TCAF Webinar Transcript

Ira Carnahan:
Hi, everyone, and thank you for joining us for today's webcast to discuss the T. Rowe Price Capital Appreciation Equity ETF. I'm Ira Carnahan, portfolio specialist for the Capital Appreciation Suite, and I'll be moderating today's discussion.

With that, let me introduce David Giroux.

David, to level set for our audience. We're just marking a first full year with this portfolio. Assets have grown to over $1.5 billion. Can you walk us through the concept for the ETF and how this portfolio came to be?

David Giroux:
Sure. Happy to do that. You know, I think, with TCAF we really wanted to create a product in an ETF wrapper that we thought was highly differentiated.

And so we created a product that had really three, still has three simple goals. We want to outperform the market, year in and year out, two we want to be less risky than the market and be more tax efficient than an S&P 500 index strategy.

And so we think if you if you can provide clients with higher returns, less risk and more tax efficient, I think that's a compelling value proposition.

Ira Carnahan:
Great. So building on that, can you explain how you narrow the universe of stocks to get to a workable list of potential investments?

David Giroux:

Yeah, I think what's interesting is if you if you just take a step back and you ask yourself, why do stocks underperform? You know, there's really like six kind of characteristics.

We've discovered over time as we've kind of delved into this issue, like what caused the stocks underperform and these six issues kind of come down to know poor capital allocation. You know, poor management te ams can be sort of ongoing secular challenge, companies that have an extreme valuation where it's hard to actually generate a good return with extreme valuation or companies don't have a business model that supports, let's call it a high single digit algorithm or a combination of EPS growth and a divid end yield over a full cycle or something that has a high single digit algorithm but are very,

very high risk or high beta, right?

So, if you, essentially if you go through the S&P 500 company by company and you say how many comp anies have one of those six kind of fatal flaws, it's actually a very large number. It's somewhere between 365 to 375 companies in the market have one of those fatal flaws.

And essentially what we are doing. And I think we're going to we create a lot of alpha by simply ignoring those 375 companies in the marketplace. That kind of leaves you with a universe of, let's call it 125-135

stocks. We add a handful of non S&P 500 stocks into the into the portfolio. And then we basically say, how do how do we get it down to 95 to 105 stocks. And we're really optimizing around, let's call it four things we want to try to balance to the magnitude of outperformance with the odds of outperformance.

Those are two things we're focused on. I mention one of the value propositions of the strategy here is making sure that we're less risky than the market. So we want to make sure that our beta, our downside is kind of 3 to 5% less risky than the market. We want to make sure the portfolio has those characteristics.

We also want to make sure we don't have too much industry risk in one area. There might be 10 or 12 utilities that kind of hit that don't have any of those fatal flaws, but we don't want to own 12 utilities in the strategy. There might be 7 or 8 life science tool companies that actually get past, that don't have the six fatal flaws. But we can't own 7 or 8 life science tool companies. So we might optimize around what are the six or seven best utilities? What are the four or five best life science tool companies? And if you think about all those in combination, kind of get you to that 95 to 105 kind of stock portfolio that makes up kind of TCAF. But I would say a lot of the alpha, actually a lot of the alpha that we generate is simply by removing all these inferior companies that every investor who buys an S&P 500 index fund is forced to buy along with it.

Ira Carnahan:
So looking at markets today, how are you viewing things and how are you positioning the portfolio?

David Giroux:
What I would say is equity markets are expensive today. It's a real contrast to what the environment we saw two years ago where everybody was talking about a recession, everybody was really very scared about where rates were going to go and valuations were attractive and cyclicals were out of favor.

And today we find ourselves in an environment where everybody thinks the Fed's going to cut rates, everybody thinks inflation is going to come under a little more control. Everyone is playing a cyclical recovery. And what we find ourselves today is at with the market over 5000, when we do our micro analysis at the company level for the S&P 500 for the next five years, you know, we think despite having maybe a little faster earnings growth of the market next five years, we think the multiple will probably come down over the next five years.

And so the result is that the equity market likely will have a period of time the next five years where returns will be below what you think about as a long term average of the very, very high single digits. We would expect S&P 500 returns next five, five plus years, kind of more, mid-single-digit kind of returns mid to high single digit returns as opposed to high returns given where we are from a valuation and sentiment perspective.

And really what that leads us to do is really focus a little more time on areas that are, you know, attractive on a longer term basis but maybe don't fit with the current macroeconomic consensus of the time. That might be a health care company, that might be a utility, that might be a waste company, or might be a software company or a GARP stock, or "growth at a reasonable price" stock.

Ira Carnahan:

And when you think about risks that you're kind of focused on today, what would those be? Are they kind of some shorter term? Longer term? Maybe you could just discuss that a bit.

