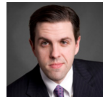
Seeking Long-Term Gains by Investing Against the Grain

Market inefficiencies create opportunities for savvy investors.

July 2023

KEY INSIGHTS

- We make investment and allocation decisions based on the potential for strong returns over a five-year horizon while aiming to take less risk than the market.
- A deep focus on company analysis and valuations gives us the conviction to be contrarian and exploit the market's persistent inefficiencies.
- We are finding opportunities in health care and utility stocks and see the potential for favorable risk-adjusted returns in high yield.



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Many investors tend to fixate on the short term in assessing the economic outlook and the prospects of individual companies. Their focus is on outperforming in the next quarter, the next month, or even the next week.

We want to take advantage of this bias and other market inefficiencies. Our investment and asset allocation decisions come down to where we see the opportunity for strong performance over a five-year horizon while aiming to take less risk than the market (Fig. 1).

Let's explore how we strive to add long-term value for our clients and where we are finding potentially compelling risk-adjusted returns.

1. Thoughtful Asset Allocation

How we allocate to stocks, fixed income, and cash is an area of focus. These

The Pursuit of Long-Term Capital Appreciation*
(Fig. 1) Goals for the short, intermediate, and long term

Short Term (1 Year)	Intermediate Term (~3 Years)	Long Term (~5 Years)
Generate strong risk-adjusted returns annually	Preserve shareholder capital	Generate equity-like returns with less risk over a market cycle

For illustrative purposes only.
Past performance is not a reliable indicator of future performance.
*Investment Objective, as of the most recent Prospectus: The fund seeks long-term capital appreciation by investing primarily in common stocks. It may also hold fixed income and other securities to help preserve principal value.
The Fund is currently closed to new accounts other than investors whose accounts meet certain criteria. See Prospectus for additional detail.

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decisions reflect our view of the relative valuation and return potential in different asset classes and individual securities, as opposed to making a nuanced call on the macroeconomic outlook.

We often lean against the crowd, which tends to fixate on present conditions and assume that they will continue. But the past 40 years demonstrate that the economy and markets tend to revert to the mean. In other words, whether times are good or bad, they don't stay that way forever.

How do we try to exploit this inefficiency? When conditions are good, people want to own cyclical businesses that exhibit greater sensitivity to the economy. That's when we're usually going against the grain by buying names in defensive industries. When people want to own defensive stocks because of fears about weakness in the economy and markets, we're usually buying cyclicals.

At the end of the second quarter, stocks appeared somewhere between fair value and slightly overvalued, in our estimation. With valuations and earnings estimates looking a bit high, we think the implied five-year return for the stock market could be modestly lower.[1]

Utilities and health care stocks strike us as relatively appealing. These sectors lagged in the first half of 2023 and contain some high-quality companies that look compelling on a risk-adjusted basis, particularly if earnings expectations for the broader market were to prove too optimistic this year or in 2024.

Fixed income offers good value, in our view, especially the high yield segment. However, selectivity is critical. We favor issuers backed by quality businesses that we believe can meet their obligations even in extremely challenging scenarios.

Although we had a neutral view on the market six months into 2023, we have the flexibility and willingness to adjust our allocations to stocks, bonds, and cash when extremes in valuation and sentiment appear to create dislocations.

We aim to reduce risk when we think the market might be near the top of its cycle. Then, we try to go all in on stocks and other risk assets toward the bottom of a cycle, when fear predominates, as we try to make the most of these opportunities.

2. Exploiting Structural and Behavioral Inefficiencies

A big part of our approach is identifying the parts of the market that are likely to contain the greatest number of “fish” that we want to catch: the names that we believe offer the highest odds of generating strong risk-adjusted returns over time. Structural and behavioral inefficiencies in the market tend to keep our favorite “fishing ponds” well stocked.

On the fixed income side, we are finding opportunities in high yield, especially high-quality BB rated[2] bonds and leveraged loans, the latter of which typically feature floating rates that go higher when the Federal Reserve increases borrowing costs.

Insurance companies and other institutions that are big players in the investment-grade market have limited participation in the high yield segment because of capital requirements and other restrictions. Even the common names for high yield securities—non-investment-grade and junk bonds—carry negative connotations.

Yes, the high yield market contains higher-risk credits from companies that we think have flawed business models or cash flows that can be extremely volatile. However, we gravitate toward what we view as the jewels amid the junk: credits where we believe the

[1] **Actual outcomes may differ materially from estimates.**

[2] The credit ratings are provided by Moody's Investors Service, Standard & Poor's and Fitch Ratings. A bond is considered non-investment grade (or high yield) if it has a rating of BB+ or below from Standard & Poor's and Fitch, or Ba1 or below from Moody's.

