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Mark Finn, CFA
Portfolio Manager,
T. Rowe Price Value Fund

U.S. Equities

EXTENDED STYLE CYCLE SUGGESTS VALUE MAY BE DUE FOR A REVIVAL

EXECUTIVE SUMMARY

- From the inception of the Russell style indexes at the end of 1978 through March 31, 2018, the Russell 1000 Value Index has outperformed the Russell 1000 Growth Index. Some researchers have suggested that this return advantage is structural, perhaps based on investor behavioral biases.

- Despite value's long-term advantage, U.S. equity performance long has been marked by periodic style cycles. The current bull market has seen an unusually extended cycle of value underperformance relative to growth.

- Although turning points in style cycles are hard to forecast, periods of extreme value underperformance historically have been followed by value overperformance a high percentage of the time. We believe prudent portfolio rebalancing may be advisable for some investors.

- We continue to find potentially attractive value opportunities among high-quality names in more cyclical sectors of the U.S. market. We believe stock selection, backed by strong fundamental research, will be the key to strong relative performance going forward.

Since the current equity bull market began in the wake of the 2008–2009 global financial crisis, the value style of investing has underperformed the growth style among U.S. large-cap stocks, producing an extended performance cycle of favoring growth stocks—large-cap technology stocks in particular.

Given the historical tendency of relative style performance to revert toward the mean, it appears highly likely that the current period of growth dominance eventually will end—although past turning points in style performance cycles have proven notoriously difficult to forecast.

The question, then, is whether investors and their financial advisors would be wise to position their equity portfolios now for a potential shift in relative style performance at some point in the future.

The answer, in our view, is yes. Years of growth outperformance have left many equity portfolios heavily overweight to growth-oriented strategies—much as many investors were at the end of the bull market of the 1990s, with unfortunate consequences for portfolio performance when that era's technology-fueled growth cycle abruptly ended in the spring of 2000.

VALUE AS LONG-TERM RETURN FACTOR

Although the Russell large-cap growth benchmarks generally have outperformed their value counterparts during the current bull market, the longer-term track record shows a return advantage for value: From the inception of the Russel style indexes on December 31, 1978, through March 31, 2018, the Russell 1000 Value Index returned an annualized 12.06% versus 11.36% for the Russell 1000 Growth Index.

This relationship is theoretically supported by academic studies that have identified valuation as one of several systematic factors that appear to explain long-run differences in equity performance, with investors historically earning a return premium, on average, for holding stocks with characteristics such as relatively low price/book (P/B), price/earnings (P/E), and price/cash flow (P/CF) ratios.[1]

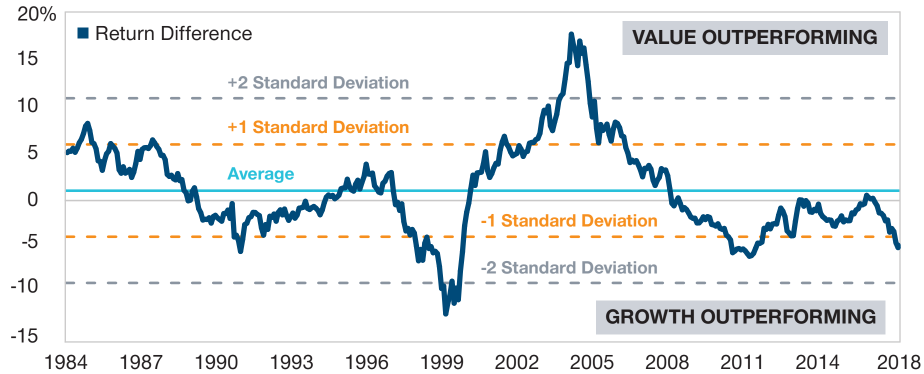
Some financial researchers also have suggested that this long-term structural return advantage for value may stem from a behavioral bias toward overconfidence, which may lead growth-oriented investors to be overly optimistic about the future earnings potential of the stocks they hold.

Historically, earnings have tended to come in well below consensus estimates, and it's been relatively rare for companies to grow consistently at very high levels over very long periods of time. This has frequently led to sharp revaluations of formerly highflying growth stocks, when events such as regulatory changes or other market disruptions have led investors to rethink their future growth potential.

