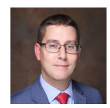
Let Your Winners Run—10 Years of European Small-Cap Investing

Identify outstanding companies and hold on to them to harvest the rewards.

January 2019



Ben Griffiths
Portfolio Manager, T. Rowe Price Funds SICAV European Smaller Companies Equity Fund

KEY INSIGHTS

- The early discovery of small companies that will grow strongly over the long term can deliver significant rewards. Be extremely wary about selling them unless there's a genuine, fundamental reason to.
- History teaches us that the "small-cap premium" typically rewards investors who make a long-term allocation to the asset class, and current valuations do not look excessive.
- We expect investing in innovative, durable-growth companies to continue to provide attractive returns over the medium term.

On the 10-year anniversary of the T. Rowe Price European Smaller Companies Equity Fund, Ben Griffiths shares 10 observations derived from his tenure as an analyst and portfolio manager. He highlights what's changed in his approach and what hasn't, the key lessons learned, and the evolution of the European small-cap market over the period.

With the fund handsomely outperforming its benchmark over the past decade, Ben sets the scene for the decade ahead.

1 How has the European small-cap market evolved over the past 10 years?

Markets have been volatile at times, but from the trough following the global financial crisis 10 years ago there has been a strong recovery. However, a large part of this was just recovering the ground lost as we went into the crisis.

What is really striking when I look at my current portfolio is how many exciting companies were not on public markets a decade ago, and some companies did not even exist in any form! This reflects the profound innovation that has occurred, especially within technology. Accompanying this—especially in the last three to four years—has been a strong initial public offering (IPO) cycle, which has brought these companies to market.

One of these disruptive newcomers is Deutsche Familienversicherung (DFV), which is challenging incumbent insurance giants in Germany such as Allianz. DFV is a niche player that offers an Internet-only platform to sell supplemental health, property, and casualty insurance at typically cheaper rates, while providing a simple

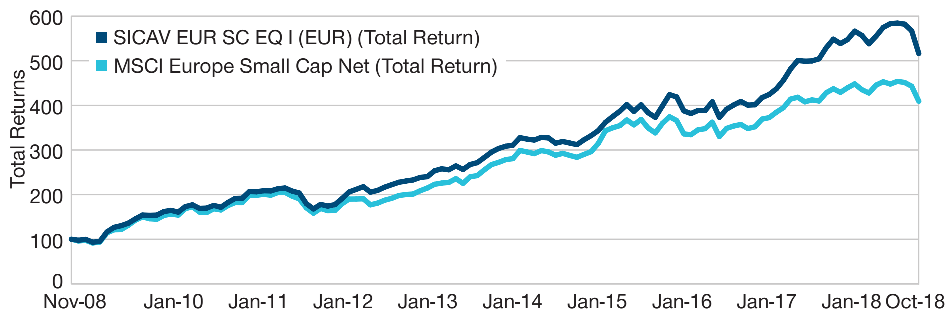
75%

The amount of value added derived from stock selection rather than through sector and industry positions.

(Fig. 1) 10 Years of Strong Performance

Beating the benchmark over three, five, and 10 years

Rolling monthly total returns December 2008 to September 2018



Past performance cannot guarantee future results.

Source: T. Rowe Price.

Fund performance is calculated using the official net asset value with dividends reinvested, if any. The value of the investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the fund and the subscription currency, if different. Sales charges (up to a maximum 5% for the A Class), taxes, and other locally applied costs have not been deducted and, if applicable, they will reduce the performance figures.

The index shown is not a formal benchmark. It is shown only for comparison purposes.

and efficient online experience for the consumer. It also uses artificial intelligence to decide which claims are valid and which are not, and the algorithm also learns from human decisions to further improve automation. The technology is helping to contain costs and keep staff numbers to a minimum, which offers significant opportunities to scale the business.

At the same time, many more established companies have matured, especially those that have been able to adapt their business models to the online world. Those that have demonstrated durable, structural growth have been strongly rewarded.

2 How has the portfolio changed over that time?

We launched the fund in November 2008, carving it out of our international small-cap strategy, when markets were pretty much at the trough from the global financial crisis. The crisis helped reinforce the benefits of our fundamental philosophy—to buy high-quality, durable growth companies with a bias toward innovation and to hold them for the long term.

When I look back to 2008, I am heartened to see how stable the portfolio has been. We have been consistently overweight the health care, information technology, and consumer discretionary sectors over the past 10 years. And we continue to typically find the strong-growth companies in these sectors. These long-term holdings include Danish health care company Ambu; Germany-based online payments processor Wirecard; market researcher and survey firm YouGov; laboratory tester Eurofins Scientific; and Irish online betting and gaming company Paddy Power, which transformed itself into Paddy Power Betfair.

3 What have been the key contributors to the fund's success?

I would highlight two consistent elements that I believe have been instrumental in the fund's performance over the last decade—maintaining a long-term horizon and the conviction to take risk in the portfolio, but in a thoughtful way.

