T. Rowe Price

TCAF one-year anniversary reflections

June 2024

Key Insights

- David Giroux and his team marked their first anniversary of managing the T. Rowe Price Capital Appreciation Equity ETF, during which they navigated an uncertain macroeconomic backdrop and an incredible AI-led rally in stocks to set new highs several times over the year.
- Against a backdrop of narrow leadership and high-momentum stocks owning a disproportionate amount of the market's rise, the team remained committed to its disciplined investment process and a tilt toward growth at a reasonable price (GARP) and quality.
- Giroux says his team's fundamental research process allowed them to narrow the investment universe of large-cap U.S. companies to a more focused, higher-quality portfolio with a long-term orientation.

David Giroux, CFA
Fund Manager, Capital Appreciation Equity ETF, Head of Investment Strategy and Chief Investment Officer, T. Rowe Price Investment Management

The Capital Appreciation Equity ETF (TCAF) incepted on June 14, 2023, reaching its one-year anniversary on June 14, 2024. The fund seeks to outperform the S&P 500 Index, deliver lower risk than the S&P 500 Index, and provide better tax efficiency than a passive S&P 500 Index strategy. The fund employs a bottom-up approach to narrow the U.S. large-cap universe by seeking to avoid companies that are poor capital allocators, overly expensive, secularly challenged, and/or unlikely to generate strong risk-adjusted returns. This process yields around 125 companies that fit the fund's investment profile, which we then narrow to a portfolio of about 100 names.

In this Q&A, Portfolio Manager David Giroux reflects on his first year managing the Capital Appreciation Equity ETF.

Market expectations have shifted pretty remarkably over the last 12 months, from hard landing fears to expectations for six rate cuts from the Fed in 2024 to uncertainty over whether cuts will materialize at all. How have you handled this uncertainty?

In 2023, markets really soared for two reasons: artificial intelligence (AI), and a total reversal in the macroeconomic and stock market consensus. It's hard to believe now, but entering 2023 almost every economist, strategist, investor, and CEO seemed to think that we were destined to go into a recession. At the start of 2023, growth stocks were dead and it was a new regime in which a recession was inevitable. By the end of 2023, growth stocks were back in vogue and the consensus had reversed. Corporate earnings had remained strong and inflation pressures had receded, and the pendulum of market expectations swung hard away from a recession and heavily favored a soft landing and imminent cuts.

In January 2024, I voiced my skepticism about the new consensus. Looking at the last 12 months within the S&P 500, high-beta stocks outperformed low-beta stocks by 40%,[1] significantly higher than the long-term average.[2] In other words, this recent rally was driven by a willingness to embrace risk. This environment wasn't particularly favorable for our fund, which has been constructed to

[1] For the trailing 12-month period ended June 14, 2024, high-beta stocks returned 53.50%, compared with a return of 13.41% for low-beta stocks. Source: T. Rowe Price. **Past performance is not a reliable indicator of future performance.**
[2] Beta measures the volatility of a security or portfolio relative to an index. A beta of less than 1 means lower volatility than the index; more than 1 means higher volatility.

Performance table

(Fig. 1)

		Cumulative		
		12/31/2023–3/31/2024	Since Inception–3/31/2024	Since Inception–6/14/2024
Capital Appreciation Equity ETF	NAV	9.72%	21.32%	25.37%
Capital Appreciation Equity ETF	Market Price	9.41	21.23	25.45
S&P 500 Index		10.56	21.63	26.12

As of June 14, 2024.
Figures shown in U.S. dollars.
Performance data quoted represent past performance and do not guarantee future results; current performance may be higher or lower than performance quoted. Investment returns and principal value will fluctuate and shares, when sold, may be worth more or less than their original cost. Market returns are based on the midpoint of the bid/ask spread of 4 p.m. ET and do not represent returns an investor would receive if shares were traded at other times. To obtain the most recent month-end performance, visit troweprice.com. The fund's gross expense ratio as reported in the most recent prospectuses was 0.31%.

be structurally 3% to 6% lower beta than the S&P 500, in keeping with our goal of taking on less risk than the broader market. When enthusiasm wavers and an emphasis on corporate fundamentals comes back into focus, we are confident that our long-established process, philosophy, and framework will work in our favor.

