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MONEY MANAGER INTERVIEW

CHRISTOPHER P. BROWN JR.

T. Rowe Price Group, Inc.

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Maximizing Total Returns with a U.S. Multisector Fixed Income Fund

CHRISTOPHER P. BROWN JR., T. ROWE PRICE GROUP, INC.



CHRISTOPHER P. BROWN JR., CFA, is a Vice President of T. Rowe Price Group, Inc., and T. Rowe Price Associates, Inc. He is a Portfolio Manager in the Fixed Income Division and a member of the portfolio strategy team for U.S. taxable strategies. Mr. Brown is also Co-Portfolio Manager of the Total Return Fund. Before assuming his current role, Mr. Brown was an Associate Portfolio Manager on the U.S. Taxable Bond team and a Portfolio Investment Strategist on the Fixed Income Quantitative team. Prior to joining T. Rowe

Price Group, Inc. in 2005, he was employed as a Fixed Income Analyst and Trader by Riggs Investment Advisors, Inc., in Washington, D.C. Prior to that, he was an Investment Analyst for Cambridge Associates LLC in Arlington, Virginia. He earned a B.A. in economics from Washington and Lee University and an MBA from the Robert H. Smith School of Business, University of Maryland. Mr. Brown also has earned the Chartered Financial Analyst designation.

SECTOR — GENERAL INVESTING

(AGV502) TWST: Can you describe your role in the firm and any funds that you manage?

Mr. Brown: I am a Portfolio Manager in the Fixed Income Group at T. Rowe Price, and I have been here for roughly 11 years. A lot of that time I concentrated on the securitized products space, specifically securitized credit. I have recently transitioned into a multisector role, co-managing the Total Return Fund, ticker PTTFX, which is a multisector U.S.-focused fund that we launched in November of 2016 and that I co-manage with Andy McCormick.

TWST: I noticed from your biography that you are a part of the fixed income quantitative team?

Mr. Brown: I am no longer a part of the fixed income quantitative team, but in my analyst days I was a part of the quant research team, and basically what that involved was not only bringing quantitative analysis to the securitized portion of our portfolios, but also working with our quant researchers to bring quantitative analysis to our multisector process. The experience I gained working with quant team has proved invaluable as Andy and I developed the underlying structure of the Total Return Fund.

TWST: Can you describe a little bit more about why the Total Return Fund has come into existence?

Mr. Brown: It is a U.S.-focused multisector fixed income fund, and one of the core tenets behind it is to have higher tracking error or higher volatility relative to the index. The index is the Bloomberg Barclays U.S. Aggregate Bond index. The thinking behind it is that, despite a few tailwinds to rates or headwinds to fixed income returns in general, we think that core fixed income is now and in the future will be a very important part of the broader asset allocation.

But we also acknowledge that it is more difficult to generate returns in the fixed income markets now, so you need to be pretty flexible. And this is one of the fund's core tenets. Whether it's shifting sector exposure or altering duration and curve positioning, being nimble will be important. The fund is not an "unconstrained" fund, but our guidelines give us a lot of room to react to rapidly changing market conditions. As far as our offerings at T. Rowe, in the fixed income U.S.-focused multisector space, this is currently our offering with the highest tracking error. So again, it is meant to have that flexibility to navigate the markets and to maneuver around the benchmark.

TWST: Talk about whether it has any kind of rules that are connected to it and whether it has a desired fixed number of instruments in it at one time.

Mr. Brown: One of the primary rules is to have a maximum of 35% in sub-investment-grade securities. Another

Highlights

Christopher P. Brown Jr. discusses his firm's Total Return Fund, which is a U.S.-focused multisector fixed income fund. One of the core tenets of the strategy is to have a higher tracking error or higher volatility relative to the index, which is the Bloomberg Barclays U.S. Aggregate Bond index. Mr. Brown believes that core fixed income is now and in the future will be a very important part of the broader asset allocation, despite concerns about rising rates.

guardrail, though not really a hard and fast rule, is for duration management, to manage a pretty wide band around the duration of the index. So we look at that as plus or minus 50% of the duration of the index, which equates to a band of roughly plus or minus three years.