The portfolio has materially outperformed over the period. At least 75% of the value added has been

T. ROWE PRICE BEYOND THE NUMBERS

Finding Innovative Small-Caps at an Early Stage

IPOs provide an early entry point for investing in innovative companies that will grow significantly over the long term. Ben Griffiths discusses a company that illustrates this approach.

One of these disruptive newcomers is Deutsche Familienversicherung (DFV), which is challenging incumbent insurance giants in Germany such as Allianz. DFV is a niche player that offers an Internet-only platform to sell supplemental health, property, and casualty insurance at typically cheaper rates, while providing a simple and efficient online experience for the consumer. It also uses artificial intelligence to decide which claims are valid and which are not, and the algorithm also learns from human decisions to further improve automation. The technology is helping to contain costs and keep staff numbers to a minimum, which offers significant opportunities to scale the business.

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> *Portfolio Manager, T. Rowe Price Funds SICAV European Smaller Companies Equity Fund*

derived from stock selection rather than through sector and industry positions, with historical attribution strongest in health care, financials, and industrials.

The way for me to destroy value would be to start worrying about delivering over the next six months and moving my sectors around to whatever I believe is going to work in the next six months, which would probably be wrong.

We also accept that we must take a risk on an individual stock or name to generate good performance. We have not been scared by valuations moving up in high-growth companies and structural winners, and we have stuck with them. That has been really important in driving these returns.

The portfolio's diversification has enabled us to deliver, since inception, greater returns than the benchmark but with less volatility. Over the years we have also continued to invest in our risk function. We build a well-diversified portfolio over time and use the risk team and analysts to ensure we are not taking undue bets on extraneous factors.

4 Have there been any significant changes to the investment team?

Experience is crucial in this asset class because there are so many companies to know, and it takes time getting to know them. Just to give you an idea, each team member holds appreciably more than 200 meetings with companies every year.

Three out of the core investment team of four have been with the fund since inception in 2008. I have 19 years of investment experience in total, 12 of them with T. Rowe Price as a small-cap analyst covering northern Europe (about a third of the portfolio) and as a small-cap portfolio manager.

I started managing the portfolio in 2015, taking the helm from Justin Thomson—now one of the firm's chief investment officers. Justin has generated excellent performance during the 20 years that he has run international small-cap equity. We have a similar investment approach and, as Justin remains invested in European smaller companies, we continue to collaborate closely.

Our dedicated European small-cap research team, backed by T. Rowe

> Finding great companies with great management teams that have compounded and managed to grow over the long term has been the right strategy in this 10-year period.
>
> — **Ben Griffiths**
>
> *Portfolio Manager, T. Rowe Price Funds SICAV European Smaller Companies Equity Fund*

Price's well-resourced global research platform of over 100 equity analysts, gives our investment process a crucial edge. Close collaboration and a regular exchange of ideas help us find the hidden gems. Our investment platform is a rare resource in an industry where research analysis is succumbing to cost-cutting and consolidation.

5 What was the most challenging period?

The strengthening economic backdrop over the past 10 years has been good for our growth style of investing. The cycle has extended—for now, at least—and that has certainly been a tailwind.

There are periods when the fund has underperformed. Donald Trump's promised tax cuts in the autumn of 2016 ignited a value-led and cyclicals rally. We were—and still are—underweight materials, financials, commodities, energy, and low-quality cyclicals, which typically do well in this environment. Our preferred companies usually perform well in most other environments. Fortunately, this kind of rally tends to be short-lived. Ultimately, we aim to be patient and focus on the attributes of the underlying companies.

Investing in small-caps inherently comes with some volatility. While we have conviction in the long-term potential of a company, it is hard to pinpoint when it will deliver the anticipated rewards—and there can often be setbacks in the meantime. There are periods when nothing seems to work and others when everything does.

We aim to counter some volatility by building a diversified portfolio. However, volatility in small-cap investing comes with the territory, and it's essential to have the courage of your convictions.

Wirecard is a prime example. We have stuck with it through the ups and downs

(Fig. 2) Overweights in Sectors Rich With Opportunities

T. Rowe Price Funds SICAV—European Smaller Companies Equity vs. MSCI Europe Small Cap Index Net

Dec. 2008		Portfolio Weight vs.v Benchmark		Sept. 2018
7.43%	Health Care	1	Info. Tech.	7.93%
6.78	Info. Tech.	2	Health Care	7.34
4.24	Consumer Disc.	3	Comm. Services	4.44
2.15	Comm. Services	4	Consumer Disc.	4.41
1.58	Energy	5	Consumer Stpls.	-2.18
-0.87	Utilities	6	Utilities	-2.29
-1.19	Consumer Stpls.	7	Energy	-2.99
-3.54	Materials	8	Materials	-5.25
-6.28	Real Estate	9	Real Estate	-5.74
-8.62	Indust. & Bus. Svcs.	10	Financials	-5.93
-9.36	Financials	11	Indust. & Bus. Svcs.	-6.99

Source for MSCI data: MSCI. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI.