David Giroux:
Well, see there are 2 risks we talked a little bit about this is this idea that, you know, people have very positive expectations about we're going to have a soft landing, which we probably will. Probably will.

But also rates are going to come down. The Fed's going to cut rates and earnings growth can accelerate those. Those things may happen. But at this kind of market level, they have to happen. If they don't happen, there's a lot of downside risk. If any one of those things kind of doesn't play so that your risk reward in the market is skewed negatively as opposed to positively.

On a longer term basis, though. You know, I don't really worry about Fed policy or the economy. What I tell people, Ira, is I worry about low probability, very, very bad outcome events. That's what that I spent a lot of time thinking about and it's the what is the odds any one year that China invades Taiwan? What are the odds that there's something that happens between Ukraine and Russia, where it uses a nuclear weapon.

There's those days where the market's down ten, 15, 20, 25%.

Ira Carnahan:
So what should an investor in the Capital Appreciation Equity ETF expect and what would you tell an investor is a benefit of the approach in this fund versus what you would get, say, which is a standard S&P index product?

David Giroux:
Well, again, it goes back to I think the biggest challenge with S&P 500 index strategy is that, you know, there's so many bad companies or inferior companies, not necessarily bad but companies, that don't have high odds of outperformance over a five year period. If you buy an S&P 500 index fund, you're kind of burdened with all those companies in the portfolio.

So again, I think we create a tremendous amount of value by just excluding those 365 or 375 companies where essentially we are swimming, we are fishing in a lake with a lot more fishes or fish and a lot bigger fishes, if you will, as opposed to in positive areas where odds are a little lower, I would say.

Ira Carnahan:
David, you've written a lot previously about disruption. How is your thinking on that evolved and has that disruption itself accelerated or decreased? What have been the impacts?

David Giroux:
Well, what I would say actually is disruption is probably it's decreased. A lot of the companies that have been disrupted, their market has fallen in many cases and they and they continue to be disrupted. But their the rate of the rate of decline, the rate of pressure seems to stabilize a lot in a lot of areas.

However, I'd say there's a couple of areas that we're thinking a little bit about. Where could that level of acceleration at sector challenges accelerate potentially? And one of those is obviously GLP-1s and what are the second and third order effects of GLP-1s ones? As you know, GLP-1s today, essentially, not only do they potentially decrease body weight up, you know, 15 to 20% for people who are who are overweight and has positive impacts on obviously diabetes as well.

But it also can reduce the cravings for alcohol. It can work, help sleep apnea, it reduces the risk of heart failure, heart attacks. It has all these positive characteristics. Today, we only have two products on the market, over time there will be more products on the market. They're probably an oral as opposed to an injectable as well.

And so you're probably going to see new companies come to the market as well. And you also see over time some of these products go generic as well. So I think if you think about this on a ten or 15 year perspective, you know, and the you know, that is probably negative for companies that are in the snack food business or the soda business. These are you know, one of the things we found is that people who are on GLP-1s ones, their proclivity to snack, drops 50%, their proclivity to drink soda drops 50%.

Their proclivity to go to a fast food restaurant drops dramatically. So if you consume less calories, all those companies, whether it be food or restaurant, could be impacted by that over time. And again, food companies, staples companies, restaurants, these aren't companies that are really fast growers.

So if a company was growing organically 2% volumes now grows zero or one that actually has a big impact not only on the algorithm of the company but on its multiple likely to receive. So we know consumer staples is an area that could be potentially kind of disrupted by that. And you could also make an argument there's parts of health care that could also be impacted by that, you know, medical device companies that have done well because, you know, replacing knees or replacing, you know, heart failure products or stents, those things could also be impacted negatively over the next ten or 15 years. So that's an area that we are spending more and more time on.

Ira Carnahan:
Great, great. So you've written a book on capital allocation. Can you talk a little bit about how you consider this capital allocation as you're putting together the portfolio a little more detail, some examples of companies that have been perhaps good and not so good on that front?

David Giroux:
Sure. Happy to do that. Yeah. I think you think about what we are doing on a day to day basis. I think we are trying to exploit market inefficiency. That is the key to what we're doing. I think capital allocation is an area or at a topic that the market isn't focused enough on. It should. And there are.

And while most companies destroy values, destroy shareholder value through inopportune or inefficient capital allocation, there's a handful comes more than a handful companies have done a really good job at deploying capital to benefit their shareholders. Whether it be a Thermo, a Danaher, a Revvity, all in the life sciences space, have created a tremendous amount of value an NXPI through share repurchase. It's created a lot of value.

And so we're really looking for those companies that are generating lots of free cash flow that can use that free cash flow in a way to accelerate or maintain a very high level of earnings growth or dividend growth for the company and, you know, generate very attractive returns. You know, what's interesting is there's a lot of people who look at a company that's growing mid-single digits organically and say, that's not for me as too that's a boring stock.