CYCLICAL TRENDS IN STYLE PERFORMANCE

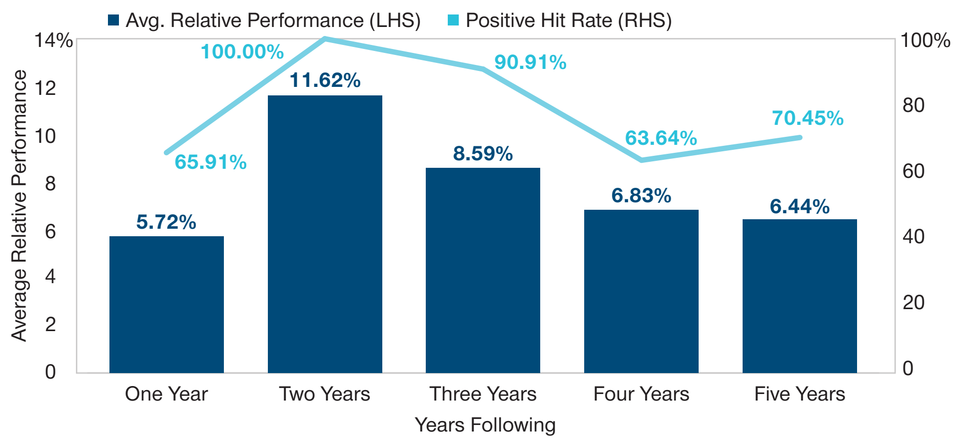
Despite value's longer-term return edge, analysts have long recognized that equity style performance has tended to move through periodic, although erratic, cycles—as can be seen in the relative returns of the Russell 1000 Growth and Value Indexes. The Russell style indexes are constructed from the stocks in the broader Russell 1000 Index, but with stocks reweighted based on key fundamental characteristics, such as book-to-price ratio and forecasted sales and earnings growth, that are used to define the value and growth universes.

FIGURE 1: Extremes in Large-Cap Relative Style Performance
Russell 1000 Value Index Minus Russell 1000 Growth Index
Rolling Five-Year Return Difference as of March 31, 2018



Past performance cannot guarantee future results.
Sources: Russell and FactSet Research Systems Inc. All rights reserved.

FIGURE 2: Russell 1000 Value Index Relative Performance Following Rolling Five-Year Periods More Than One Standard Deviation Below the Average
December 31, 1984, Through March 31, 2018



Past performance cannot guarantee future results.
Sources: Russell, FactSet Research Systems Inc. All rights reserved; data analysis by T. Rowe Price.

The current cycle of growth outperformance has been unusually extended in historical terms. As of March 31, 2018, the five-year relative style return difference was more than one standard deviation away from its 33-year average, suggesting a considerable disconnect with the longer-term tendency toward mean reversion (Figure 1).

Since 1979, the Russell 1000 Value Index has trailed the Russell 1000 Growth Index by more than one standard deviation in less than 12% of all rolling five-year periods (rolled monthly).

As previously mentioned, turning points in style cycles have been extremely difficult to forecast. However, extreme periods of value underperformance historically have been followed by periods of value overperformance a high percentage of the time.

Looking at rolling five-year periods from December 31, 1979, through March 31, 2018, when Russell 1000 Value Index

[1]See, for example, Eugene Fama and Kenneth French, "Value Versus Growth: The International Evidence," *The Journal of Finance*, December 1998, and Josef Lakonishok, Robert W. Vishny, and Andrei Shleifer, "Contrarian Investment, Extrapolation, and Risk," *The Journal of Finance*, December 1994.

performance trailed the Russell 1000 Growth Index by more than one standard deviation from the historical average, value turned the tables and outpaced growth in 100% of the following rolling two-year periods, almost 91% of the following three-year periods, and more than 70% of the following five-year periods (Figure 2).

SECTOR WEIGHTING HAS DRIVEN VALUE UNDERPERFORMANCE

Although growth-oriented sectors have outperformed value sectors in the current style cycle, leadership has been narrow, with a handful of very large stocks in the technology, industrials, and consumer discretionary sectors providing the lion's share of the Russell 1000 Growth Index's gains since the bull market began. The Russell 1000 Value Index, meanwhile, has been held back by its heavy exposure to the financials and energy sectors, both of which have underperformed in the current cycle due to the aftereffects of the financial crisis and the sharp declines in energy prices seen in 2014 and 2015.