T. Rowe Price uses the MSCI/S&P Global Industry Classification Standard (GICS) for sector and industry reporting. Each year, MSCI and S&P review the GICS structure. The last change occurred on September 28, 2018. The telecommunication services sector was expanded and renamed communication services. Some securities previously assigned to information technology or consumer discretionary were reclassified as communication services. T. Rowe Price will adhere to all future updates to GICS for prospective reporting.

> I think we are in the middle of a big period of economic change, driven by the Internet and innovations in medicine, which is driving structural-growth companies and not traditional industries.
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because we believe in its long-term potential. It is an innovative online business model, building a global payments system and delivering a compound annual growth rate of 20%—if not a bit faster—over that period. The world economy is still cash-based, really. So moving to electronic and online payments still has a massive runway.

6 What has been the most valuable lesson you have learned?

Well, I would highlight two. First, to be successful in this asset class you need to identify those outstanding companies that will deliver a strong compound growth rate over the long term. An internal study of the European small-cap universe that we conducted last year showed that these companies add a significant amount of the value.

Second, if you find a great business, keep it. I don't sell a company unless there is a genuine reason to—and typically, valuation is not the driving force. I learned this the hard way! I once held a German combination-oven manufacturer, Rational. It is probably one of the best companies that I have come across, but I managed to convince myself to sell it because it became a bit expensive. Lesson learned!

7 Where do you see the main opportunities for the decade ahead?

I've mentioned it before, but I continue to see a huge opportunity in identifying companies with strong potential derived from innovation. That's because Europe spends a significant amount on research and development, both absolutely and as a percentage of gross domestic product, holding up well against the U.S. and China. There are plenty of applications for patents as well, although China applies for more. Don't forget that Europe is home to some of the most innovative industries on the planet—the automotive industry is a standout example, while genomics, particle physics, and renewable energy all have strong foundations.

8 What are the risks you're monitoring?

The main risk in Europe is political. The outcome of Brexit negotiations, concerns over the Italian budget and debt situation, and the rise of populist movements all contribute to an uneasy geopolitical backdrop that we continue to monitor.

Although market conditions are volatile currently, I am not changing my focus. I believe that value-added, durable growth will continue to be rewarded over the medium term, at least.

Overall, I'm encouraged by various game-changing developments, including Internet-led transformations and innovations in medicine that favor structural-growth companies over traditional industries.

9 Do you see further upside potential in Europe?

I don't believe valuations in Europe look extended. In 2008, valuations were incredibly cheap, and a strong rally took hold very quickly. Current aggregate price-to-earnings levels for European smaller companies are not showing any warning signs. I also don't view small-cap companies as significantly overvalued relative to large-caps.

There have been pockets of extreme valuations among some technology and structural-growth names. But encouragingly, there are many exciting innovative companies still to be found.

10 What excites you about the asset class over the next 10 years?

I believe European small-caps remain a great place to invest. It is an exciting time to be invested because change brings opportunity. Well-managed smaller companies with good ideas have the potential and drive to capitalize on new trends and innovations. Conversely, incumbents—often the large-caps—are more likely to come under pressure due to new ways of doing business or the arrival of new products in the market.

Smaller companies are harnessing new technology, digitizing their businesses to drive productivity and innovation. Take finance—in particular, banking. The way we do things has completely changed in 15 years. You don't have to call your bank anymore to do a transaction, you can use your smartphone instead.

And this is just the tip of the iceberg. It feels to me we are only just on the cusp of starting to benefit from the spread of digitization, which could revolutionize supply chains and make them more efficient.

So that sets the scene for me over the next 10 years. I've only just started!

The specific securities identified and described do not represent all of the securities purchased, sold, or recommended for the SICAV sub-fund, and no assumptions should be made that the securities identified and discussed were or will be profitable.

Objective

To increase the value of its shares, over the long term, through growth in the value of its investments. The fund invests mainly in a diversified portfolio of stocks of smaller publicly traded European companies.

Risks—the following risks are materially relevant to the fund (refer to prospectus for further details):

- **Country risk (Russia and Ukraine)—**in these countries, risks associated with custody, counterparties and market volatility are higher than in developed countries.
- **Currency risk—**changes in currency exchange rates could reduce investment gains or increase investment losses.
- **Small and mid-cap risk—**stocks of small and mid-size companies can be more volatile than stocks of larger companies.

General Fund Risks

- **Capital risk—**the value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the fund and the currency in which you subscribed, if different.
- **Equity risk—**in general, equities involve higher risks than bonds or money market instruments.
- **Geographic concentration risk—**to the extent that a fund invests a large portion of its assets in a particular geographic area, its performance will be more strongly affected by events within that area.
- **Hedging risk—**a fund's attempts to reduce or eliminate certain risks through hedging may not work as intended.
- **Investment fund risk—**investing in funds involves certain risks an investor would not face if investing in markets directly.
- **Management risk—**the investment manager or its designees may at times find their obligations to a fund to be in conflict with their obligations to other investment portfolios they manage (although in such cases, all portfolios will be dealt with equitably).
- **Operational risk—**operational failures could lead to disruptions of fund operations or financial losses.

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