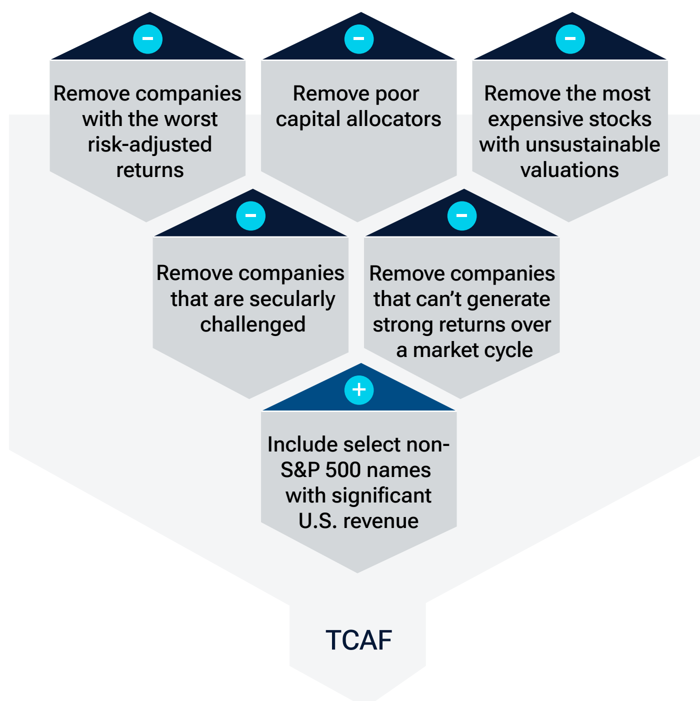
As a portfolio manager, it is really hard to invest against the grain. It is really hard to buy cyclicals when everyone says we are going into a recession. It is really hard to buy utilities when everyone thinks rates are going higher. It is really hard to buy stocks as they are going down every day, and just as hard to sit out a rally when we see the underpinnings are shaky. However, this is one of the greatest market inefficiencies that we can exploit. Time and time again, by taking a longer view than the market, by focusing on trying to maximize returns over the next five years as opposed to the next five minutes, five hours, or five days, we believe we can create shareholder value by investing against the macroeconomic consensus.

The Capital Appreciation Equity ETF invests in a larger number of companies than the Capital Appreciation Fund, which you also manage. How do you arrive at the ETF's investment universe, and what accounts for the difference between the two?

One thing I would highlight up front is that the equity investment universe for the ETF is actually not materially different from that of the Capital Appreciation Fund.[3] We start with the 500 companies that make up the S&P 500 and then eliminate all of the companies that have one or more of what we consider fatal flaws. These flaws reduce their odds of outperformance over the short term and reduce the odds even further over the long term. These flaws include poor capital allocation, inferior management, extreme valuations, and exposure to secular risk.

How do we get from the S&P 500 to 100 stocks?

(Fig. 2)



The result:

- Portfolio optimized for risk-adjusted return potential, possibility of outperformance, and magnitude of long-term outperformance potential.
- Approximately 100 names that are significantly overweight GARP and quality, with excellent risk-adjusted return potential.

[3] By prospectus, the Capital Appreciation Equity ETF seeks to maintain approximately 100 securities in the portfolio. The actual number of holdings within the fund may fluctuate over time.

By identifying these flaws, we remove around 375 of the 500 companies in the index, and we look at the remaining 125 or so companies as the investible Capital Appreciation universe. The next step of our portfolio construction process is to optimize the portfolio to align with each fund's objectives and risk tolerance. For the Capital Appreciation Fund, this yields a fairly concentrated equity allocation of 50 to 70 names. For the Capital Appreciation Equity ETF, we arrive at a larger, all-equity portfolio of about 100 names. Both portfolios have a quality tilt, are significantly overweight GARP, and are filled with names that offer attractive risk-adjusted returns.

The Capital Appreciation suite has really grown in the past year as well. You launched not only the ETF, but also the Capital Appreciation and Income Fund shortly thereafter. What's changed since you started managing these additional strategies?

When I think about the Capital Appreciation Fund, I think it's a highly differentiated strategy that historically has delivered on its objectives over the long term to the benefit of our investors. We've always thought about delivering new strategies that could have a positive impact for different segments of investors, with two clear caveats:

- Any new strategy couldn't hurt the Capital Appreciation Fund or its shareholders in any way.
- Any new strategy would need to be a highly differentiated portfolio that solves a problem in a way that lets it clearly stand out in the market.

With the Capital Appreciation Equity ETF, I think we've built a portfolio that may be a good option for investors looking for U.S. large-cap exposure. Our value proposition is seeking to outperform the S&P 500 with less risk and better tax efficiency than S&P 500 Index ETFs, and I think that's a really compelling opportunity. Our ETF addresses a need for investors looking for higher equity exposure, while our Capital Appreciation and Income Fund is designed for investors with a greater emphasis on current income and capital preservation without sacrificing the potential for growth.