> Working with our equity and fixed income analysts, who are well-versed in the industries they cover, gives us the conviction to be contrarian.

potential stability of the cash flows generated by the underlying business helps to limit default risk.

Insurance brokerages are one example in the high yield market where we see this dislocation. Elevated debt levels mean that some of these companies have lower credit ratings and offer compelling yields, but these business models historically have not exhibited much volatility.

On the equity side, people often ask whether they should own growth or value stocks. Our view is that the middle—companies that offer the prospect of growth at a reasonable price (GARP)—can generate compelling risk-adjusted returns over the long term. The kind of GARP stocks we favor typically exhibit these qualities:

- A combination of potential dividend yield and annual earnings or cash flow growth that we believe can be 20% or higher than that of the market
- A business model that we believe should result in less earnings volatility
- The prospect of meaningful free cash flow, or the cash that is left over after the expenditures needed to maintain the existing business.

But GARP companies typically don't appeal to growth managers, many of whom want names that are increasing their revenues organically by at least 10% annually. For value-focused managers, these stocks often trade at price-to-earnings ratios that might be outside their comfort zone. And hedge funds tend to favor high-volatility names.

With these large pools of capital biased against GARP companies, we've historically found opportunities to take advantage of what we regard as irrationally low prices for high-quality businesses that should be able to compound in value over time.

3. A Deep Understanding of Individual Industries and Companies

Our process focuses intensely on company analysis and valuations. Working with our equity and fixed income analysts, who are well-versed in the industries they cover, gives us the conviction to be contrarian.

Rigorous research helps us to identify situations where we see the potential to obtain the highest yields possible while limiting the risk of a permanent loss of capital because of a default. It also helps us to understand the factors behind why a stock may be down and whether the cause of that weakness is likely to be temporary or more lasting.

Our team concentrates its equity research efforts on roughly 100 names that we believe have the highest odds of generating strong risk-adjusted returns over time. These companies operate what we view as durable business models and are run by strong managers who we trust to deploy capital in ways that should compound value for patient shareholders. The fund typically holds the 40 to 60 stocks that strike us as offering the best risk/reward proposition at any given time.

Sentiment around these stocks may move around a bit. But these fluctuations do not worry us if the underlying business fundamentals remain sound.

Consider the recent earnings hiccups experienced by one of our holdings that provides products and services essential to creating and producing biologic drugs.

The industry is working through excess inventory in the wake of the coronavirus pandemic. However, the five-year growth story remains compelling, in our view. Regulatory requirements mean that once a drug enters clinical trials, the tools and services involved in their production are unlikely to change. Strong innovation in biopharma has also created robust drug development pipelines that should provide a powerful demand tailwind.

A Closing Word to My Fellow Shareholders

We come to work hungry every day and remain committed to constant improvement as we pursue the fund's three performance goals. The team has expanded over the years, helping us to develop an even deeper understanding of the companies in which we invest. No matter how the market evolves, we look forward to doing our best for you, our clients.

WHAT WE'RE WATCHING NEXT

Electricity infrastructure in the U.S. will change significantly over the coming decade, as the industry seeks to reduce carbon emissions and reinforce the grid against disruptions. Names in the utilities sector strike us as well positioned to benefit from the clean energy transition. As they replace and upgrade critical infrastructure, regulated utilities grow their rate base—that's the net value of the plants, property, and equipment on which they can earn a return. We think that the market does not necessarily appreciate the rate at which some of these companies could grow their cash flows and dividends in the coming years.

Investment Risks:

The value approach to investing carries the risk that the market will not recognize a security's intrinsic value for a long time or that a stock judged to be undervalued may actually be appropriately priced.

Fixed-income securities are subject to credit risk, liquidity risk, call risk, and interest-rate risk. As interest rates rise, bond prices generally fall.

Investments in **high-yield bonds** involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities.

Investments in **bank loans** may at times become difficult to value and highly illiquid; they are subject to credit risk such as nonpayment of principal or interest, and risks of bankruptcy and insolvency.

Health sciences firms are often dependent on government funding and regulation and are vulnerable to product liability lawsuits and competition from low-cost generic product.

There is no assurance that any investment objective will be achieved. Because of the fund's fixed-income holdings or cash position, it may not keep pace in a rapidly rising market.

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ID0006156 (07/2023)
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