



Betting on Secular Change Is Not Just for Growth Investors

Disruption creates risks and opportunities for value strategies.

August 2020

KEY INSIGHTS

- Value stocks have come under pressure as economic uncertainty prompts investors to shorten their time horizon, pile into secular winners, and avoid cyclicals.
- We believe our rigorous fundamental research gives us an edge in identifying where the market's misunderstanding of secular risks could create opportunity.
- We are looking for the most compellingly valued stocks relative to their long-term prospects.

Widespread innovation and the resulting disruptions to many industries are big reasons why value stocks have lagged over the past decade and a half. But a deep understanding of an investment's secular risks,¹ along with a disciplined valuation focus, can give skilled investors an edge in seeking to exploit opportunities created by market dislocations.

The challenges facing value stocks intensified during the first half of the year. In certain sectors, the economic damage stemming from the coronavirus pandemic heaped cyclical² pressures on top of long-standing secular headwinds, many of which stem from technological innovation. The global health crisis also accelerated the adoption of disruptive

technologies—such as e-commerce, streaming media, and cloud-based software that supports remote work. Fear and uncertainty have also meant that investors have favored well-understood growth stories during the recovery rally without regard to valuation.

Near-term headwinds aside, we believe that leveraging our rigorous fundamental research, valuation discipline, and longer time horizon can help us to find investments that offer more ways to outperform than simply betting on a broad-based rotation into value stocks.

Innovation and the Growth-Value Disparity

Value's extended run of relative underperformance since 2005 has



Heather McPherson

Co-Portfolio Manager, Large-Cap Value Fund



John Linehan

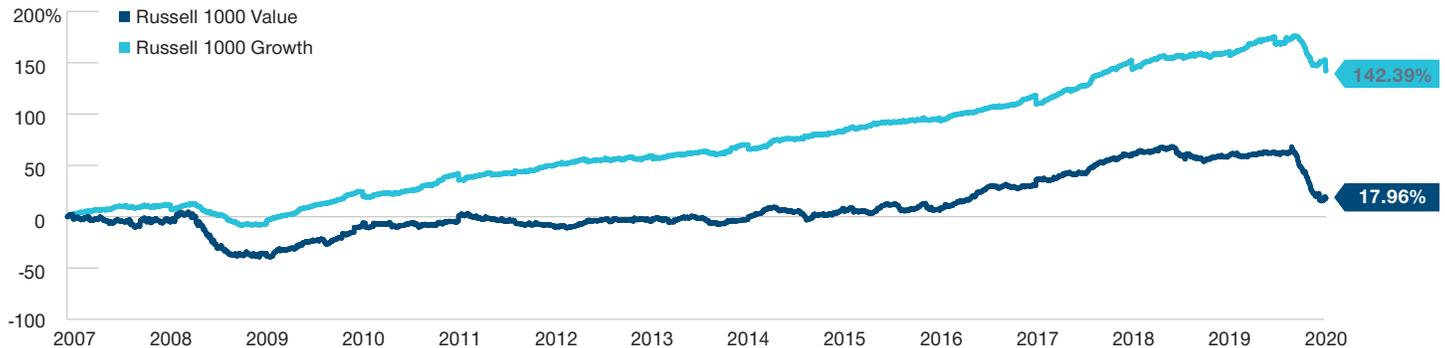
Portfolio Manager, Equity Income Fund

¹ Secular risks are durable changes or trends that a business may face. In some instances, secular developments can be headwinds that present risks to a particular business or industry. In other instances, secular trends may provide a tailwind to a specific company or industry.

² Cyclical risks are temporary headwinds, often related to the economic cycle. Cyclical companies and industries tend to exhibit greater sensitivity to macroeconomic conditions.

Divergent Fundamentals

(Fig. 1) Free cash flow growth for large-cap growth and value stocks



Past performance is not a reliable indicator of future performance.

June 1, 2007, to June 30, 2020.

Source: T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved.

“But fundamentals have mattered less to growth’s outperformance since the onset of the coronavirus pandemic.”

coincided with a period of widespread innovation that has disrupted some industries by siphoning off profit pools or introducing deflationary pressures that compress profit margins. Companies that find themselves on the wrong side of innovation have seen their valuation multiples shrink and, in the worst cases, have priced in legitimate existential risks.

The disparate fortunes of the disruptors and the disrupted help to explain the wide gap in free cash flow growth between value and growth stocks in the Russell 1000 Index. For much of the period, the leading mega-cap growth stocks have earned their relative outperformance.