“An important part of the strategy is to differentiate ourselves from not only what we already offer, but also some of our peers. One way of doing that is being more benchmark agnostic.”

As far as number of securities we have in the portfolio, we have a wonderful research group here at T. Rowe that we want to take full advantage of. One way to do that is to have a fairly high issue concentration. The portfolio will likely have anywhere from 100 to 300 securities. So versus the Agg index, which contains thousands of issues, it would be considered a fairly concentrated portfolio.

Again, we feel comfortable looking to generate alpha this way given the strength of our research platform. We have over 50 credit and sovereign analysts covering every sector of fixed income globally. They assign a proprietary credit rating to every single credit held in our portfolios. They have a very strong track record of avoiding blowups and adding value. I have a lot of confidence in their work, and this, in turn, is why we feel comfortable taking relatively bigger bets in the portfolio.

TWST: Can you walk us through your investment process?

Mr. Brown: An important part of the strategy is to differentiate ourselves from not only what we already offer, but also some of our peers. One way of doing that is being more benchmark agnostic. When we look at the index, it has some pretty glaring shortcomings. First and foremost is the fact that it's capitalization-weighted. Basically, an issuer's size in the index is determined by how much debt they have issued. More debt earns an issuer a greater weighting. That's not always a great thing.

This methodology also tends to skew the benchmark's underlying risk factors. When you're looking at the Agg index, you are dealing with two main risk factors: duration, or sensitivity to interest rates, and credit default risk, as measured by credit spreads. Depending on your view of interest rates, you may not want to be exposed to the level of duration captured by the benchmark, which in recent years has grown longer and longer. In terms of credit risk, when you look at the benchmark's construction, the benchmark is pretty much dominated by the credit risk associated with investment-grade corporates. According to our analysis, roughly three-quarters of the credit risk of the benchmark comes from one sector: investment-grade corporates.

A core tenet of our strategy is to have a more balanced credit risk profile and spread that risk around a little bit more, have more coming from all the various sectors at our disposal. That means we are on average going to have a higher allocation to securitized products — that includes Agency MBS, and the securitized

credit areas of ABS, CMBS and non-agency mortgage-backed securities. We are likely going to have a lower allocation to investment-grade corporates than the index and more traditional core plus funds. We are going to take a bulk of our corporate exposure in the sub-IG space, so that means high-yield and bank loan markets. Within sub-IG corporate exposure, we are going to be skewed toward bank loans. Not only do we think there are some very attractive structural properties of bank loans, but we have a fantastic staff in our high-yield group that analyzes the bank loan market.

That is the base portfolio framework. Again, it is fairly benchmark-agnostic. When you talk about the tactical process, we are not reinventing the wheel; we are going to follow the process that we use for all of our multisector strategies, which is a very robust process that has been in place for years and that involves a monthly set of strategy meetings. We start with global economics, we move on to global interest rates and currencies, then we have a meeting focused on sector strategy. We then take all that information we have absorbed, and as a portfolio management team, we implement our tactical moves from there.

While our formal process is monthly, which is aimed at generating consistency, managing a portfolio like this will obviously involve a good amount of tactical movements between those monthly meetings. Being tactical will mean using derivatives to gain or reduce exposure to various sectors. When I say derivatives, I don't mean the more complicated versions. We intend to focus on the plain-vanilla derivatives that have very liquid markets. An example of that would be the high-yield CDX synthetic index, which basically allows you to very quickly tweak your sector exposure to the high-yield sector. We want to be flexible and tactical, so those are very liquid instruments that you can use to adjust your sector exposure. Additionally, we're always looking for the best ideas at the security level from our great research staff, and that will always be a core part of the strategy.

TWST: How do you adjust these sectors? What makes you decide to proceed in terms of changing the fund composition over time?