There's a lot of there's a lot of companies in this marketplace that grow organically five or 6% to get a little bit of margin expansion and take that free cash flow they're generating and buyback stocks, do accretive acquisitions and can generate really attractive market beating EPS growth sustainably in higher

quality and with less risk. And you know, we have a large portion of our portfolio, these GARP stocks, aho tend to do a really good job of capital allocation.

So this is an area of efficiency, an area we really seek out companies that deploy capital well and try to avoid that systematically deploy capital poorly,

Ira Carnahan:
David, one of the big topics on people's minds today is certainly artificial intelligence. Can you talk a little bit about how you're thinking about its impact over time and how you're positioning the portfolio in light of that?

David Giroux:
Sure. Happy to do that. You know, I think from a high level, we'll talk about the impacts on the market and we'll talk to the companies who are kind of into that ecosystem next. So what I would say is, you know, I think AI is going to be a big deal for the marketplace. I think it will, at least in the early days of A.I., is going to drive a lot of cost savings.

And we are actually already seeing signs of A.I. cost savings already. You know, I like to give the example of GitHub copilot, GitHub copilot basically makes a computer programmer 25 to 50% more productive in what they do. And a couple of years ago that number was like ten or 15% and probably in two or three years, it will be 100%.

And so, you know, if you think about get a copilot costs $19 a month for $19 a month, I can replace potentially 25% of my computer programmers who on average, according to census data, make over $100,000 a year. So that's a incredible return in that area. And you're already seeing this. Some large cap companies who are who basically for a lot of their workforces, computer programmers, you know, they're not they used to be they were growing their workforces that double digit rates a couple of years ago.

Now it's roughly flat or in some cases declining in the case of, I guess, Google or Alphabet. So cost savings is going to be a big part. So whether that be computer programing, whether it be marketing, whether that be customer service, I think you're going to get very, very high returns. On the corporate side there. I also think, again, we've had kind of inflation's taking a little longer to get back down to 2%.

And actually the expectations, you know, it won't get back to 2% this year, now. I think AI will be something over a let’s call it a five year period of time. It will be something that will be deflationary nature. It's basically a productivity tool. If I can make someone much more productive, whether it be 25, 50% more productive, you probably don't need as many employees as you did in the past, especially in areas like white collar work.

And in that result, the supply and demand imbalance we have today for workers versus job openings should shrink in more favor of employers versus employees. Maybe not a great thing for us white collar workers, but at the same time, you know that that probably helps bring inflation back down to the 2% time, which there wasn't necessarily a catalyst to get it back there before AI.

So I think that's deflation that also makes me feel a little bit better on a longer term basis.

The only thing else I would say on that, on that particular area would be that again, I think that is positive for companies that are lever to lower rates that, you know, we have a number of those in our

portfolio in TCAF that will benefit over time if rates go lower. We think they should benefit either from their multiple or just their core business fundamentals getting stronger.

But let's also talk about AI in terms of who the companies are going to benefit from A.I. And again, we've seen the first route of beneficiaries of AI. You know, probably the most obvious example is NVIDIA, which basically makes the chips which enable AI today.

You know, I think when we think on a five year perspective right now I don't I'm not convinced NVIDIA will be the big winner that it has been the last couple years. I think the hardware and the software become a little more competitive, especially as we go from a market that is dominated today by training where NVIDIA is dominant to a market is more inferencing on AI, where the barriers to entry are a lot lower, today.

We also do think AMD will be a competitor to NVIDIA on the training side, over time. We also think over time, just think about what really we're talking about here. It's really about software for labor arbitrage.

And so while the software companies are not the first route of beneficiaries of AI, they're probably the second derivative beneficiaries of AI. And so as you think about 25, 26, 27, 28, a lot of these companies are going to be able to offer productivity enhancing copilots for lack of a better term, that companies will be willing to pay for given the productivity savings, and that those incremental copilots will probably accelerate their organic growth.

These software companies also have the benefit from when I talked about earlier is we probably need a lot more employees. So it used to be if we want to grow the top line at 10%, we had to hire five, 10% new employees. You know, again, with these productivity enhancements and things like, you know, computer programing, you may not need to hire that many more employees.

So what that result is, is probably more multiple expansion. So software companies from my perspective are really in the sweet spot where you can actually see top line accelerating as well as margin expansion or the rate of margin expansion accelerating. That's a really attractive place. Again software companies have not been the go to names the last year, so we've been adding to software.

We feel good about that. We feel like the risk reward within software is as good as it's ever been. And we have the next five years, which really good. Where as the range of outcomes for NVIDIA is really, really wide, especially where we are today, whereas we think software has a positive skewed risk reward and a lower range of outcomes.

