MEMORANDUM

DATE: February 2023
TO: State of Delaware Plans Management Board
FROM: CAPTRUST
RE: Fund Recommendation – T. Rowe Price Growth I

Overview

The review below highlights the differences in management, construction, and performance for the current T. Rowe Price Blue Chip Growth I fund, along with two potential alternative recommendations. The review of these fund's emphazies performance over the long-term, and aims to explain how these funds are expected to perform in various market conditions.

T. Rowe Price Blue Chip Growth, the current fund, is a high growth strategy that seeks to outperform the index by overweighting companies with above average market caps and maintaining a persistent overweight within technology stocks. The fund's annualized performance metrics have decreased during 2022 substantially, as the majority of its concentrated portfolio holdings all exhibited increased downside correlation.

JPMorgan Large Cap Growth, is a large cap growth fund that emphazieses stock selection and short-term sector positioning as the primary drivers of portfolio returns. The fund has concentration risks that are inline with category peers, and management has shown a proclivity for outperforming in various market conditions (including strong risk-on years such 2020 and downside exposure years such as 2018 and 2022). At times the portfolio will dip into smaller market cap companies when opportunities arise, though sector exposure is mostly kept inline with its benchmark.

Harbor Capital Appreciation, is also a high growth strategy, however, they do not exhibit the same level of concentration risk as T.Rowe Blue Chip Growth, preferring to gain its edge over the index through persistent sector overweights (namely technology and consumer discretionary). This strategy underperformed during 2022 which has impacted its near term performance history, however, it offers a more diversified portfolio with better downside protection than the current fund option.

Current Fund: T. Rowe Price Blue Chip Groweth

Management:

Despite only taking over this strategy in October of 2021, Paul Greene leads an experienced team that prioritizes a long-term approach, which builds upon the foundation laid by previous portfolio manager, Larry J. Puglia, over several decades. Greene's association with the strategy began in January of 2020, during which time he served as an associate manager. His prior knowledge of many of the strategy's key holdings gave him an edge, but he also devoted significant time to expanding his expertise beyond his previous role as an analyst.

Process:

In October 2021, Paul Greene took over as manager for Larry Puglia, and he has largely kept the core principles of his successful predecessor's process intact. Like Puglia, Greene is focused on a company's long-term fundamentals and prefers to anchor the portfolio in more mature businesses with strong economic moats and free cash flow, while also mixing in younger, faster-growing companies that have more upside potential but may also be more volatile. The portfolio's research effort is still powered by stock ratings and insights from T. Rowe's vast analyst team.

However, there have been some notable changes since Greene took over, which contributed to the fund’s heightened risk profile durin 2022. The most significant is the increase in weightings of the portfolio's largest holdings, with Apple's weighting rising from just under 5% in March 2021 to 8.7% in December 2022, Microsoft's doubling to 11.6% of assets, and Alphabet's rising by about 4.5 percentage points to 11.2%. The top 10 holdings now make up 61% of assets, compared to the Russell 1000 Growth benchmark's 40%. This shift reflects Greene's desire to make his highest-conviction bets count.

To achieve this, Greene has also trimmed many small positions (most under 1% of assets) from the portfolio, reducing the name count from over 120 in early 2021 to 77 as of December 2022.

However, other aspects of the portfolio remain consistent, including higher trailing revenue growth rates than the benchmark, lower debt/capital levels, slightly higher price multiples, and a bias towards stocks with wide economic moats. While Greene previously favored Chinese tech and consumer stocks, he has continued Puglia's trend of reducing those positions due to increased regulatory risks.

Performance:

While historically a strong performer compared to its Russell 1000 Growth benchmark and large-growth peers, the strategy has taken a step back since 2019 due to poor stock picks, particularly underweightings in Apple and Tesla, as well as other selections, such as Rivian RIVN and Alibaba, that have negatively impacted the portfolio.

2022 wound up being particuarily painful for the strategy, as a whirlwind of unforeseen events contributed to the worst drawdown in large market cap companies since 2008. Quickly rising interest rates caused many investors to question the sustainability of these high price multiple companies to act as a reliable safe haven, as they often had done during recent periods of market turbulence (such as during 2018 and initially 2020).

