

TRANSCRIPT

## Weather the Storms of Volatility with An Active Approach

*Presenters: Christopher P. Brown, Ryan S. Hedrick, and Christopher Dillon*

**CHRISTOPHER DILLON:** Thank you for joining our webinar to discuss what's happening in the market today. If you aren't familiar with T.Rowe Price as a global, we are a global investment management firm with \$1.3 trillion in assets under management. We are focused on helping investors achieve more confident futures by providing the best risk-adjusted returns we can find in the global investment marketplace.

[00:00:21.39] I'm Chris Dillon, an investment specialist, covering global capital markets. And today, I'm thrilled to introduce two panelists to discuss this presentation, weather the storms of volatility with an active approach. I've got fixed income portfolio management expertise, long-tenured investment professional, I'm going to welcome, Chris Brown, the head of the Securitized Products Team for the Fixed Income Division at T. Rowe Price. [00:00:45.78] Chris also co-manages the total return bond strategy for T. Rowe Price and also represents Core Plus Bond Strategies as well. That's been experienced going all the way back to 2000, joining T. Rowe Price 2005, great academic background, investment experience. Chris Brown, thank you so much for joining today.

**CHRISTOPHER BROWN:** Thank you, Chris. Happy to be here.

**DILLION:** Brian Hedrick, representing active management from the equity side at T. Rowe Price, incoming portfolio manager for US Value Equity Strategy, which includes the T. Rowe Price value fund. Ryan, your investment experience goes back to 2004, then with T. Rowe Price since 2013, been an associate portfolio manager for our value strategies for the past three years.

[00:01:32.33] Interesting in your educational background-- electrical engineering and then going on to further your education, MBA from Columbia Business School, and joining T. Rowe Price, as we mentioned, 2013. Ryan, a lot going on with you, stepping into new responsibilities from the value portfolio management side. Thank you so much for joining today.

**RYAN HEDRICK:** Hi, Chris. Good to be with you.

**DILLION:** Thanks, Ryan. So today, as mentioned, we are going to discuss what is a volatile and uncertain investment environment from three perspectives. We have left an environment, where just owning the S&P 500, provided annualized investment returns of 17%. If you stepped into the markets in the spring of 2009 and just stayed the course and own the S&P 500, just owning

the S&P 500 and taking that ride, you were earning 17% per year, which is remarkable.

[00:02:47.00] We've stepped into a more, I guess, we'll call it gray investment landscaping or investment landscape. And against that backdrop, we'll phrase this or frame this up as good old-fashioned stock picking is back. We will spend time discussing the difference between value and growth stocks today. We will also look at interest rates and the investment opportunity that exists in today's fixed income markets.

[00:03:10.79] There's much to discuss, not much time to do it. We also want to get to questions. Let's jump right in. Ryan, let's start with you. Remarkably, even with a global pandemic, an additional wall of worry highlighted here in slide 3, S&P 500 is up well over 90% since March 23, 2020. During this stretch, it has gone back and forth between value versus growth.

[00:03:33.74] And now, as highlighted, there are many reasons to be cautious as an investor. Ryan, as a former equity analyst, and now value portfolio manager, you're the perfect person to be discussing this gray investment environment. Ryan, how do you see the current equity investment environment?

**HEDRICK:** Chris, thanks for the question. I really see a lot of what I call crosswinds in the economy in the markets. We've all seen a lot of stress in the global economy in the last couple of years. We felt it in our personal lives. The pandemic, in short, really, to me, has strained the normal functioning economy.

[00:04:07.76] We've seen supply chain shortages. We've seen tight labor markets.

There's been changes that are bordering structural in our working and personal lives. There's been a significant human cost to the pandemic as well. I would say that those stresses have been met with overwhelming fiscal and monetary stimulus, as governments have responded to the uncertainty.

[00:04:28.46] And it's certainly led to higher inflation. We're currently, probably, the highest levels in 40 years right now. My take on that is the stimulus increased demand at a time when supply couldn't respond adequately. And we've seen the Russian invasion of Ukraine exacerbate some of this with higher food and energy prices.

[00:04:48.72] The response function to higher inflation, of course, has been at the Federal Reserve, and other central banks are beginning to hike interest rates aggressively. They're beginning to unwind the positions of their balance

sheets. We saw the Fed balance sheet grow by almost \$5 trillion during the pandemic.

