

# INSIGHTS

## INVESTMENT



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## The Right Side of Change

Disruption is often discussed in the context of technology — smaller, faster and increasingly virtual. But the world today is undergoing disruption on many fronts, not just technology. Think energy and health care, for example. So how can investors be on the right side of change? P&I speaks with David Eiswert, Portfolio Manager of T. Rowe Price's Global Focused Growth Equity Strategy, about how he views secular shifts involving change and innovation.

**Q.** *The world has undergone many disruptive changes in the last 10 years. Will the next decade resemble the last one?*

**A.** We have undergone a lot of change, but the disruptions are still relatively immature. Though change will continue and in some ways accelerate, we're going to see more of a social and political response to its consequences.

We've gone from I can't believe I can watch video over broadband — or I can't believe that I can get an Uber or I can't believe that we have all this oil and natural gas — to, what does this mean for society? How do we deal with the consequences of these disruptions that are displacing jobs, putting pressure on communities, concentrating wealth?

**Q.** *Does the market appropriately price disruptive change?*

**A.** The market continues to be quite skeptical around a lot of the disruptive platform companies and their valuations. For most of the companies that we would consider to be on the right side of change, valuations are reasonable. I began my career in 1999 and I saw the tech bubble. I don't think we're anywhere near that kind of market valuation.

The financial media, investors and clients tend to be very focused on this idea of crisis, the crisis around the corner. That's not an environment that usually creates bubbles, although, clearly, these stocks are not cheap.

**Q.** *How are you, as an investor, able to be on the right side of change?*

**A.** Being on the "right side of change" means you're investing in companies that have higher probability of increasing economic returns in the future. You're investing in companies that become more competitive over time, that become stronger, that have a tailwind.

The trouble with identifying those companies is that it requires you to imagine the future. You're studying the future, not trying to quantitatively measure the past or find a quantitative past factor.

And that requires a deep understanding of the compa-

nies. How do you think about brands in the age of Amazon? You're imagining a world where people use voice to shop at home based on things they need in the moment. I ran out of paper towels. You ask the Amazon Alexa voice service to order paper towels.

*The Alexa voice service interrupts: "paper towels."*

*Eiswert: Sorry. Alexa off! Sorry, she is ordering paper towels when I said that.*

*Alexa: I found paper towels. This comes in 24 giant rolls. It's \$24.77 total including tax after a discount of \$4.12. Would you like to buy it?*

*Eiswert: No! I'll put her on mute.*

How does the Alexa voice service disrupt really giant companies that have owned distribution and shelf space in brick-and-mortar retail? If you ask an average person, "Do you think you'll be ordering your staples via a digital voice assistant?" they might say you're crazy.

But for us, who want to be on the right side of change, we ask ourselves, "Well, is that crazy?" What are the dynamics around the adoption of that new technology? What does it mean for the existing business models that are based on brick-and-mortar distribution?

**Q.** *Is the market correctly distinguishing what's on the right side of change and what's not?*

**A.** The market tends to underestimate good and bad things. The market underestimates the right side of change and it underestimates the wrong side of change.

I don't see Google or Facebook or Amazon or Apple as dramatically overvalued stocks. I don't see them as dramatically cheap stocks. At the same time, there are some companies in consumer that are more challenged than the market realizes.

The market lags the future. It's focused on what's happening today.

**Q.** *What are the biggest opportunities?*

**A.** The places where we really see the most dramatic disruption are clearly in the areas of e-commerce and

brick-and-mortar retail. Society and local communities are feeling the pain of this spiraling down of brick-and-mortar retail.

There's dramatic disruption in energy to the point where we're realizing that we have too much energy. And so countries like Russia and Saudi Arabia are starkly facing this challenge and the disruption of the commodity these economies are built on.

In health care, we are consistently seeing innovation that is wonderful for the patient and disruptive to existing markets. We own a Japanese biotech company that has a new drug for hemophiliacs. Existing drugs are being disrupted by a new, cheaper molecule that is dramatically better for patients.

We own a biotech company that has developed a drug that, in essence, cures cystic fibrosis. What does that mean for the ecosystem around people with cystic fibrosis who are treated? It's great for the patient, but it's disruptive for the industry.

We own a company that is working on a whole range of genetic therapies, including a way to genetically modify your immune system to attack cancer, and another company that has tapped into the mass market of custom genetic sequencing and is making it affordable for individuals to understand and decode their genetic makeup.

The biggest opportunities are places where there's the most disruption in legacy business models. You want to be on the right side of the companies doing that disruption, but what about the other side?

**Q.** *Yes, what about the other side?*

**A.** On the other side, the place that's most interesting is around the consumer. This is where the most damage has been inflicted.

You might say the consumer sector has been destroyed because of this idea of e-commerce, this massive convenience and selection introduced by online retailers like Amazon. And then you have social networking that has broken down the barriers of advertising and taste.

