



**PRICE
POINT**

October 2015

Timely intelligence and
analysis for our clients.



Dean Tenerelli
*Portfolio Manager,
European Equity Strategy*

European Equities **A DECADE AT THE HELM—THE LESSONS LEARNED**

EXECUTIVE SUMMARY

On the 10-year anniversary of Dean Tenerelli's stewardship of the T. Rowe Price European Equity strategy, we take time to look back at the highs and lows he has experienced and discuss any key lessons he has learned over this lengthy period.

We shall examine what, if anything, has changed in his approach over the past decade, particularly in response to often volatile, even fraught, market environments—the global financial and euro sovereign debt crises, to name two extreme examples. We also look into the factors underpinning the consistency of his performance over the past decade, and discuss whether or not these remain relevant for the decade ahead.

Over the past 10 years, your performance track record shows remarkably consistent returns. Given the extremes we have seen in market direction, risk and style, to what do you attribute this consistency?

The consistency of the performance comes from diligently focusing on good quality companies. I only invest in what I believe to be high quality businesses that I understand and which have strong management teams in place. If these companies execute on their strategy, selling the products or delivering the services that you expect them to, then the portfolio tends to reflect this and deliver performance in a similar way. Where this focus on company quality is really borne out is during periods of uncertainty, when the market changes direction, for example, or when sentiment turns negative. Time and again it has been proven to me that strong businesses, run by capable management, have the ability to adjust their processes and practices when necessary and effectively adapt to a changing environment. In doing so, they have been able to maintain pricing power, stay competitive and very often emerge from the downturn in an even stronger position.

The zero growth DCF model is effective as it essentially strips out any conjecture about how a company will grow into perpetuity.

Are there any market conditions or periods of the economic cycle that your strategy is particularly well, or poorly, suited to?

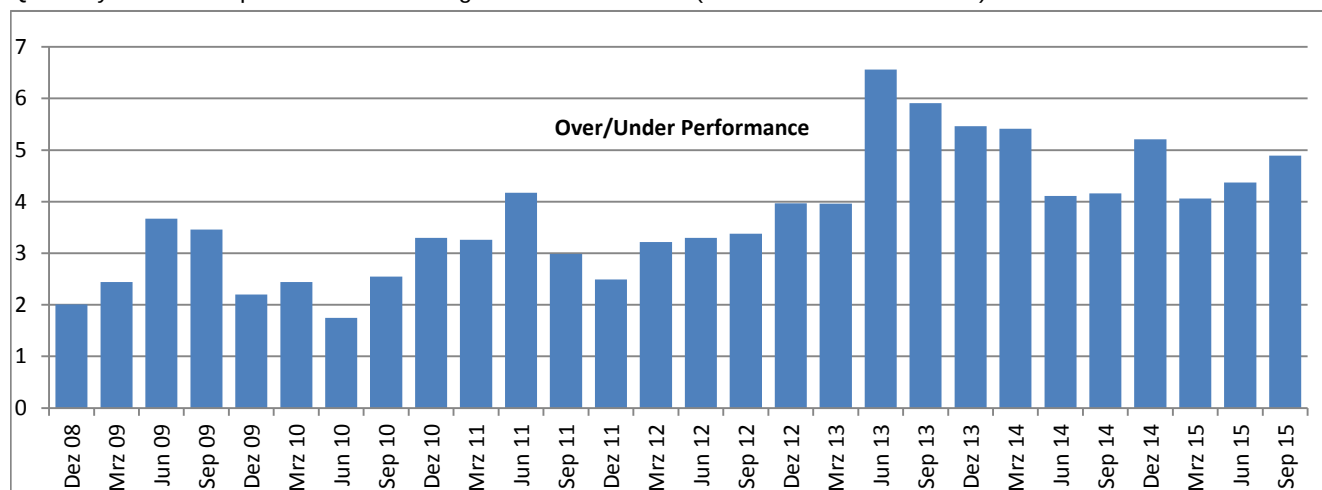
At a broad level, by focusing on company quality and maintaining broad diversity, the portfolio is designed to generate outperformance of the benchmark in a wide range of market environments. As an indication of this, we have achieved positive hit rates in both up and down markets and outperformed in growth and value-style environments (Figure 1). A distinctive feature of the strategy is that it does show a tendency to outperform when the market changes direction. This has a lot to do with the fact that I focus on a zero growth discounted cash flow (DCF) model where I assume zero growth beyond what I believe to be a relatively visible forecast window. This gives a very good steer as to a company's intrinsic value and avoids paying up today for distant and uncertain growth 'potential'. By focusing on this valuation metric, and by being highly disciplined about its application—buying cheap and selling when expensive—I have been able to capitalise on these points of inflection, as markets often tend to overshoot in either direction, creating mis-pricing opportunities, before eventually catching up and correcting.