Early indications are that the needs for these funds are real. In the year since we launched the ETF, we've seen really incredible flows and interest, which helped propel assets under management to more than USD 1.5 billion.[4] That growth has made it the fastest-growing ETF that T. Rowe Price has ever offered. When I look at the suite now, I'm excited to be able to bring our experience and investment capabilities to a much wider spectrum of investors than we had with the Capital Appreciation Fund alone.

1.5 B

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Has expanding your offerings been a challenge for the team?

I've actually found the opposite to be the case. I mentioned before that one of our key requirements for new strategies was to do no harm to the Capital Appreciation Fund and its investors. What I've found is that adding these new strategies has been additive for our process and our investment professionals across each portfolio.

Part of our long-standing investment process has been to devote significant time and energy to deep dives into specific industries or strategic opportunities for our portfolio. Some recent examples include the deep dives we did to try to understand the impact of the coronavirus pandemic in early 2020 or, more recently, to evaluate the impact and potential of AI. Now, when we dedicate that time for one strategy, whether it be the Capital Appreciation Fund or the ETF or the Capital Appreciation and Income Fund, the analysis our research yields can benefit both of the other strategies as well.

The investments that we've made in our team, whether it be adding associate portfolio managers and dedicated analysts or building out our research platform and capabilities, have brought us to a place where we are better resourced than ever. The daily collaboration across the team has helped us sharpen our ideas and enhance our research and analysis in ways that we think make each portfolio stronger on its own and each of us as investment professionals better, collectively.

Looking ahead, are there any areas of the market where you are seeing particular opportunities or challenges over the next couple of years?

I mentioned artificial intelligence earlier, and that has clearly been a central theme for markets over the past year. I think AI is going to have a real economic impact over the long term, but I also think the market is overly focused on what I would call the first derivative winners of AI. I'm thinking about semiconductor manufacturers, for example, many of which have seen huge share price

[4] As of June 14, 2024

appreciation. By contrast, we're focused on identifying the second derivative winners in the AI arms race. Software companies, for instance, are uniquely positioned to benefit from AI, not just on the revenue side as they develop tools and services that leverage the power of AI for businesses and consumers, but also on the margin side as AI increases computer programmer productivity and pushes down long-term labor costs.

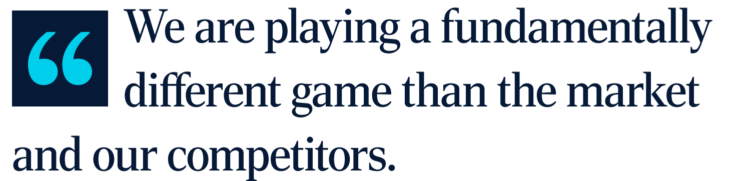
I also really like utilities over the long term. Utilities companies are, in my view, structurally undervalued relative to the S&P 500. Several sector names have been able to grow their earnings faster than they have traditionally, while still also offering attractive dividend yields. These companies don't face pressure from foreign currency risk or international exposure, they don't have secular risks that we see in other market segments like consumer staples or legacy tech, and several have a strong ESG tailwind from their investments in grid modernization and a shift to renewable energy. I also think utilities could be among the second derivative winners from AI. The energy demand for GPUs to power AI is substantial, and growing adoption across a whole range of industries could meaningfully increase usage and revenue for utilities.

Against today's uncertain backdrop, what gives you confidence that you can deliver on the fund's investment objectives?

We are playing a fundamentally different game than the market and our competitors. So much capital is focused on returns and performance over the short term, and you see vast sums chasing momentum and trends. On the other hand, we're focused on meeting our goals and delivering performance over the long term, which allows us to stay focused on fundamental research, follow our analysis, and scrutinize every dollar we invest. So there is this imbalance in objectives in the market, and we think this creates a durable opportunity for investors with a long-term orientation to outperform over time.

We have a strong team of experienced investment professionals and a great culture on our team. Being contrarian investors is part of the DNA of the Capital Appreciation team, and that plays out in our collaboration every day. There are no yes-men or yes-women on our team. Every person is committed to doing the research and analysis to come to the strongest possible ideas, and we aren't afraid to challenge ourselves or each other to do that.

And last, I'd say we have a really strong process that we have developed and refined for years while managing the Capital Appreciation Fund. And that's laid a firm foundation for everything we do for the Capital Appreciation Equity ETF and the Capital Appreciation and Income Fund. We're focused on identifying and exploiting durable market efficiencies in pursuit of our investment objectives, and that commitment holds true no matter how markets shift over the short term.



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