Clearly brick-and-mortar retail is suffering from these shifts. What about brands? How does brand work in this world?



## FINDING OPPORTUNITIES IN AN ERA OF RAPID CHANGE

### Examples of Disruptive Change

#### How to pick?

Skill: The ability to quantify change, understand its dimensions, identify companies in favor



#### INTERNET BASED DATA SERVICES

##### POTENTIAL COMPANIES IN FAVOR:

large online retailers or consumer technology companies that can leverage their own data platforms to serve the outsourcing market

##### AT RISK:

older providers of hardware, software, or system integration services for in-house corporate IT departments



#### STREAMING VIDEO

##### POTENTIAL COMPANIES IN FAVOR:

on-demand services that have achieved global scale and can use intensive viewer analytics to identify niche audiences

##### AT RISK:

cable providers or content producers that rely on bundled channels for significant revenues



#### PHARMACEUTICALS

##### POTENTIAL COMPANIES IN FAVOR:

stable biotech firms developing promising therapies and some larger diversified pharmaceutical companies with profitable drugs that are still under patent

##### AT RISK:

firms relying on patent roll-ups and/or acquisition deals to generate revenue growth



#### DIGITAL PAYMENT

##### POTENTIAL COMPANIES IN FAVOR:

web-based payment systems and supporting technology vendors

##### AT RISK:

traditional credit card companies and bank issuers



#### ELECTRIC VEHICLES

##### POTENTIAL COMPANIES IN FAVOR:

startups or existing tech companies that can use the luxury market to scale up production of electric and/or self-driving cars, then leverage that platform to penetrate the mass market

##### AT RISK:

established U.S. automakers and their foreign counterparts

Source: T. Rowe Price.

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There have been a few hot retail brands recently that have had very strong performance over the last two years. So does that mean there's a place to find consumer ideas where the market has thrown the baby out with the bathwater? Where you can find ideas that still have the power of innovation and have this emotional connection with consumers?

That's an area where we are looking. There are names we own in that sector where we think companies are either undergoing a transformation to being a very well-run, multi-brand company, or the business has the power to innovate and to drive its own traffic in wide-open growth opportunities, say in China. We also own an off-price retailer that benefits from excess supply in inventory.

We're using active management to fish in that bucket where being contrarian in consumer is interesting.

**Q.** *What are the implications of today's political, macroeconomic and technological disruptions for active vs. passive investing?*

**A.** A passive strategy is not going to understand when a company is categorized in a negative sector but has a wonderful business model and, over the next three to five years, is going to generate returns for investors. The other side is you have to be able to differentiate companies that are more flawed than others, companies where there's more risk.

It really comes down to not just, are you active or passive? It's, how is your product designed? Can it generate con-

sistent returns over time? Are we running a product that is not replicable by passive investing?

You have to wake up every day and say, am I adding value? Differentiating those companies that are real winners and the companies that are real losers is where you add a lot of value.

**Q.** *Where do you think the current cycle is heading? Is it different from past investment cycles?*

**A.** We are seven years into very good stock market returns and unemployment or nonfarm payrolls are at a level that typically signals lower overall market returns going forward. But this cycle is different in the level of economic growth and investment that we have seen because it's so slow globally.

Disruptions across sectors are shrinking markets, and I think that's something that's really hard for people to grasp. Use the example of music. I have more access to music today than I've ever had. I can pick up my phone and go to YouTube and listen to any song recorded by human beings. That's pretty good. But I don't pay for it. Who's making money?

The sum of these disruptions across the economy is putting pressure on overall growth rates. Where are we in the cycle? Prices should be rising, but what we're getting is that technology is unlocking capacity across the sectors simultaneously and that's keeping pressure down on prices, on growth. So it's why our GDP growth doesn't signal that we're at the end of an investment cycle. Investors

keep waiting for this end to happen and it doesn't happen because of all these different forces.

**Q.** *Tell us about U.S. vs. global in the context of what we've been discussing.*

**A.** Right now, I don't have a strong regional positioning. It's much more bottom-up stock picking.

An important point, though: China really did undergo an incredible stabilization in first-quarter 2016 following the crisis in 2014. China has been great. I have exposure to China.

**Q.** *Why is — or should — your approach be important to plan sponsors, both defined benefit and defined contribution?*

**A.** They should care because they should have a paradigm for why the world is not growing quickly. What's driving that? This disruption across sectors, shrinking industries, concentrating wealth, a disgruntled electorate, an increasing move to populism, winner takes most — what does that mean for the companies you own?

This is not the same old playbook, and if you play by the same old rules, you're exposing yourself to a lot of risk.

The upside is that the opportunity for innovation and to invest has never been better. It's one of the best times to be a stock picker. You just to have to understand — and be on the right side of — change. ■

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