[00:05:03.80] I would say that it's certainly untested what happens as we go through this period, as we start to moderate the balance sheet, and that's probably going to accelerate in the coming years. If we shift gears and talk about the economy, we're starting to see some of the effects of inflation in monetary policy weigh on the economic backdrop.

[00:05:22.43] Higher rates are beginning to curtail housing activity. Stocks and bonds have repriced in response. The consumer appears to be pulling back and trading down somewhat. Industrial activities is slowing. Despite the signs of slowing, the labor markets are still exceptionally tight, and that does pressure somewhat of the Fed's ability to respond.

[00:05:43.50] We're seeing meaningful wage growth, nonetheless. And unemployment's are sitting at 50-year lows, which, I think, does pressure some of the leeway that the Fed has. As companies are raising prices to catch up, consumers are responding in turn to higher prices, and we have got somewhat lesser demand, if you will.

[00:06:04.34] I think that breeds the chance of a profits recession. We've seen margins that, 30 or 40-year highs relative to the GDP levels, and I think that that's potentially going to have some consequences. When we look at some of the other areas outside the economy, there certainly geopolitical tension as well.

[00:06:26.34] We all read in the daily headlines the invasion of Ukraine. There's been a very direct impact on the agricultural commodities. There's been somewhat hidden impact on the fertilizer sector. There's a tremendous amount of ammonia that flows through a Ukrainian pipeline that's been disrupted.

[00:06:44.31] We've also seen very severe but indirect effects on the price of natural gas in Europe. If you had to look at the price of natural gas in Europe, it's about \$350 a barrel equivalent, which is really unprecedented compared to oil at around 100 today. That certainly caused countries around the world to scramble for more natural gas and substitutes, like coal.

[00:07:07.11] There's tension in the Taiwan Strait that we see more recently. Taiwan is obviously a substantial supplier of semiconductors. They're integral to the digital economy. I think companies are starting to think much more holistically

about their supply chains. The era of just in time inventory might be subsiding. We're going to see more of a holistic view around resiliency.

[00:07:27.57] But that's all in response to, perhaps, some of these geopolitical tensions. So I would summarize. I think we face a lot of uncertainty. It's more than usual at the moment. If you put all this together, I see a growing risk to the cyclical picture. I'll talk in a few minutes about how we're managing the portfolio in the value funds in light of this backdrop. But I would say it's premature to sound the all clear sign, even though some prices are somewhat lower.

**DILLON:** Brian, that last part-- Ryan, I'm sorry. That last part that you mentioned about we're going to come back and we're going to revisit some of those themes in your portfolio. But then, also, some of those themes in your portfolio, relative to stocks, it's going to be an interesting part of the conversation. One takeaway I just had just hearing your backdrop, macro matters here, but there's also the bottom up side here. We're going to get the bottom up. We just got the top down. Thanks so much, Ryan, to start this conversation.

**HEDRICK:** Sure. Chris Brown, let's get you into this conversation. It's needless to say, it's interesting in equity markets, but it's also extremely interesting in fixed income markets. For myself, client meetings, having discussions, a lot of the conversation has been around the two-year US Treasury yield. If you look at the two-year US Treasury yield, look at history, gives you a good approximation of where the Federal Reserve is going with monetary policy.

[00:08:45.90] Chris, I mean, we started the year with the two-year Treasury yielding just 0.7%. And as I look at the tape right now and be interesting to get your take, that two-year Treasury yield has gone from 70 basis points all the way out to 3.37 or north of 3.3%. It is a remarkable move. Meanwhile, 10-year US Treasury yield is just above 3%.

[00:09:08.76] Meaning, the two-year yielding more than the 10 year. That's unusual. Add it up, this is far from a normal fixed income investment environment. Chris, you as a fixed income portfolio manager and active portfolio manager, in this unusual environment, what are the opportunities? If you could walk us through some of that.

**BROWN:** Yeah, thank you, Chris. You're absolutely right. I think Ryan did a great job laying out all the various challenges that we're facing right now in markets,



broadly, not just fixed income or just equity. In terms of fixed income, we think a lot about monetary policy. And it's been a historic shift in monetary policy, both the amount, but importantly, how quickly the Fed has tightened policy via their rate hikes.