Economic Uncertainty Amplifies Pressure

But fundamentals have mattered less to growth’s outperformance since the onset of the coronavirus pandemic. The market’s myopic focus on secular growth and an extreme aversion to cyclical risks have contributed to the narrowing in market leadership.

Only one-third of the Russell 1000, for example, outperformed the index over the six months ended June 30, 2020. Or consider that Microsoft,

Apple, Amazon.com, Facebook, and Alphabet (Google’s parent company) together represented more than 21% of the S&P 500 at the end of June and accounted for 480 basis points³ of the index’s year-to-date return through midyear.

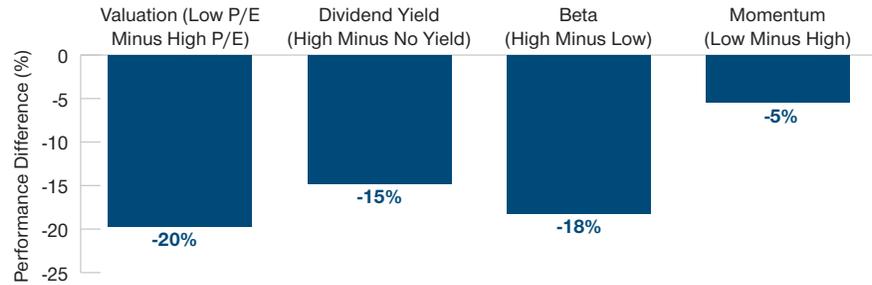
Atypically, value stocks with higher dividend yields have underperformed during this period of risk aversion, likely because extreme economic uncertainty has spurred fears about whether companies would be able to maintain their payouts. In keeping with the market’s bias toward the short term, value names exhibiting lower beta—or less volatility relative to the broader market—outperformed despite what we regarded as overly demanding valuations.

The market’s embrace of secular growers at any cost and reluctance to take on cyclical exposure help to explain why 92% of the stocks in the Russell 1000 Growth Index outperformed the Russell 1000 Value Index over the trailing 12 months ended June 30. This trend has pushed the valuation gap between growth and value equities to the highest level since the early 2000s.

³ A basis point is 0.01 percentage point.

Low Valuation and High Yield Have Been Headwinds

(Fig. 2) Russell 1000 Value Index Factor Performance¹



Past performance is not a reliable indicator of future performance. For illustrative purposes only and not indicative of any specific investment.

December 31, 2019, to July 31, 2020.

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¹ Relative performance of select factors, or the difference between the top and bottom quintiles.

Stocks in the Russell 1000 Value Index are sorted based on each metric noted in the graph and then divided into quintiles. Then, the market capitalization-weighted return for each quintile is calculated. Our graph isolates the difference in returns between the top and bottom quintiles to capture the relative returns for each factor. P/E is the ratio of a stock's price to the consensus estimate of the issuer's earnings per share for the next four quarters. Dividend yield is the most recent dividend payment, annualized and divided by the stock price. Beta measures a stock's volatility relative to a benchmark. Here, the benchmark is the Russell 1000 Value Index. Lower-beta stocks exhibit less volatility relative to the benchmark; higher-beta stocks exhibit more volatility. Momentum is a stock's price performance relative to the Russell 1000 Value Index's performance over the trailing nine months.

How We Manage Secular Risks

We believe that these excesses eventually will unwind or at least moderate, potentially to the benefit of our portfolio holdings in cyclical sectors. However, we are not trying to call the timing of a turn in the growth-value performance cycle, especially a sustainable reversion.

Instead, we remain focused on finding high-quality companies that we think are trading below their intrinsic value, usually because of some shorter-term dislocation that our rigorous fundamental research suggests could be resolved with time. We are not looking for the cheapest stocks; we are looking for the most compellingly valued names relative to their long-term prospects.

One way that we have found attractive investment opportunities is by identifying individual instances where we believe the market misunderstands the potential secular risks a company faces. This approach leverages T. Rowe Price's

global research capabilities in equities and fixed income to develop a robust understanding of an individual company and the durability of its business.

