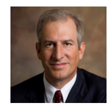
Investing in All-Season Large-Cap Growth Stocks

Larry Puglia's consistent approach for more than 25 years.

January 2019

KEY INSIGHTS

- Mr. Puglia seeks companies that can sustainably compound earnings and generate free cash flow growth at a strong rate.
- At the start of 2019, there were significant market risks and more challenges than a year ago.
- The strategy entered 2019 with overweight positions in consumer discretionary, health care, and communication services stocks.



Larry Puglia
Portfolio Manager, US Large-Cap Core Growth Equity Strategy

Larry Puglia has managed the US Large-Cap Core Growth Equity Strategy for more than 25 years, a remarkable feat. In this interview, Mr. Puglia discusses his consistent approach to managing the strategy, his market outlook, and how the strategy is positioned going into 2019.

Q. What are the key lessons you've learned in managing this strategy for such a long time?

Among the many lessons is that no one has a monopoly on intelligence. So I try to learn from various sources and remain open to opposing views, innovations, or other disruptive developments.

Second, in investing in volatile markets, it is especially important not to dwell on mistakes or celebrate winning stocks. We strive to focus on investments' values going forward. You also should realize that you only rarely are able to buy at the bottom and sell at the top.

Third, investing is not a popularity contest. If you buy the same stocks as others, you will get about the same results. Portfolios generally need to include a least a few controversial ideas. Being contrarian often can lead to significant investment gains.

We try not to confuse activity with true insight. Successful investing requires calm thinking. Recognizing mistakes early—and earlier than your competitors—is necessary. At the same time, it is important to not judge investment ideas over too short of a time horizon. The best ideas often take some time to be recognized by the market.

Q. What's your approach to running this strategy, and how has it evolved?

Our approach to investing has remained consistent. Stock prices tend to follow earnings and free cash flow growth over time. As a result, we seek out companies with sustainable earnings and free cash flow growth.

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— **Larry Puglia**
Portfolio Manager, US Large-Cap Core Growth Equity Strategy

(Fig. 1) US Large-Cap Core Growth Equity Strategy

Diversification, as of December 31, 2018

Sector	Representative Portfolio	S&P 500 Index	Russell 1000 Growth Index
Information Technology	26.99%	20.12%	31.46%
Consumer Discretionary	22.49	9.94	15.12
Health Care	20.46	15.54	14.29
Communication Services	13.92	10.12	11.93
Industrials and Business Services	9.05	9.20	11.85
Financials	6.35	13.31	4.40
Materials	0.50	2.73	1.84
Utilities	0.14	3.34	0.00
Consumer Staples	0.05	7.41	6.03
Real Estate	0.02	2.96	2.32
Energy	0.00	5.32	0.76

Source: T. Rowe Price.

The representative portfolio is an account in the composite we believe most closely reflects current portfolio management style for the strategy. Performance is not a consideration in the selection of the representative portfolio. The characteristics of the representative portfolio shown may differ from those of other accounts in the strategy.

T. Rowe Price uses the current MSCI/S&P Global Industry Classification Standard (GICS) for sector and industry reporting. T. Rowe Price will adhere to all updates to GICS for prospective reporting.

Index performance is for illustrative purposes only and is not indicative of any specific investment. Investors cannot invest directly in an index.

We particularly look for high-quality growth stocks that can sustainably compound earnings at a strong rate. These rare companies tend to have strong market share, large addressable markets, and—not to be underestimated—very strong managements that know how to allocate capital. They typically generate durable free cash flow growth.

We also prize companies with a high degree of recurring or service revenue and companies that are well diversified by product and geography. Warren Buffett talks about franchise businesses; Morningstar describes quality businesses as having a moat surrounding them; others call it a sustainable competitive advantage.

Last, we try to be aware of the strategy's benchmarks [the S&P 500 and Russell 1000 Growth Indices] but not overly concerned about having investments in certain components. Some of our best decisions have been to avoid large components of the benchmarks that did not meet our criteria.

Q. What's your market outlook for 2019?

At the start of 2019, there were very significant risks in the market and perhaps more challenges than existed at the end of 2018. I would put the unsettled trade negotiations with China at the top of our concerns, but some slowing in global growth also is noteworthy. Moreover, we're evaluating the unsettled political environment in several countries, including Brexit uncertainties in Europe and the possibility of greater regulation from the change in the U.S. House leadership.

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Relying on the Firm's Research Platform

Seeking Franchise Businesses With Sustainable Competitive Advantages

We've consistently relied on the extensive research platform that T. Rowe Price continues to build and the firm's environment of trust and collaboration among portfolio managers and analysts as we search for high-quality growth companies that can sustainably compound earnings and free cash flow. We particularly seek companies with strong managements that allocate capital well, have a high degree of recurring revenue, and are franchise businesses with a sustainable competitive edge.