[00:09:57.09] And also, don't forget balance sheet reductions, which started a few months ago. In my world, it's really made it a year for the ages. We all know that inflation is the primary culprit here. It's proven not to be transitory, which is a word I'm guessing that Jay Powell wishes he never used. It's gone higher and lasted longer than many expected.

[00:10:19.78] And aggressive Fed tightening has meant much higher rates in a very short period of time. So those two things are really important, not just higher rates, but how quickly it's all happened. However, when you consider the impact this has had on markets, in my mind, the more important metric is not necessarily the level of Treasury yields, but the volatility of Treasury yields. Basically, what that means is how much yields have jumped around.

[00:10:45.40] Now, remember, the foundation of all financial markets, in my opinion-- stocks, credit, currencies, even commodities, I'd say, is the US Treasury market. US Treasury yields are the foundation of what is used by investors of

all types to price risk. And when yields have a lot of volatility, they really upset the apple cart in a major way, and it makes it much more difficult and adds much more uncertainty to pricing risk in financial markets.

[00:11:12.43] And therefore, it leads to volatility in other markets, too. So the interesting thing about yield volatility, this year, is not only how high it's gone, but how long it's lasted. We've seen spikes before. We typically see spikes in volatility when you have times of crisis. But usually, they subside quite quickly, and that hasn't been so much the case this year.

[00:11:35.95] Also, and I'd say relatedly, the typical correlation between US treasuries and risky assets, like equities, has been less reliable this year. Usually, when prices go down in equities, you'd expect bond prices to go up or yields to go down. Not so much this year, at least not all the time. So why? I mean, again, we all know that inflation has made this environment a much different beast.

[00:12:00.37] So all of this is the bad news, right? But I think there's good news, too. And the good news is, first of all, there's now value in owning fixed income, more value than there's been in some time. So if you look at the average yield of the 10-year Treasury back the last 20-plus years, it's been roughly 3.2%, and that's roughly where we are today.

[00:12:23.22] So yields have normalized. Second, as the narrative shifts from inflation to the impact that Fed tightening is having on economic growth, which I think it will and probably soon, if not, if it hasn't started shifting that way already, the traditional diversification properties of fixed income will, I believe, re-establish themselves. And then, third, as you mentioned, Chris, opportunity.

[00:12:50.18] It's opened up some really good opportunities for active fixed income managers. So in various areas of active management, actively managing duration or interest rate exposure, not just in the US, but globally, active sector rotation, active currency management, and, of course, our bread and butter here at T. Rowe, active bottom-up security selection. It's really a target-rich environment right now. And I think being active is extremely important right now. Things are moving so quickly. As an investor, you really need to be nimble.

**DILLON:** Thanks, Chris. I latched on to a couple of things that you said there. One, this year one for the ages. I latched on to that. It's created investment opportunity. And then, Chris, I think, back to the spring of 2020, and we were less than 1% on a 10-year US Treasury. Now, here we are, around 3% Fed funds hovering where it is now on its way to 3 and 1/2, possibly 4%.

[00:13:51.79] Interesting, again, in fixed income. But the good news, and you've brought it up, that movement from less than 1% on a 10-year Treasury yield to now 3%, a lot of that action has happened. But that obviously deleterious to fixed income investors. That ride, a lot of that painful ride now gone, sets the stage for you.

[00:14:10.03] So great to hear your excitement in fixed income markets right now. Your actions demonstrate active fixed income. Just like stock picking is back, active fixed income also back. And on that line of thinking or in that line of thinking, for our audience, Chris, besides active managers, there are also passive strategies often designed to simply just match an index.

[00:14:32.59] Fixed income investment, simply investment, passive options also exist where you're owning the index. That's also an option. There's also an option to own you, active management, in fixed income. Chris, could you walk us through some of the key differences between active and then that passive fixed income that's more akin often to just the index? Chris, it'd be good to get your thoughts here.

**BROWN:** Yeah, sure, Chris. First of all, I'd say you're right. Passive, as we all know, has become a bigger and bigger part of our markets. And I think as an investor, for me, you ignore it and its influence at your own peril. From an investment standpoint, this means following trends, mostly looking at flows, and passive, and the ETF landscape technicals.