Figure 1: European strategy outperforms in a range of market environments

As of September 2015

T. Rowe Price Europe Equity Composite vs. MSCI Europe Index

Quarterly Over/Underperformance—Rolling Three-Year Periods (Annualised Gross of Fees)



Has your investment strategy or philosophy changed or evolved over the past decade, perhaps in the face of the various crises Europe has seen during this time?

While the investment strategy has remained largely unchanged over the past decade, I am constantly learning. The market and economic environment is always changing and so, as investors, we are always encountering new and different scenarios. An important lesson learned from the 2010-12 euro sovereign debt crisis was that, even in the most extreme circumstances, the strategy really does hold up. By investing in quality, operationally robust businesses, the majority of our holdings proved relatively resilient throughout the crisis, and in fact a number emerged in even stronger positions. Even in such difficult circumstances, these types of companies have shown willingness, and an ability, to continue to invest in their businesses, to try and develop new products or improve services and so maintain, or even grow, their profitability. In turn, these are the companies that excelled as we emerged from the crisis period.

Are there any specific countries or sectors that have been particularly rewarding over the period in question? Similarly, which sectors or countries have disappointed?

We tend to be fairly fluid with our country and sector allocations, focusing more on individual stocks and adopting a broadly diversified approach to portfolio construction. We are not wedded to any particular country, sector or stock, but rather look to invest in quality companies that appear undervalued and so offer good upside potential. Having said that, Spain has been a very good area of investment for the portfolio in recent years. Just after the peak of the sovereign debt crisis, towards the end of 2012, we began building a large exposure in Spanish companies. Having been massively sold off, we had the opportunity to buy a number of good quality companies at significant discounts, with the purchases notably broad-based; from very defensive regulated utilities (Gas Natural, Enagas) through to more cyclical media companies (Mediaset Espana) and the Spanish stock exchange operator Bolsas y Mercados. The recovery of many of these stocks since purchase has been very beneficial to the portfolio's performance over multiple years.

More recently, I have been adding exposure in the industrials area, buying select stocks that have become relatively cheap in my view. The industrials sector is traditionally an area of strength in Europe, populated by a number of quality, global businesses. I have added two automotive suppliers whose share prices have fallen materially. Both companies have exposure to emerging markets and have been negatively impacted by recent concerns about slowing demand from China, as well as the general turn in sentiment against the automotive sector. This allowed us to buy these quality, industry leading businesses that we have followed for some time, at what look like attractive valuation levels.

Have you learned anything from the way in which the regulatory authorities have responded to the crisis flashpoints we have seen in Europe?

The regulatory authorities, and the actions they have taken in response to the various crises in Europe, have undoubtedly made things more difficult for a number of European companies—the financial sector is the clearest example of this. While the more stringent and onerous controls that have been put in place have undeniably been warranted, and can only make for a stronger system in the long-term, such actions are nevertheless difficult to invest around, creating a great deal of noise and uncertainty. However, more often than not, the regulatory bodies have been very open, transparent and informative about any changes being implemented—it's not really in their interests to not be—so if you are astute and pay close attention, you can hopefully figure out the potential outcomes or ramifications of the regulatory changes. This can present buying opportunities as investors tend to over sell in the face of new rules or structural changes brought on by increased regulation. Of course, even with all the information and transparency you could hope for, sometimes new rules can still throw up a host of unknowns and create uncertainty. The sheer level of increased regulation within the financial sector, for example, makes it a difficult area to invest with any conviction currently.

Getting back to your focus on a zero growth discounted cash flow (DCF) model, what is it about this methodology that makes it such an important indicator of company value for you?

