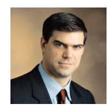
Intriguing Opportunities in Health Care and Utilities

How our unique process helps us create a concentrated portfolio.

March 2019

KEY INSIGHTS

- The deceleration in corporate earnings growth poses a major risk to the U.S. stock market's continued recovery.
- Our analysis has led us to see encouraging opportunities in the health care and utilities sectors.
- We have developed a four-part process to establish a concentrated portfolio of high-conviction, best idea stocks.



Jeff Rottinghaus
Portfolio Manager, T. Rowe Price US Large-Cap Core Fund

Jeff Rottinghaus has managed the US Large-Cap Core Fund since its inception in 2009. He discusses his approach to building and managing the fund, his current positioning of the portfolio, and the market environment.

Q. What is your approach to managing this concentrated portfolio of growth companies?

We focus on high-quality companies with strong business models and management teams that have opportunities to increase their market share or have barriers to entry around their business that help them grow organically in a variety of market environments. To do that, we rely heavily on our research analysts' highest-conviction, best ideas to build a diversified portfolio of 50 to 60 stocks that should provide attractive risk-adjusted returns over time. We believe the strength of our research process and our analysts' experience provide a competitive advantage.

Q. What is the process you employ for creating your portfolio?

We employ a four-part process to vet every potential investment.

- We analyze a company's fundamentals—its capital allocation process and its pricing power—and determine if it faces the threat of disruption. We want to understand the strategy and how the company creates value over time.
- We assess management's ability to create value. We want to know if that playbook has been used before and if it has been successful. We also want to understand the compensation incentives. What are the metrics management is trying to achieve, and can management create value?

0%

The potential growth in corporate earnings in 2019 over 2018.

- We conduct a top-down view of the industry and its relative attractiveness compared with other industries.
- We assess a company's valuation in a broad context, examining its cash flow profile and addressable market as well. This is important because were we to dismiss an idea strictly based on valuation, we never would have owned Amazon because it has historically been an expensive stock.

Q. What is the risk/reward profile of your strategy?

Our process has generally resulted in a higher-quality portfolio than the overall market with higher returns on invested capital and on equity. There are times when this type of portfolio will perform well relative to the benchmark and times when it will lag. This strategy appeals to investors looking to earn potentially excess returns over the S&P 500 Index over the course of a cycle while taking more risk than a passive strategy.

Our sector allocations are driven by a fundamental, bottom-up process based on stock-specific views. We also tend to have relatively high position sizes in individual companies.

Q. How do you manage risk in the portfolio?

Because this is a fairly concentrated portfolio, it can experience greater volatility than a more broadly diversified portfolio. We manage risk by focusing only on our highest-conviction ideas coupled with prudent portfolio diversification. We also use monitoring systems and procedures to ensure the investment process is keeping within the strategy's objectives.

(Fig. 1) U.S. Large-Cap Core Fund Investment Process

A research-driven, best ideas, bottom-up approach

1	**Defining the Universe**	▪ U.S. companies ▪ S&P 500, Russell 1000 ▪ Generally USD 5B+ market cap	**500+ Companies**
2	**Idea Generation**	▪ Analyst buy-rated companies ▪ Analyst-managed strategy overweights	**150–200 Companies**
3	**Fundamental Research and Analysis**	▪ Work through process framework (company, management team, industry, valuation) ▪ Collaboratively work to identify compelling investment ideas: Insight from analysts, sector leaders, and other portfolio managers	**80–100 Companies**
4	**Portfolio Construction and Risk Management**	▪ Highest-conviction ideas over two-year time horizon ▪ Targeting Active share >70% ▪ Active risk management process to help eliminate "unintended bets"	**50–60 Companies**
5	**Self-Discipline**	▪ Forced displacement ("better ideas") ▪ Deterioration in management team ▪ Analyst downgrade ▪ Change in business strategy undermines investment thesis ▪ Deterioration in fundamentals ▪ Investment thesis fully reflected in stock price	

T. ROWE PRICE BEYOND THE NUMBERS

Finding Opportunity in the Permian Basin

Shale energy plays that rose to the surface amid a depressed sector.

We meet with corporate managements over time and do extensive field research. Although we are not optimistic about the longer-term outlook for the energy sector, for example, we recently invested in several energy and exploration companies operating in the Permian Basin. Their stocks were depressed by production bottlenecks in the Basin and the collapse in oil prices last year, and our on-site research enabled us to take advantage of that opportunity.

"Health care, our largest overweight position, provides the best combination of solid fundamentals and acceptable valuation.

At the individual stock level, we employ upside and downside ratio discipline for every company we own. We review results carefully with our analysts and manage position sizes accordingly. We examine two types of risk. Fundamental risk—is the company likely to hit earnings and free cash flow estimates, for example? And then we look at valuation risk. We also meet quarterly with our quantitative group, which conducts a risk analysis of the portfolio in terms of its structure or exposure to such things as interest rates or broader economic developments.

Q. What is the key lesson you have learned from managing this fund for almost a decade?

Our investment style is sometimes in or out of favor, but we must be disciplined and consistently remain true to it. So we avoid trying to catch up with the market after a period of underperformance. You need to be honest with investors and set realistic expectations. If the market has a short-term surge in performance, this approach may not keep pace with those expectations. We have tended to do better in modestly growing markets or in down markets but expect to outperform our benchmark over the long term.