[00:15:19.18] That's become a bigger part of what we do in our day to day because these things can really move markets. But for this audience, I think there are two things I'd warn investors out there about when it comes to passive vehicles. First, they just buy, so fundamental or other analysis is not a consideration. They get cash. They buy to match an index.

[00:15:41.11] So the cynical, so, of course, I'm cynical, could incur-- I'm sorry, it could infer that this has led to allocations of capital, where maybe it isn't deserved, right? Second, fixed income indexes that passive vehicles track are often poorly constructed and inefficient. And it's for a myriad of reasons, but I'll mention a few.

[00:16:04.12] One, they're weighted by the amount of debt outstanding, whether it be a nation or a corporation. The more debt, the higher the weighting in the

index. So the biggest weights are the biggest debtors, and that doesn't seem to make a whole lot of sense for the investor.

[00:16:22.63] Second, standard benchmarks often don't include large portions of the fixed income markets where there's a ton of opportunity. So let's take a look at the Bloomberg US Aggregate Bond index, which you see here on this page, Chris. It's a very common index with a lot of passive money behind it, and it's meant to represent US fixed income markets broadly.

[00:16:44.47] And basically, at the end of the day, as you can see, it's roughly three sectors, right? US treasuries, mortgage-backed securities, investment-grade corporates. And on a market value weighted basis, which is what you see here, it's roughly a third, a third, a third. [00:17:01.57] Now, what you don't see here is if you risk weighted this benchmark, there's basically two types of risk exposures that you're getting. One is duration risk, so duration being sensitivity to rate movements. And then second, you get a little bit of credit risk. And again, what you don't see here is that credit risk comes from just one sector-- investment grade corporate.

[00:17:23.87] So that sounds great. Why is this a problem? Well, it's a problem for two reasons. First, you're missing a huge opportunity set on fixed income. So

large parts of, for example, securitized credit are not represented here. High yield bank loans, large parts of emerging market, debt markets not represented here.

[00:17:44.50] And second, your risk exposures are not well-diversified at all, and diversified risk factors lead to better investment outcomes. So you can see on the left, in the T. Rowe Price Total Return ETF, ticker TOTR, we're able to utilize the full depth breadth of our global research platform to seek out a much broader set of opportunities and construct a well-diversified portfolio that is robust to a lot of different market environments.

[00:18:13.18] We're able to mix in sectors, like you see here, where there's a lot of opportunities-- the sectors I mentioned before. We do this, both structurally, but also tactically, shifting risk exposures when opportunity presents itself. We're able to more actively allocate to more granular parts of the market. So Chris, you mentioned, I think, it was in the-- maybe it was the previous session, but the yield curve.

[00:18:37.13] The yield curve is very flat, so short credit markets. When you have the yield curve this flat, you get a lot of yield in short duration, short maturity credit without taking that much duration risk. So you can overweight that part of the

benchmark. It's a much more efficient place to be if you're active. We're also able to deliver alpha selecting securities through thoughtful analysis rather than just blind buying.

[00:19:04.72] We're able to actively manage duration. All of this is hugely important, especially in dynamic markets like today's, and passive can't deliver this. So ultimately, our goal in the total return ETF is to be the balance that you'd expect from your fixed income allocation, but also to deliver yield above and beyond the benchmark. That's what we're seeking to do. And we think that's a solution that a lot of investors want.

**DILLON:** So Chris, it's one thing to have all of those different bands in this graphic of that investment opportunity and not so many choices in terms of that other more index-like option. We don't need to quote yield here, but there's a couple of hundred basis point extra yield you're able to get in your strategy versus what the index offers.

[00:19:49.60] All of that has been a byproduct of things that have happened this year. Great to get your perspective on that, Chris. And I think the active side of it and having to move in those sectors somewhat, we're going to come back to that theme. But Chris, thanks for that perspective.



[00:20:03.44] Ryan, let's come back to you. We had promised diversification themes in your portfolio stocks. Love this part of the presentation, this questioning. Stock picking is back. We've already stated this is a complex investment environment.

[00:20:18.34] But Ryan, for you, as a portfolio manager, a value portfolio manager, can you please describe some of the diversification themes you have in your portfolio right now? And then also some mention of the stocks embedded within some of those themes. Ryan, it'd be great to hear your thoughts here.

**HEDRICK:** Sure. Thanks for the question. We're always looking for bargains and a value fund. I'd say that there's a few different buckets I'd like to talk about, and it does weave into some of the comments I made earlier. But the first bucket is really the defensive bucket.