As discussed earlier, the zero growth DCF model is effective as it essentially strips out any conjecture about how a company will grow into perpetuity. Investors and, in turn, markets, can be irrational and prone to sentiment-driven swings that can persist for long periods. Over time, I have come to learn that the zero growth DCF model is an effective way of rising above this market noise, providing good visibility on a company's 'true' valuation in any market environment. When the market is overly optimistic, it helps to keep me from getting caught up in the hype and potentially overpaying today for expected growth into the future. Conversely, an overly pessimistic market backdrop can present an ideal buying environment, with the DCF model providing visibility on undervalued opportunities.

I first started using the zero growth DCF model during the TMT bubble period in the late 1990s. There was so much blind emotion and hype during that time, pushing stock prices ever higher, that it was increasingly difficult to avoid succumbing to the idea that maybe such high valuations were sustainable, despite the lack of fundamental support. This is where adopting the DCF valuation model was pivotal, as it highlighted the potential downside risk associated with TMT stocks. By assuming zero growth, it became abundantly clear just how vast the disconnect with reality had become, with companies appearing grossly overvalued on the basis of wildly optimistic expectations of future growth. The model continues to prove invaluable in terms of highlighting where bubbles in the market might be forming, as well as potential areas of opportunity, drawing attention to stocks or sectors where sound fundamentals are being ignored or overlooked by the market and so not fully reflected in valuations.

Do you consider any other valuation metrics as part of your decision-making process?

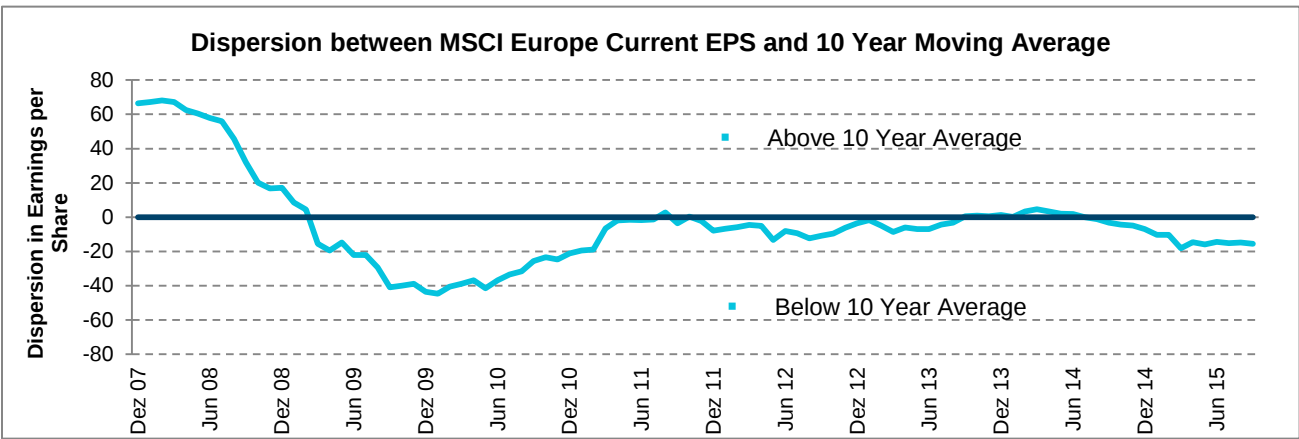
I look at a number of other valuation measures, including P/E ratios, but I don't base any investment decisions on these alone. At the risk of sounding repetitive, over the past decade I have found that the zero growth DCF model provides the best approximation of a company's true valuation, whatever the backdrop, and with this I can then determine whether or not it is currently being under or overvalued by the market. The P/E ratio of a company is usually (though not always) related to the DCF valuation, so it is useful as a means of supporting/confirming the primary DCF investment thesis. In fact, I take this a step further and tend to focus on a cyclically adjusted P/E ratio, given that a company's earnings can be highly variable in the short term. A cyclically adjusted P/E ratio takes a 10-year average of earnings. This addresses one of the main flaws of the basic P/E ratio, removing the potential year-to-year volatility, by capturing a company's reported earnings over a full business cycle.