Ira Carnahan:
Great. Let's talk about another area that I think you spend a lot of time on are utilities. Is one of the sector overweights in the strategy? Can you say a bit about why we like utilities and the thinking there?

David Giroux:
Well, sure. That actually dovetails into the AI discussion a little bit. If you think about today, data centers in the US, let's call it easy, 2 to 3% of kind of overall power consumption today, depending on different estimates, there are projections that that number could go anywhere from high single digits to 10% of total power over the next five, six years.

And what that really requires is new generation. In some cases, it requires new transmission, new grid hardening and essentially you know, really for the last ten years, the underlying electric demand in this country has been growing very, very slightly, let's call it less than 1%, close to zero, honestly. And this is a situation between AI and electric cars and hybrid cars and the electrification of everything, if you will, in factory floors as well.

You could have an environment where your power consumption, which was flat, close to flat surface, growing 2 to 3% per year, and that drives faster rate base growth for utilities projects, faster EPS growth for utilities. Yes, it drives customer bills lower on a per unit basis. So it's a really positive thing for utilities. You know, I think utilities are in a really sweet spot today because not only do they have AI and EVs driving greater demand, but between, you know, greater storms in some areas, wildfire risks there do a lot more grid hardening, adding to their infrastructure, to their strength so their poles don't go down. And this transition to renewables, which over time will be the vast majority of their fleets away from gas and coal and to a lesser extent nuclear, that also helps drive rate base growth. So utilities, there is a time not too long ago, I think 1986 to 2002 where utilities had no earnings growth so only thing you got was the dividend yield.

Today, utilities are a number of utilities that we own in the portfolio are growing earnings base or growing their earnings anywhere from 6 to 8% per year. And then if you add on a 3% or in some cases almost a 4% dividend yield attached to that, you're getting a low teens return or algorithm.

So we've seen utilities start to rally here in the last month or so. And now as of this date, they're actually outperforming the S&P 500 year to date. And again, if rates were to decline in a couple of years, we think we think utilities have a lot of ways to win. Great algorithm, low valuation, tailwinds from AI and EVs.

You know, we think they're in a great risk reward in the marketplace.

That concludes today's webcast. We appreciate the discussion. And I want to thank David Giroux for joining us today.

Important Information

Consider the investment objectives, risks, and charges and expenses carefully before investing. For a prospectus or, if available, a summary prospectus containing this and other information visit troweprice.com. Read it carefully.

ETFs are bought and sold at market prices, not net asset value (NAV). Investors generally incur the cost of the spread between the prices at which shares are bought and sold. Buying and selling shares may result in brokerage commissions, which will reduce returns.

Risk considerations: All investments are subject to market risk, including the possible loss of principal. Stocks generally fluctuate in value more than bonds and may decline significantly over short time periods. Stock prices can fall because of weakness in the broad market, a particular industry, or specific holdings. The fund is "nondiversified," meaning it may invest a greater portion of its assets in a single company and own more of the company's voting securities than is permissible for a "diversified" fund. The fund's share price can be expected to fluctuate more than that of a comparable diversified fund. Because the fund may hold stocks with either growth or value characteristics, it could underperform other funds that take a strictly growth or value approach to investing when one style is currently in favor.

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Sector exposure: To the extent the fund invests in specific industries or sectors, it may be more susceptible to developments affecting those industries and sectors.

Definitions

Alpha compares risk-adjusted performance relative to an index. Positive alpha means outperformance on a risk-adjusted basis.

Beta measures the volatility of a security or portfolio relative to an index. A beta of less than one means lower volatility than the index; more than 1 means great volatility.

Earnings per share (EPS): Earnings per share (EPS) is a measure of a company's profitability that indicates how much profit each outstanding share of common stock has earned. It's calculated by dividing the company's net income by the total number of outstanding shares.

Multiples: Multiples measure some aspect of a company’s financial well-being, determined by dividing one metric by another metric. Multiples quantify a company’s growth, productivity, and efficiency. Multiples are used to make comparisons among companies and help find the best investment opportunities.

Past performance cannot guarantee future results.

Top 10 Portfolio Holdings As of March 31, 2024	
Holding	**% of Fund**
Microsoft Corp Common Stock	**8.06%**
NVIDIA Corp Common Stock	**4.76**
Apple Inc Common Stock	**4.47**
Alphabet Inc CL A Common Stock	**4.25**
Amazon.com Inc Common Stock	**4.17**
UnitedHealth Group Inc Common Stock	**2.37**
Canadian Natural Resources Common Stock	**2.34**
Meta Platforms Inc Class A Common Stock	**2.26**
Waste Connections Inc Common Stock	**2.02**
Revvity Inc Common Stock	**2.00**

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