[00:20:55.33] The Southern Company is a utility and based in Atlanta. They've got one of the-- they certainly are one of the most defensive stocks in the market in my eyes. It's got above average earnings growth over the next several years as they're completing a nuclear plant. They've been working on for a number of

years. It's a very high quality utility with good regulation. The yield's about 3 and 1/2%, even though it's been a relatively good stock this year.

[00:21:18.46] Republic Service is another example. It's a waste collection company that we view as having a defensive profile and over indexes to having a lot of landfill capacity compared to its peers. We think that's the ultimate source of pricing power comes from. Nobody wants a landfill in their backyard, so it's got a very nice moat around it.

[00:21:37.09] Coca-Cola, another household name. This is a company that I think has a little bit of offense within a defensive sector. The offense comes to the fact that about half their sales are away from home, which were affected in the pandemic. And there's still some recovery opportunity. The yield on this one's attractive at about 2.75%. It's got decent earnings growth.

[00:21:57.40] The next bucket, these are really what I call quality or growth at a reasonable price. We're really looking for good business models with decent growth at reasonable valuations. So I'll go through a couple of examples. The first one is Elevance Health. It recently changed its name. It used to be known as Anthem. It's the largest Blue Shield licensee.

[00:22:18.58] It has about 50% commercial market share in some of their key states, and we think there's a really unique opportunity to replicate that scale in government programs, such as Medicare and Medicaid, and in health care delivery through what's called value-based care. I think there's going to be earnings growth that should be in the teens. It's very reasonably valued against that type of profile. It should be relatively cyclical.

[00:22:43.39] Danaher, this is a company that provides equipment to the biologic drug manufacturers, very unique business. It's the picks and shovels to the biologic revolution. They also do molecular testing for things like the COVID virus. Very attractive long-term revenue tailwinds, compelling business model because they've got a very wide moat, very nice incremental margins, exceptionally well-run company.

[00:23:11.03] Alphabet or Google. We all know this. It's really a digital advertising giant that I consider certainly, almost like a utility, very cash-generative, but it's got some unique options around monetizing YouTube and even some self-driving technology. It's obviously an advertising company. It's cyclical, but it's got a nice moat around it, and it's reasonably valued.

[00:23:33.13] Maybe turning to the last bucket which are cyclicals. This is an area where I do see caution, so I would say that the flavor that we're really looking for are companies with unique franchises that have either long-term tailwinds or some idiosyncratic opportunity. The first one I'll go through is Progressive. We all see the ads on TV, but it's a very advantaged direct marketing company.

[00:23:59.05] Used car pricing has been up quite a bit, and that's pressured their loss severity. They and other auto insurers have been raising prices. As prices go up, consumers tend to shop for new plans. Because Progressive has such a unique moat around their business, they tend to win share early in these pricing cycles.

[00:24:20.95] And then, ultimately, if used car prices fall, I don't think anybody really believes that used car prices are going to remain at elevated levels. They should start to see losses fall, and they have a nice call option from rising interest rates. Wells Fargo, a very large US Bank that's had some regulatory challenges. We've got a new CEO that's been in the sea for a few years.

[00:24:41.73] I think he's making very positive long-term changes. But in the long run, we think it's a franchise, where quality will win eventually, and they have a lot of sensitivity to rising demand for loans in the coming years. I mentioned the dynamic of companies wanting to invest in supply chains. I do think there's

going to be an eventual capital spending boom in the country. And we've certainly seen some of the trends that are a way.

[00:25:03.90] That should benefit loan demand, and Wells Fargo's got a long-term cost opportunity. Eaton, this is an attractive company. They make electrical capital goods. The push for clean energy is a tailwind. They really touch a lot of areas that we're excited about-- renewable energy, I mentioned, data centers, vehicle charging, electrification, greater reliability, just a lot of things that we think have a lot of legs over a multiyear horizon.

[00:25:29.92] Last one is KLA Corp. This is a provider of equipment to the semiconductor manufacturing industry. They have a very high share in an area that helps reduce defects, which is important, given the billions of dollars that are going into new semiconductor plants. The on-shoring of semiconductor manufacturing as a tailwind and also the simply the growing importance of the digital economy means we're going to need a lot of semiconductors for many years to come.