Despite this recent performance, the strategy has a much stronger track record during other periods in its long history. For example, over rolling three-year periods since former manager Larry Puglia's start in 1993, the U.S. mutual fund's no-load shares outperformed its average peer 86% of the time and the Russell 1000 Growth 65% of the time.

The strategy's tendency to outperform when the growth factor is in favor and underperform when it is not has been a consistent pattern. While the current market environment coming into 2023 has not been favorable, if it changes, the strategy has the potential to quickly make up lost ground.

Potential Replacement #1: JPMorgan Large Cap Growth

Management:

This strategy benefits from the expertise of Giri Devulapally and a well-established team of co-managers. Devulapally's experience as a technology and communications analyst at T. Rowe Price prior to joining JPMorgan in 2003 aligns well with the tech-heavy focus of this strategy. He became co-manager in August 2004 and lead manager in August 2005, and this portfolio is the only one he manages, indicating his full attention is devoted to it.

Devulapally partners with four sector managers, each of whom brings between eight and 17 years of experience to the team, to construct the portfolio. Although Devulapally has the final say in every decision, the team's recent promotions of Larry Lee, Joseph Wilson, Holly Fleiss, and Robert Maloney to co-managers between 2020 and 2022 reflect their tenures and contributions to the team. Each co-manager has a deep understanding of JPMorgan's investment philosophy and brings extensive experience in their respective sectors to the team.

While the team experiences few personnel departures, the departure of standout consumer analyst Sarah Lassar in 2022 prompted the hiring of Janet King as a replacement. King's 20 years of experience covering consumer stocks make her a capable addition to the team.

Process:

Lead manager Giri Devulapally and his team aim to identify companies with long-term growth and margin expansion opportunities, seeking to invest in potential big winners while avoiding those at risk of notable underperformance. While momentum plays an explicitly large role in the strategy, Devulapally and his team still prioritize competitively positioned companies. The emphasis on positive price momentum often drives shifts in sector allocations and the underlying characteristics of the portfolio. Devulapally believes that a stock's positive price momentum signals further upside potential, but he is also willing to reduce or eliminate a stock if momentum weakens, even if the fundamental thesis remains strong, showing a willingness to value the market's opinion over his own at times.

The portfolio's sector allocations and underlying characteristics can often differ from the Russell 1000 Growth Index due to the team's emphasis on positive price momentum. For example, the strategy's nearly 10-percentage-point overweighting to technology during 2018 shifted to a 13-percentage-point underweighting as of December 2022 due to the collapse of price momentum and frothy valuations in the sector following the 2020 market rally.

The strategy's valuation metrics relative to its benchmark can also fluctuate. For much of Devulapally's 18-year tenure, the portfolio exhibited high price multiples relative to the index as high-growth stocks led the market higher. However, since early 2021, the portfolio has looked more defensive, aligning with the team's momentum-conscious philosophy. As many high-growth stocks began to roll over in 2021, the team rotated into lower-multiple sectors such as healthcare and energy, which experienced higher positive price momentum during the period. As of December 2022, the portfolio's 18.6 price/earnings ratio and 1.9 price/sales ratio sat well below both the index's 23.2 and 3.0, respectively.

Performance:

The team has successfully outperformed the index during both the 2020 market rally and the 2022 bear market, a rare accomplishment that only 3% of large-growth peers have achieved. Their focus on price momentum proved fruitful, as well-timed moves from sectors, such as technology and consumer cyclicals to healthcare and energy, helped drive performance. Additionally, new positions in healthcare giants, such as Eli Lilly LLY and AbbVie ABBV, helped boost performance during the 2022 market downturn.

However, investors should expect a bumpy ride at times, as the strategy has ranked in the top or bottom quartile of large-growth peers in nine out of 13 calendar years since 2010. The explicit momentum bet of the portfolio increases performance uncertainty, as the portfolio follows the market's tides. Over Devulapally's tenure as lead manager, the strategy's returns had a standard deviation of 17.0 versus its benchmark's 16.1.

From August 2004 through December 2022, the fund's 11.3% annualized return outperformed both the Russell 1000 Growth Index's 10.8% and the average large-growth category peer's 8.8%. Performance has been consistent as well, with the strategy outperforming the index and average category rival 69% and 89% of the time, respectively, in rolling five-year periods under Devulapally.