Mr. Brown: We will certainly use the input from our existing strategy process, which again is a monthly process where we have the series of strategy meetings that tend to determine a lot of our tactical moves. But then, between monthly meetings, it will just be based on what we are hearing from analysts, from various sector teams and from what we're seeing in the markets. Those insights will shape discretionary decisions made by Andy and I as far as how we are going to tactically tweak our exposures.

TWST: Are there any sectors you are staying away from?

Mr. Brown: We have very skilled teams across the board in all sectors, and we take advantage of that. There is not really one sector that we are actively staying away from. Generally speaking, we are currently invested more up in quality, and that would apply to the securities in our securitized credit buckets as well as in our corporate buckets. Given where we are in the cycle and the kind of uncertain environment we are in, we are definitely have a higher-quality bias. This sentiment also feeds into our lower allocation to investment-grade corporate bonds relative to the benchmark. We prefer to take

more of our corporate risk in the sub-IG space, particularly bank loans. We think there is more value currently in the bank loan space.

“Despite concerns about rising rates, we believe that bonds deserve an allocation in most portfolios. Historically, bonds have been a great diversifier to other riskier assets during periods of market volatility.”

TWST: Who is the right investor for this fund, and what sort of minimum investment do they need to make?

Mr. Brown: Despite concerns about rising rates, we believe that bonds deserve an allocation in most portfolios. Historically, bonds have been a great diversifier to other riskier assets during periods of market volatility. That said, there are a lot of different ways to get bond exposure in your portfolio. Some investors take the core-satellite approach, which is to invest in a very plain-vanilla bond index fund or a fairly index-centric fund and then tack on to that the more return-seeking areas, such as high yield, bank loans and emerging markets.

Other investors look for more of a one-stop solution, utilizing a bond fund where they allow the portfolio manager to decide the relative value between the core and plus sectors. This strategy falls in the latter camp and seeks to deliver a bit more return by taking modestly more active risk. We believe the fund’s latitude to go into a lot of different areas of the market, allowing us to capture the best thinking of our research platform, will lead to a lot of alpha opportunities. And while we will definitely be looking to use the fund’s risk budget to its full advantage, one of our chief aims is to keep these risks well-balanced.

TWST: What is the minimum investment?

Mr. Brown: It is \$2,500 at the retail level and \$1 million for the institutional share class.

TWST: You are being diversified across sectors so as to insulate yourself from some degree of risk?

Mr. Brown: I think that is the case. Yes, I think we want to be very diversified at the sector level, and when I talk about diversification, I mean more from a contribution-to-risk perspective, which we do not feel you are getting in the benchmark or in the traditional core-plus type of strategy. Again, because we are giving ourselves the latitude to be more benchmark agnostic, we can spread out the contribution of risk to the various sectors, as we don’t have to worry about looking like the benchmark.

TWST: Stress testing in the banks has been a big issue post-financial crisis. What are your rules of thumb when you are researching collateralization and securitization?

Mr. Brown: It is a tough question to answer across the board because every sector is different, but for securitized credit sectors, we have a staff of analysts who cover ABS, non-agency MBS and commercial mortgage-backed securities. They are paying very close attention to broader trends in their particular market,

whether that be the consumer in terms of ABS, obviously residential housing in terms of RMBS and commercial real estate in terms of commercial MBS. That means following the health of those markets but also following the structure of the securities to keep track of the amount of credit enhancement embedded in the securities, and if that meshes with the underwriting, things like the FICO of the underlying borrower and various other credit metrics.

We look for enough credit enhancement to cover any expected losses and assess whether we are being paid adequately in terms of the spread of the security for the risk that we are taking. We also have a very large IG corporate credit analyst staff and a very large sub-IG analyst staff, and they are following a similarly rigorous process, but of course the analysis is different.

TWST: Do you think you have a different approach to duration management than your peers in the industry?