[00:25:54.34] It's a very cyclical area, but it's an advantage company, and it's not very expensive here. So those are the flavors that I would say we're really looking for good bargains. Of all flavors, probably we had a little more of a bias toward

the defensive companies. We always are looking for high quality companies which we think tend to outperform over time. And then, as the opportunity presents itself, we have the ability to shift into more cyclical companies as they merit.

**DILLON:** Ryan, thanks for walking us through the portfolio. Let's not leave this slide just yet. Ryan, have you had a chance to see our previous session. But in that session, we talked about zero price multi-asset getting overweight value in the summer of 2020-- enormous valuation difference between hard charging growth stocks and value. And we rode that trade up until just recently, where we become more neutral value versus growth and potentially seeing more opportunity and growth.

[00:26:47.51] When I say that, though, our investment dollars in our US equities are split about 50/50, value versus growth. I think the one thing I wanted to emphasize is cyclicity and value. If we're flirting with recession, the cyclical nature of your asset class is the cautionary part of it. But you're breaking apart your portfolio and talking about defensive, talking about quality, talking about picks and shovels for the health care space.

[00:27:13.40] People that made money in the gold rush weren't the people going to look for the gold. It was the hardware salesman. Interesting to give you a framework around Danaher that way. But when multi-asset is giving our value dollars, domestically speaking over, Ryan, it's your strategy. So to see these defensive quality and then cyclical components within your portfolio, it is active management we're counting on here. So thanks so much for walking us through your portfolio.

**HEDRICK:** Sure.

**DILLON:** Thank you. Chris Brown, also exciting time and fixed income. You've already talked about that. Many sectors and bonds to choose from, building a portfolio. I will say, in terms of PowerPoint rules, we have violated all of them with this slide. The point of the slide is a lot of investment opportunity for you.

[00:27:59.36] But the other side of it is, it's very rare that one of these subsectors that you can invest in is the leading performer from a year-to-year perspective, which gets back to active management. The opportunity is here. But if you could just walk us through some highlights, Chris, in terms of what we're staring at on this great visual.

**BROWN:** Yeah, sure. Yeah, leave it up to the fixed income guy to complicate things.

But Chris, you did tell me I could include this, so it's my defense. Yeah, there's a lot going on here. I apologize to the audience in advance. This page can certainly give you a headache, but I think it has an important message.

[00:28:36.53] And Chris, you touched on it. In a nutshell, what we show here is meant to illustrate how risk adjusted returns, among fixed income sectors, really vacillate through time. And it shows that things vacillate a lot, right? And this is important for a few reasons, and it really helps to reinforce my previous messaging.

[00:28:58.64] First, this vacillation tells you that a multisector fixed income portfolio should be diversified structurally. It should incorporate the full opportunity set and not put all of its eggs in one or two baskets. So that's the first thing.

[00:29:15.48] Second, again, reinforcing what we've talked about, this vacillation tells you that there's a lot of alpha opportunity in effective, active tactical management. Again, I'll just reinforce. These concepts are foundational to how we manage the total return ETF, and again, so important, but not captured by passive vehicles. So those are the points I'd make about this overly busy slide, Chris.



**DILLON:** And Chris, let me be clear, I didn't mean any offense by what I said about the visual. I was trying to pay you an indirect compliment, but great visual.

**BROWN:** None taken.

**DILLON:** Great, because we want to have this dialogue again. So thanks, Chris. But Chris and Ryan-- so Chris Brown, portfolio manager fixed income total return bond, long tenure here at T. Rowe Price, a lot going on in fixed income. Chris Brown, thanks so much for joining today.

**BROWN:** Thank you. I've enjoyed it.

**DILLON:** Ryan Hedrick, much going on there in the values space. You walked us through those subthemes within your portfolio and then took the extra time to go through stocks that populate those investment themes. You've got a lot on your plate as well. Ryan Hedrick, thank you so much for joining today.

[00:30:32.63] And Fidelity, thank you for hosting our session today. Thank you also for all that joined. I think from our perspective, the takeaway here is investment environment has become gray. Good old-fashioned stock picking is back, along with active fixed income management. Thanks again,

everybody. And Heather, over to you. And before Ryan and Chris walk away, we have some time for questions. Heather, over to you.

End Audio

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