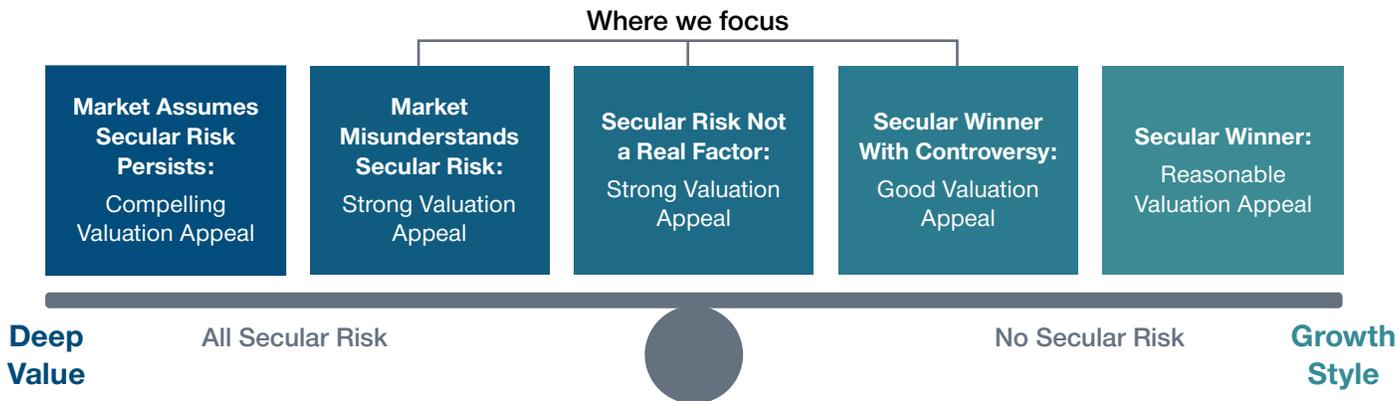
Valuation helps to guide where we focus our efforts. For example, we believe that the financials sector contains many cheap stocks because of concerns about economic weakness resulting from the coronavirus pandemic, the implications for banks' credit quality and insurance claims, and the effect of lower interest rates on their financial results.

But cheap is not enough. In the financials sector, we focus on names where the potential upside depends on idiosyncratic, company-specific factors—cost reductions, for example, or lower credit risk because of business changes implemented in response to the 2008–2009 financial crisis—that could help a stock to upwardly revalue relative to its peers. Here, the potential catalysts for us to realize value go beyond macro factors, such as an improved outlook for the economy or expectations for an uptick in

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Managing Disruption Risk

(Fig. 3) For value investors, balancing secular risk while staying true to style can be challenging.



For illustrative purposes only.

interest rates. At the same time, we seek risk/reward profiles that appear favorable across a variety of business environments.

We are also finding opportunities in areas where we believe that this market has priced cyclical risks as though they are secular, overlooking the potential for improvement in company and industry fundamentals.

For example, our research has increased our conviction in the potential for cost curves to rise throughout the paper and forest products value chain, a development that could support product prices and improve profit margins in the industry. Among other factors, we see paper-for-plastic substitution in packaging as a longer-term catalyst. Real estate investment trust Weyerhaeuser owns timberlands and operates a wood products business. Although near-term cyclical challenges prompted the company to suspend its dividend, we appreciate the the industry's potentially improving demand outlook and possible longer-term tailwinds related to the role

timberlands play in pulling carbon from the atmosphere.

We also pursue opportunities to buy potential secular winners when such companies are facing controversies that create compelling valuations. One such company is Qualcomm. This leading chipmaker could benefit from the global ramp-up in 5G wireless networks but has faced several idiosyncratic challenges in recent years, including legal setbacks that raised questions about its royalty agreements with smartphone handset makers Apple and Samsung Electronics.

In value investing, investment theses take time to come to fruition. We acknowledge that the uncertain macroeconomic environment stemming from the coronavirus could extend some of these timelines. Nevertheless, we are confident that our rigorous fundamental research and longer time horizon should eventually unlock value provided conditions normalize and the market becomes more discriminating.

Securities mentioned in this material comprised the following percentages of the Large Cap Value Fund-I Class as of 6/30/20: Microsoft 2.82%, Weyerhaeuser 1.56%, and Qualcomm 2.53%. Apple, Amazon.com, Facebook, Alphabet, and Samsung Electronics were not held in the fund as of 6/30/20. Securities mentioned in this material comprised the following percentages of the Equity Income Fund as of 6/30/20: Microsoft 1.52%, Weyerhaeuser 1.48%, and Qualcomm 2.96%. Apple, Amazon.com, Facebook, Alphabet, and Samsung Electronics were not held in the fund as of 6/30/20.

The Institutional Large-Cap Value Fund changed its name to Large-Cap Value Fund and designated all outstanding shares as I Class as of May 1, 2020.

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