Mr. Brown: I cannot speak for what every other manager out there does. If I had to speculate, you could put other managers in two buckets and then maybe a third bucket. But the two primary buckets are those who don’t take duration bets or duration risk. They are more benchmark-like and more agnostic when it comes to interest rates, and maybe they focus on credit, for example. Then you have those who are more macro-driven, and they will tend to take a lot of large duration bets.

We fall somewhere in the middle. We tend to not take huge duration bets, but we also don’t have to follow the benchmark. If our macro analysis tells us that we should be leaning one way or another in terms of duration, we certainly will. Again, we have built relatively wide guardrails into this strategy. If we do have a very, very strong conviction on rates moving one way or another, we can take a fairly large bet on that, but I would view that as more tactical in nature.

TWST: In light of your role there, can you give us some of your general thoughts about global macroeconomics and, in particular, the impact of rising interest rates?

Mr. Brown: Obviously the focus in 2017 is trying to decipher what will happen here in the U.S., and that is really going to drive the global market environment. There were a lot of promises made on the campaign trail, and the markets, for the most part, have priced in all the good that might come with Donald Trump and very little of the bad. And many people are ascribing the run in stocks and the dramatic spike in yields we have seen since November 8 entirely to this optimism.

But I don’t think you can draw a straight line here. If you take a step back and look at the big picture, the U.S. economy was on really strong footing coming into the election. And the data continue to point to a solid trajectory for the near term. You can make a pretty strong argument that a good portion of the recent rally is just the markets catching up with the fundamentals. Theoretically, this should leave investors pretty constructive on risk assets.

That said, there are a lot of questions to be answered. No one knows which policies will actually come to fruition, in what form, and what the ultimate timing will be. Against this backdrop, spreads across credit sectors have tightened considerably since early 2016, leaving valuations somewhat stretched. This left us taking a fairly cautious stance coming into the year.

In terms of interest rates, we launched after a fairly big selloff in rates. There was a lot of uncertainty in terms of how much higher rates could go, but our conclusion was that, given the uncertainties out there, we don't know the kind of impact all of this will have. The bond market felt a little bit oversold at that point, and we came in with a fairly neutral duration stance and expected some consolidation in rates.

That is exactly what has happened. We saw the 10-year jump up to the 2.60% area, and now we are down into the 2.30s. We are playing duration from neutral to short, so we are going to look for opportunities to get short. At current levels, we are closer to neutral. We will see what happens after January 20 and what they tackle first, whether it is going to be health care, infrastructure spending or lowering taxes. We are going to follow that very closely. You also have to follow how much pushback he is going to get from Congress, because remember this is a Republican Congress, and they tend to be pretty hawkish when it comes to the deficit.

Aside from the impact of politics, market positioning is a factor that will definitely play heavily into our duration positioning. You saw a very large short base in Treasuries coming out of the election, and when you see positioning that extreme on one side or the other, that tends to actually support the other side of the trade. If the entire market is short, you want to take the other side of that, because you will likely see a lot of buying into any meaningful selloff as profits are taken. Being defensive to neutral on duration

has been the right call into the little bit of consolidation that we have seen in the last few weeks here.

TWST: Overall, why should an investor invest in your fixed income fund versus another fund like this?

Mr. Brown: When you invest in our fund, you get a firm and a group that has proven to be able to manage risk throughout various cycles. Our strong risk management culture is an advantage. You also get access to our fantastic global research platform. We don't just focus on one or two areas of the market. We have very strong research staffs in each of the areas of the market across the globe. So it is really a benefit to us to be able to take all that research in and have it inform our investment process.

TWST: Is there anything else you wanted to add before we end?

Mr. Brown: Thank you very much for the opportunity to introduce the T. Rowe Price Total Return Fund to your readers.

TWST: Thank you. (KJL)

CHRISTOPHER P. BROWN JR., CFA
Vice President and Portfolio Manager
T. Rowe Price Group, Inc.
100 East Pratt St.
Baltimore, MD 21202
(410) 345-2000
www.troweprice.com