30%

Typical turnover rate for US Large-Cap Core Growth Equity Strategy.

However, the basic building blocks of stock performance remain. Specifically, corporate earnings continue to grow at solid rates, and the revenue growth underlying earnings remains resilient.

It is true that corporate tax reform boosted earnings in 2018, and that will create more difficult comparisons. But valuations, which were becoming a significant potential impediment to future stock performance, appear more reasonable with time and the market pullback in the fourth quarter of last year.

Q. How was the strategy positioned coming into 2019?

We entered 2019 with overweight positions in consumer discretionary, health-care, and communication services stocks. We have experienced volatile markets and a significant pullback in technology but also in several other sectors. However, the type of company in which we invest has not really changed significantly. Our turnover rate has run only about 30%, and many of our large positions entering 2018 continue to be large positions.

These include consumer discretionary stocks, such as Amazon and Alibaba; health-care stocks, such as Becton Dickinson, Intuitive Surgical, Stryker, Cigna, and UnitedHealthcare; and technology stocks, such as MasterCard, Visa, PayPal, Intuit, and Microsoft. Several of our large holdings, such as Alphabet [formerly Google] and Facebook, have been reclassified into the new communication services sector, where we have an overweight position. So we actually are now underweight in technology after the latest sector classification changes effective in the fourth quarter of 2018.

We have strived to maintain ownership in a broad array of growth companies, and most of these companies are quite reasonably valued. For example, even stocks such as Amazon and Google, which had experienced strong, consistent revenue growth and solid stock performance, now trade at well below 20 times the free cash flow they may generate in 2020. However, we should point out that we own large positions in companies outside these sectors, such as Boeing and Ameritrade.

Q. What about sector underweights?

We have generally underweighted sectors and industries that are deeply cyclical and overly fragmented or where most of the participants do not earn their cost of capital. We also have avoided

As of December 31, 2018, Amazon made up 10.04% of the US Large-Cap Core Growth Equity Strategy; Alibaba, 2.95%; Becton Dickinson, 1.99%; Boeing, 3.86%; Intuitive Surgical, 1.71%; Stryker, 1.95%; Cigna, 1.74%; UnitedHealthcare, 3.22%; MasterCard, 2.90%; Visa, 3.50%; PayPal, 1.72%; Intuit, 1.62%; Microsoft, 5.75%; Alphabet, 6.09%; Facebook, 3.84%; Tencent, 2.26%; and Ameritrade, 1.51%. Strategies that invest in growth stocks are subject to the volatility inherent in common stock investing, and their share price may fluctuate more than that of a strategy investing in income-oriented stocks.

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>
> **— Larry Puglia**
> *Portfolio Manager, US Large-Cap Core Growth Equity Strategy*

industries in which the competitive environment or structural changes are making consistent growth challenging.

Consequently, we are underweight the materials and industrials and business services sectors. We also have largely avoided the consumer staples sector as we believe that private-label products will continue to be a significant threat to the pricing power of branded staples. And we have had very limited investment in the energy, utilities, and real estate sectors.

Q. What are the top risks these days?

We've already noted the risk of a broadening trade war with China, which could hamper global economic growth, as the most significant concern.

In addition, antitrust or data privacy issues or rhetoric directed at many of the internet leaders are certainly potential challenges. Slowing growth and greater regulation in China also could weigh on the growth of such holdings as Alibaba and Tencent. Finally, increased regulation from a divided Congress could affect such sectors as health care and financials.

However, our investment approach recognizes that it is very difficult to forecast how these macro factors will develop and how much they will affect stock prices. So we continue to emphasize companies that we believe can continue to generate strong earnings and free cash flow growth in most scenarios.

Essentially, we are trying to buy all-season growth companies that we think can do reasonably well in most economic and regulatory environments. We acknowledge that a growth strategy may not be especially defensive relative to certain other strategies. However, over reasonable time horizons, we believe the quality and growth prospects of our holdings could provide relatively favorable prospects.

Q. Last word?

It has been an honor to manage the US Large-Cap Core Growth Equity Strategy for more than a quarter century. I especially appreciate the confidence that our clients have placed in our investment team by maintaining their investments and adding periodically, including during market turbulence. I also very much appreciate the extensive research platform T. Rowe Price continues to build and its unwavering commitment to research excellence.

WHAT WE'RE WATCHING NEXT

Valuations are more reasonable after the December pullback. However, investors face several key challenges, including the trade negotiations with China, slowing Chinese and global growth, rising U.S. interest rates, and possibly more regulatory scrutiny in selected industries. We believe corporate earnings will decelerate but still will be sufficient to drive meaningful stock performance for many stocks.

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