It seems markets have started discounting economic recovery in Europe. While company valuations may not be as appealing as in recent years, do you feel that there is further upside potential in Europe?

When viewed in simple P/E ratio terms, based on the next 12-months earnings, European valuations are starting to look reasonably full, trading around long-term averages. This reflects the gains we have seen over the past 18 months in Europe as the market has started to price in recovery. However, on a cyclically-adjusted P/E basis, the picture looks quite different, suggesting that valuations remain low relative to long-term average levels, and still some 20% below the peak earnings levels of 2007. I still feel that there is more to come in terms of the recovery in European corporate earnings, which remain below long-term average levels (Figure 2). This suggests that, despite the gains we have seen, there is still scope for further market gains as earnings continue to recover towards more normalised levels. Tempering this expectation, however, is the moderation in global growth that we have seen in recent months. While for some time a growing global economy has been a supportive tailwind, it now represents a negative in terms of corporate earnings prospects, both in Europe and globally. I continue to believe that Europe remains on an improving path, but the potential of that improvement and the speed at which it plays out, now appear more modest because of the slowdown in global growth.

Figure 2: European corporate earnings remain below long-term averages

As of September 2015



Source: T. Rowe Price & MSCI.

In closing, do you expect that the factors you have highlighted will be as relevant over the next 10 years?

Every market environment is different with no way of knowing what to expect. However, if there is one thing I have learned during the past 10 years, it is that market bubbles, investment fads, hot sectors—all of these things come and go, not necessarily quickly, but at some point, the sentiment wanes and market fundamentals reassert themselves. Accordingly, I believe that buying quality companies when they appear undervalued and being disciplined about selling them when they become expensive, will be just as important over the next 10 years, in whatever environment emerges, as they have been during the last decade.

---END BODY CONTENT---

INVEST WITH CONFIDENCE®

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

To learn more, please visit troweprice.com.

Important Information

This material, including any statements, information, data and content contained within it and any materials, information, images, links, graphics or recording provided in conjunction with this material are being furnished by T. Rowe Price for general informational purposes only. The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price. The material does not constitute a distribution, an offer, an invitation, recommendation or solicitation to sell or buy any securities in any jurisdiction. The material has not been reviewed by any regulatory authority in any jurisdiction. The material does not constitute advice of any nature and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. Past performance is not a reliable indicator of future performance. The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The views contained herein are as of September 2015 and may have changed since that time

Australia - Issued in Australia by T. Rowe Price International Ltd (ABN 84 104 852 191), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. T. Rowe Price International Ltd is exempt from the requirement to hold an Australian financial services licence in respect of the financial services it provides in Australia. T. Rowe Price International Ltd is authorised and regulated by the UK Financial Conduct Authority under UK laws, which differ from Australian laws. For Wholesale Clients only.

Canada - Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services. T. Rowe Price (Canada), Inc. is not registered to provide investment management business in all Canadian provinces. The investment management services provided by T. Rowe Price (Canada), Inc. are only available for use by Accredited Investors as defined under National Instrument 45-106 in those provinces where it is able to provide such services.

DIFC - Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA - Issued in the European Economic Area by T. Rowe Price International Limited, 60 Queen Victoria Street, London EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

Hong Kong - Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 21/F, Jardine House, 1 Connaught Place, Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Japan - Issued in Japan by T. Rowe Price International Ltd, Tokyo Branch (KLFB Registration No. 445 (Financial Instruments Service Provider), JIAA Membership No. 011-01162), located at GranTokyo South Tower 7F, 9-2, Marunouchi 1-chome, Chiyoda-ku, Tokyo 100-6607. This material is intended for use by Professional Investors only and may not be disseminated without the prior approval of T. Rowe Price International Ltd, Tokyo Branch.

Singapore - Issued in Singapore by T. Rowe Price Singapore Private Limited, No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Limited is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

Switzerland - Issued in Switzerland by T. Rowe Price (Switzerland) GmbH ("TRPSWISS"), Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

USA - Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

T. ROWE PRICE, INVEST WITH CONFIDENCE and the Bighorn Sheep design are, collectively and/or apart, trademarks or registered trademarks of T. Rowe Price Group, Inc. in the United States, European Union, and other countries. This material is intended for use only in select countries.