Identifying the U.S. Equity Market's Quiet Achievers

Why growth compounders are the bedrock of a portfolio's long-term performance.

April 2019

Taymour Tamaddon
Portfolio Manager, Institutional Large-Cap Growth Fund

KEY INSIGHTS

- Investors tend to overestimate companies' ability to deliver consistent, double-digit growth.
- The actual number of companies that achieve this year on year and in all market conditions—what we call power growth compounders—is much lower than anticipated.
- For growth investors, while dynamic companies that can grow 50% in a year might be exciting, it is the growth compounders that are the bedrock of long-term performance.

The U.S. equity market is highly efficient and the largest, most liquid securities market in the world. However, as efficient as it is, history shows that investors tend to overestimate the potential for companies to consistently deliver double-digit growth. The number of companies that actually achieve this year on year and in all market conditions is typically much lower than anticipated. Therefore, the reward for finding those that can genuinely grow at this level—the quiet achievers we call the power growth compounders—is potentially significant.

Distinguishing Dynamic and Power Growth

For most growth-oriented investors, excitement and kudos tend to revolve around dynamic growth companies—those stocks that grow 40% to 50%, or even more, in a single year. Any growth investor worth the title strives to find these dynamic names, given the significant payoff potential. However, it is also true that, for most companies, this kind of "shoot the lights out" growth is very difficult to maintain year after year. As a result, dynamic growth companies are often prone to above-average volatility and price swings once the initial rapid growth phase begins to fade.

Power growth compounders are companies that have the potential to consistently deliver double-digit growth year over year. They can come from any area of the market, but quality compounders tend to display common characteristics, such as strong franchises, high barriers to industry/sector entry, high cash flow generation, and low capital intensity and are not overburdened by debt.

> "...the importance of companies that can consistently compound double-digit growth over time cannot be understated.
>
> — **Taymour Tamaddon**
> *Portfolio Manager, Institutional Large-Cap Growth Fund*

12%+

Target, year-on-year growth rate for quality, growth-compounding companies.

Characteristics of a Power Growth Compounder

These companies can come from any area of the market and have the potential to consistently deliver double-digit growth year over year.

Source: T. Rowe Price.

Importantly, these companies often go under the radar of other growth-oriented investors, given the more modest levels of short-term growth. They don't fit traditional perceptions of what a dynamic growth stock should look like. Some high-quality compounding businesses might even be considered relatively boring. However, this is where a longer-term view is critical. Over 5- or 10-year time horizons, quality compounding businesses are precisely the companies that tend to show up prominently on lists of top contributors to long-term performance. What's more, given the more consistent and lower-volatility nature of the performance over time, they can also add stability to long-term returns.

Characteristics of the Quiet Achievers

Within the health care sector, we own a company that operates hospitals and other health care facilities. In the two and a half years that we have owned the company, it has outperformed the benchmark every quarter. What is particularly noteworthy is that the stock has never been among the top contributors to portfolio performance in any individual quarter. Yet, over the entire two-and-a-half-year period, the stock has risen by more than 60%.

Two other examples of quality compound growth stocks we own are utility companies. This is particularly unusual for a growth-oriented strategy as the sector is typically associated with defensive, lower-growth investment styles. Our global research platform is a crucial factor here. Stock selection is driven by the research of sector-specialist analysts who provide insights and differentiated views that are often overlooked or underappreciated by the broader market.

One of these is a water utility company, which has grown at an annual rate of around 9% plus a 3% dividend yield. The investment thesis is simple: Municipal water infrastructure in the U.S. is in dire need of nationwide upgrading. Water assets have been poorly maintained for decades, with little investment into new or upgraded systems. A recent documentary focusing on the town of Flint, Michigan, brought the issue sharply into public focus and highlighted the need for urgent action. In 2014, substandard treatment of water from the Flint River caused lead from aging water pipes to leak into the town's water supply, exposing the more than 100,000 Flint residents to dangerous levels of lead.

The water company that we own is at the front line of this urgent need to upgrade and improve U.S. municipal water infrastructure. And this is no quick fix, with an estimated $1 trillion needed to upgrade U.S. water systems over a potentially 40-year period. Accordingly, this company is set to be a prime beneficiary of this vast upgrade/modernization program and so should be able to continue to consistently grow its earnings and capital over multiple years.

