile than a fund that focuses on securities issued by larger companies. Medium-sized companies often have less experienced management, narrower product lines, more limited financial resources, and less publicly available information than larger companies. In addition, smaller companies are typically more sensitive to changes in overall economic conditions and their securities may be difficult to trade. Because growth stocks have higher valuations and lower dividend yields than slower-growth or cyclical companies, the fund's share price could decline further in market downturns than non-growth-oriented funds. The fund's growth investing style may become out of favor, which may result in periods of underperformance.

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