Q. How was the portfolio positioned as of the end of February 2019?

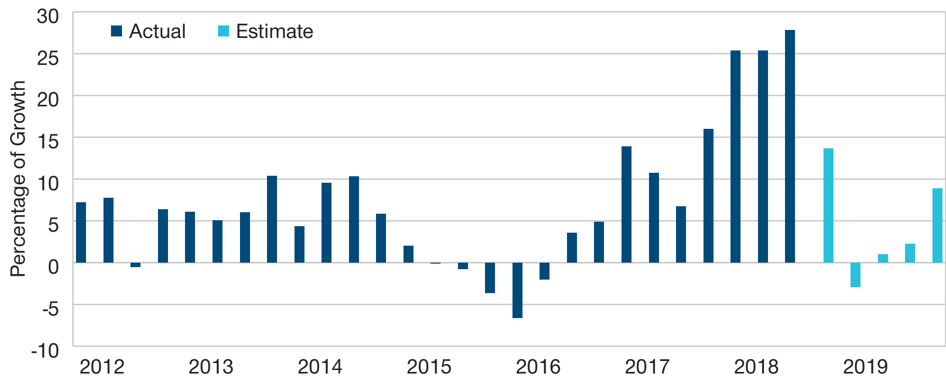
Health care, our largest overweight position, provides the best combination of solid fundamentals and acceptable valuation. It also has a secular tailwind from an aging population. We favor companies that take advantage of long-term industry trends such as cost-saving distribution methods and highly innovative and effective therapies. Our primary exposure is in the health-care equipment and supplies industry, where we have been long-term owners of Becton, Dickinson & Company, Danaher, and Medtronic.

Information technology represents one of our largest absolute weightings but is our biggest underweight position, largely due to underweight positions in Apple and the software segment. In this sector we favor companies with durable business models that address large and growing markets, including electronic payment processing businesses and providers of social connectivity. We also favor companies benefiting from secular demand for public cloud computing services. We took advantage of the fourth-quarter 2018 sell-off to increase our investment in semiconductor companies, which have generally had a nice rebound.

We are also mindful that the factors that spurred the downturn during the fourth quarter of 2018 could lead to further challenges.

(Fig. 2) Slowing Growth in Corporate Earnings

S&P 500 quarterly earnings, year-over-year growth
As of February 28, 2019



Our second-largest overweight is in utilities, a sector that usually benefits from a stable interest rate environment and economic uncertainty. Two utilities the portfolio has owned for several years are NextEra Energy, the largest renewable energy producer in North America, and American WaterWorks, the largest private water utility in the United States.

Financials are a large absolute weighting, but we are modestly underweight in that sector, with a more concentrated focus on insurance brokers such as Marsh & McLennan and Willis Towers Watson, which have attractive business models, modest pricing power, and highly recurring revenue streams. Some of our top holdings include high-quality banks, but we are more cautious now as the credit cycle is about as good as it gets, and banks tend to do better in a rising rate environment, which I don't expect.

We also took advantage of the depressed prices for some energy exploration and production companies operating in the Permian Basin when oil prices collapsed last year.

Q. What is your assessment of the current investment environment?

We believe the United States is in the later stages of an economic cycle. We are also mindful that the factors that spurred the downturn during the fourth quarter of 2018 could lead to further challenges. The slowdown in the U.S. and global economies certainly pose some market risk. Corporate earnings growth is decelerating due to rising labor costs and the fading benefits of the 2017 U.S. tax cuts. The market rebound that began at the end of the year was largely driven by the Fed reversal on raising rates for the time being. Volatility will likely persist until we get more clarity on the U.S.-China trade situation. Global trade policy uncertainty may further undermine business capital spending and other growth-driving efforts. As the presidential election campaigns gain momentum and controversial policy issues are debated, political headline risk may become more of a concern.

Investors should lower their expectations, in our view. However, markets could continue to perform well if there is resolution on geopolitical issues and trade disputes. Also, it appears that the European Central Bank may provide more stimulus, and China is also stimulating its economy. There is valuation risk in certain sectors, such as software, but I'm not that concerned about valuations given where interest rates are. We maintain a cautious view of the market overall, but we believe stock selection will be the primary driver of longer-term performance.

WHAT WE'RE WATCHING NEXT

Along with the economic slowdown in the United States, Europe, and China, we are focused on the decelerating rate of earnings growth for U.S. companies. Earnings surged last year, boosted by tax reform and a strong economy. At the start of this year, earnings were estimated to rise about 10% to 11%. That has now fallen to a 7.5% earnings growth estimate, and I believe earnings expectations are still too high. Earnings may only grow 0% to 1% this year. Eventually, the market is going to demand some progress on earnings and free cash flow growth. If the market flattens out from here, it will be due to earnings, in our view.

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Important Information

Call 1-800-225-5132 to request a prospectus or summary prospectus; each includes investment objectives, risks, fees, expenses, and other information you should read and consider carefully before investing.

The securities accounted for the following percentages of the fund's assets as of 12/31/2018:
Amazon.com: 3.0%; Becton, Dickinson & Company: 2.1%; Danaher: 2.1%; Medtronic: 2.4%; Apple: 1.8%; NextEra Energy: 1.7%; American WaterWorks: 1.7%; Marsh & McLennan: 1.2%; Willis Group Holdings: 2.0%.

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T. Rowe Price Investment Services, Inc.

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