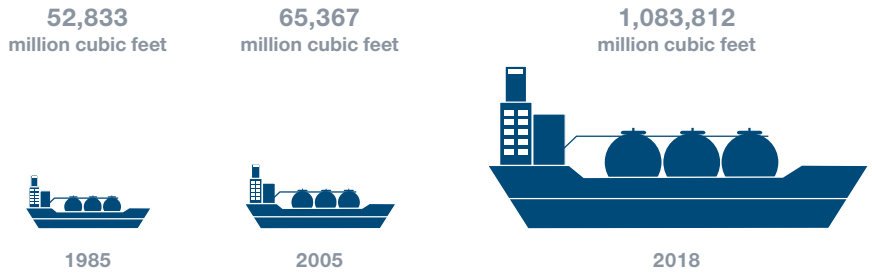
> "...quality compounders tend to display common characteristics, such as strong franchises, high barriers to industry/sector entry, high cash flow generation, and low capital intensity and are not overburdened by debt.
>
> — **Taymour Tamaddon**
> *Portfolio Manager, Institutional Large-Cap Growth Fund*

> ...a longer-term view is critical. Over 5- or 10-year time horizons, quality compounding businesses are precisely the companies that tend to show up prominently on lists of top contributors to long-term performance.
>
> — **Taymour Tamaddon**
> *Portfolio Manager, Institutional Large-Cap Growth Fund*

(Fig. 1) The Boom in U.S. LNG Production Is Game Changing

The sharp rise in U.S. liquefied natural gas (LNG) exports is creating critical demand for new infrastructure.

As of December 31, 2018



Source: U.S. Energy Information Administration.

The second utility that we own is an energy company. It is a direct beneficiary of the boom in liquefied natural gas (LNG) production and capacity in the U.S., as high-pressure fracking has unlocked vast new shale reserves. This has seen the country transformed from a net importer of energy to a net exporter.

However, despite years in the planning, the commissioning of new U.S. liquefied gas terminals has lagged. The boom in new gas processing and capacity has created a critical demand for new infrastructure—including processing capacity, construction of LNG export terminals, and new rail links enabling transportation. Indeed, the scale of both supply and demand means that huge investment over many years is needed.

Figure 1 gives some indication as to the burgeoning need for new infrastructure. In 2018, over 1 trillion cubic feet of LNG was exported from U.S. liquefaction terminals—an increase of almost 500% over 2016 levels.[1]

As a provider of LNG terminal infrastructure, the energy utility we own is a direct beneficiary of this boom in LNG production. We believe that this positions the stock to consistently deliver our target double-digit growth rate each year and over an extended period.

All growth investors aim to find those innovative, disruptive, and dynamic businesses offering the potential for 50% growth in a year. These are exciting and make a great contribution to shorter-term performance. However, the importance of companies that can consistently compound double-digit growth over time cannot be understated. These may not be headline-grabbing stories in the short term, but they tend to form the bedrock of long-term performance. They have the effect of compounding shareholder wealth while also helping to limit the potential downside capture, something that many growth-oriented strategies tend to ignore. These quiet achievers are worth making a noise about.

[1] Source: U.S. Energy Information Administration, as of December 31, 2018.

INVEST WITH CONFIDENCE®

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

To learn more, please visit troweprice.com.

T.RowePrice®

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.

This material is provided for informational purposes only and is not intended to be investment advice or a recommendation to take any particular investment action. The views contained herein are those of the authors as of April 2019 and are subject to change without notice; these views may differ from those of other T. Rowe Price associates.

This information is not intended to reflect a current or past recommendation, investment advice of any kind, or a solicitation of an offer to buy or sell any securities or investment services. The opinions and commentary provided do not take into account the investment objectives or financial situation of any particular investor or class of investor. Investors will need to consider their own circumstances before making an investment decision.

Information contained herein is based upon sources we consider to be reliable; we do not, however, guarantee its accuracy.

Past performance is not a reliable indicator of future performance. All investments are subject to market risk, including the possible loss of principal. 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. All charts and tables are shown for illustrative purposes only.

T. Rowe Price Investment Services, Inc.

ID0002184 (04/2019)
201904-816478