Potential Replacement #2: Harbor Capital Appreciation

Management:

Firm co-founder Sig Segalas has been a manager since the strategy launched over 50 years ago. Co-manager Michael Del Balso joined Jennison in 1972 and previously served as the team's director of research. Co-heads of growth-equity Blair Boyer and Kathleen McCarragher joined the firm in the 1990s. Natasha Kuhlkin and Rebecca Irwin have been integral to the strategy for longer, becoming managers in 2014 and 2017, respectively.

Kuhlkin has covered consumer- and Internet-focused companies for 18 years at Jennison and nine years before that, making her an expert in the field. Irwin also focuses on those areas and has 24 years of industry experience, 16 of which have been spent at the firm. The firm's collaborative approach is supported by 11 additional growth-focused analysts who average 12 years at Jennison and 20 years in the industry. Analyst departures are infrequent, with just two since 2020 and three additions.

Process:

The managers at subadvisor Jennison Associates seek out market leaders with superior top-line growth prospects and prioritize businesses with healthy financials, strong research and development capabilities, and defensible, if not dominant, franchises. Their rigorous fundamental research is conducted by a talented group of analysts who specialize in hunting for growth stocks, collaborating with the managers and the firm's multi-cap scope to maintain a fresh and thoroughly vetted pipeline of new investment ideas for this large-cap portfolio.

Since 2017, annual portfolio turnover has ranged from 40% to 54%, compared to about 32% to 45% for the large-growth Morningstar Category median. However, turnover by name generally stays lower. The strategy continuously holds some stocks for nearly a decade while trading around others more frequently.

The managers' selections are driven by the analyst team's bottom-up research. As of December 2022, the portfolio is concentrated with 55 names in a few key growth-oriented sectors, with technology, communication services, and consumer cyclicals accounting for 67% of its assets. Its consumer cyclicals overweighting has been the most persistent, with a heavy presence in that sector by 3-11 percentage points since mid-2017, and nearly 10 points in December.

The managers allocate the strategy's assets across individual positions that can deviate substantially from the index. For example, its 7.1% stake in electric-vehicle maker Tesla TSLA is its biggest overweighting in December, nearly 4 percentage points larger than the benchmark's share, while its 6.9% position in benchmark-bellwether Apple AAPL is roughly 5 percentage points below the index's weight.

Performance:

Although Harbor Capital Appreciation has generally outperformed most of its large-growth peers over the long term, it has struggled in recent months and underperformed the Russell 1000 Growth Index. Over the past 15 years, the fund's institutional shares returned an annualized gain of 9.42% through December 2022, which was 100 basis points higher than the category average. The fund's performance during market rallies, including 2009, 2013, 2017, and 2020, has generally been strong, with the fund beating the benchmark by a significant margin in 2020 thanks to its large exposure to Tesla. However, the fund has tended to fare worse than its benchmark during market downturns, with its returns dropping more than the index in eight of the 13 downturns of 10% or more over the past 15 years.

Conclusion

T.Rowe Blue Chip Price was originally selected during a period of time where the top performing large cap growth managers were heavily overweighting widely held index names. At the same time, overweighting high price multiples within the technology space led to consistent outperformance. 2022 has shown the vulnerability of this type of strategy, however, and our recommendation is to move away from this type of concentration risk as market volatitility and uncertainty continues to loom on the horizion.

JPMorgan Large Cap Growth is our primary recommendation, as the fund has shown outperformance in various market conditions, and the ability to rapidly adapt to shifting market dynamics. Historically it has had more exposure to active management risk, with higher volatility, and the potential to underperform when growth orientated sectors (technology, consusmer cyclical) outperform heavily. These periods of underperformance have been short-lived, however, as the strategy is able to reposition during these periods of misalignment with the broader market.

Harbor Capital Appreciation is an additional consideration for a portfolio that is similar in philosophy to T.Rowe Price Blue Chip growth. If the committee wanted to retain a fund with high growth exposure and persistent risk-on sector overweights, our recommendation would shift towards Harbor Capital Appreciation. Given that this is a retirement plan, however, our team leans more towards a strategy that can adapt to volatile markets, and not just attempt to wait them out.