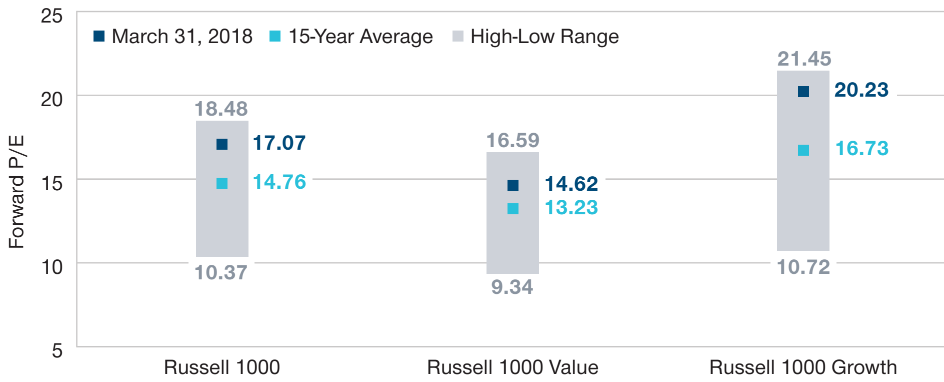
While valuations appear full in historical terms across most U.S. market sectors, on balance, the large-cap value universe looks more attractively priced to us relative both to the broad market and to historical averages. As of March 31, 2018, for example, the Russell 1000 Value Index was selling at a forward P/E ratio of 14.62—well below both the Russell 1000 Index and the Russell 1000 Growth Index and not far above its 15-year historical average. The Russell 1000 Growth Index, meanwhile, sold for a 20.23 P/E, more than 20% above its 15-year average (Figure 3).

As we begin to see evidence of a cooling off among popular large-cap technology stocks—as well as improved financials sector profitability and a stabilization in energy prices, we believe the headwinds to better value performance may start to lift.

CURRENT VALUE OPPORTUNITIES

In our U.S. value strategy, we have identified a number of potential opportunities among high-quality names

FIGURE 3: Growth and Value P/E Ratios*
March 31, 2003, Through March 31, 2018



*P/E ratios are based on FactSet market aggregates.
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Financials continue to have the largest sector weight in the U.S. value strategy, reflecting our view that U.S. financial companies stand to benefit from deregulation, lower taxes, and higher interest rates.

in some of the more cyclical parts of the U.S. equity market and have recently added shares of durable performers that we believe can hold up in more challenging market conditions. Overall, we feel less inclined to take large sector tilts, and expect stock selection to be a more important contributor to relative performance going forward.

Financials continue to have the largest sector weight in the U.S. value strategy, reflecting our view that U.S. financial companies stand to benefit from deregulation, lower taxes, and higher interest rates. During the first quarter of 2018, we continued to add selectively to our positions in U.S. insurers, as these stocks are trading at attractive valuations and stand to benefit from a better pricing environment.

We remain underweight the energy sector, as we continue to believe that oil prices are likely to remain under pressure from ample global supply. As a result, within the sector we favor companies with strong balance sheets, access to low-cost sources of oil and gas, and lower cost structures.

As always, we remain focused on identifying attractively valued, high-quality companies with strong management teams, as well as companies that have been challenged by macroeconomic forces but that we believe are well positioned for an improved operating environment. We believe our strategic investing approach—backed by rigorous fundamental research—will be crucial to identifying attractive investment opportunities.

CONCLUSIONS

Patience is a perennial friend of the value investor. We also believe it is important for investors to be aware of the impact of equity style cycles. The current growth cycle appears greatly extended, and we believe the balance of risks suggests the potential for mean reversion.

Through all market environments, we would encourage investors to focus on stock fundamentals. One key foundation to success for value investors in recent years has been the ability to stay engaged with stocks during periods of distressed sentiment in order to benefit from the transition to a better outlook.

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P/E Ratio: The price of a stock divided by its earnings per share. This ratio, also known as the multiple, shows investors how much they are paying for a company's earning power. The higher the P/E, the higher the expectation for earnings growth.

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