Global Value Search

Finding undervalued investments around the world requires a rigorous investment process and thorough research. In addition to attractive valuation, the International Growth & Income Fund of T. Rowe Price needs to see a potential catalyst and an asymmetrical risk/reward before it invests in a stock. Dividends are an important part of the fund's strategy to provide both income and long-term growth.

Q: *What is the investment philosophy of the fund and how is it different from other funds in your group?*

A: Our philosophy is finding undervalued investments. We believe that the market often overreacts and underestimates a company's ability to create value over time. It may be a simple philosophy, but it's one that has worked. We tend to be longer-term investors because valuation anomalies often take several years to play out.

If you're buying stocks that are less expensive, even in the absence of information, there's a tendency for the market to equalize and for less expensive assets to come back. In other words, the price can be its own catalyst and that's one of the inherent benefits of value investing. For example, the low price may provoke a buyout or may cause the management to work harder to increase the company's and the stock's performance.

The fund has an emphasis on companies that return cash to shareholders primarily through dividends and also through share buybacks. That's important because it shows management's discipline and concern for the shareholders. At the end of the day, it's a tangible reward and evidence that the company is making money. The exact mechanism of returning cash to the shareholders is not quite as important, but I prefer dividends because part of the fund's mandate is to provide some level of income.

Q: *Running an international fund obviously requires proper balancing decisions. Do you rely on cross-country or cross-sector comparisons?*

A: We look both across sectors and across countries. For sectors like autos or technology, one needs a global approach. At the other extreme, in a sector like utilities the local market effects are extremely important. It would be a big mistake to compare the valuation of a utility company in Japan or Australia to the valuation of a utility company in the UK.

The drivers to the top line and the profitability of these companies are very much localized; the regulation is very much localized. In technology, it's quite the opposite. The country effect is largely overridden by the global sector effect.

For example, Japanese P/E ratios for years were very high because earnings

T. Rowe Price International Growth & Income

Fund Facts

Symbol	TRIGX
Website	www.troweprice.com
Address	T. Rowe Price Associates, Inc. 100 East Pratt Street Baltimore, MD 21202
Tel. No.	800-564-6958
Inception	12/21/1998

Portfolio

Total Net Assets *	$ 1,307
Avg Mkt Cap ($ Weighted) *	49,504
Average Price/Earnings Ratio**	14.3
Average Price/Book Ratio	2.2
Turnover Ratio	47 %

Investment Information

New Investment	Open
Min Initial Investment	$ 2,500
Min Subsequent Investment	$ 100
Min Initial IRA Investment	$ 1,000

Risk (Against MSCI World USA IX ND - 5 Years)

Alpha	1.25
Beta	0.92
R-Squared	0.96
Ann Std Deviation	14.54
Sharpe Ratio	0.37

Returns vs. Lipper International Fund Index

	TRIGX	Index
1 Year (Cum.)	15.75 %	15.67 %
3 Year (Ann.)	25.73 %	23.10 %
5 Year (Ann.)	7.68 %	5.34 %

Returns vs. MSCI World USA IX ND

	TRIGX	Index
1 Year (Cum.)	15.75 %	14.96 %
3 Year (Ann.)	25.73 %	24.83 %
5 Year (Ann.)	7.68 %	5.32 %

Fees and Expenses

Max Sales Charge - Front	0.00 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee***	2.00 %
Total Expense Ratio	0.92 %

Portfolio Manager

Raymond A. Mills	1/1/2002

** millions ** for current fiscal year*
**** within 3 months after purchase*

Data through: 12/31/05

Source: Company Documents; Lipper

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were very low, not because the market was doing well. Lately we've seen the market picking up, but P/Es still look higher than in most parts of the world. Short-term interest rates in Japan essentially are zero, so one has to take that into account.

Q: ***How do you decide what is value and what is an undervalued company? Do you always look at historical valuations?***

A: That's one of the things I look at, but I also look at valuation in absolute terms and relative to the country. For example, within the context of Japan, Toyota doesn't look very expensive, but relative to GM, it looks quite expensive. So where does the truth lie? I actually think that Toyota is reasonable value because a lot of the stock is owned in Japan and it's working off of that market base. In addition, it's a much better positioned company than GM and that's another reason for the valuation to be richer.

Q: ***How do you implement that philosophy into an investment process or strategy?***

A: We're looking for inexpensive companies with prospects of improving earnings growth, so we want some catalyst for the valuation to be realized. Our stock selection process is mainly bottom-up, but I believe that one also has to look at top-down effects.

Energy, for example, has been a big theme for the fund. Energy stocks looked very attractive a couple of years ago on many different metrics, including P/E ratios, dividend yields, book value, or just the inherent value of the assets. Oil was trading in the teens of dollars per barrel, so we asked ourselves if oil really was going to go down in value. All of these companies looked attractive from the bottom-up, so we're buying them for that reason, but from the top-down perspective oil looked relatively low-priced. China is growing, India is growing, and the U.S. increases its demand for oil every year. Supply, at the same time, is becoming constrained. When we see a trend both from the bottom-up and the top-down sides, that's when I like to take a sector bet.

Q: ***When you take a sector view, do you try to spread it out geographically?***

A: It depends on where the stock opportunities are. In the case of energy, there was some spread. Most of it was in Europe because a lot of the large integrated companies are there, like Total and Statoil, but we also had a decent position in Petrobras, a Brazilian company. We did well in an Australian company called Oil Search and in Japan with Inpex.

Q: ***Australia actually works as a good back-door way to the rising growth in China with the mineral, mining, and agricultural companies. Is that correct?***

A: Absolutely. People tend to miss the fact that Australia is a much safer way to invest in China's growth from an investor protection standpoint. The market in Australia is developed; the legal system is mature and efficient; the companies are well governed and well run. Of course, there is still risk in terms of volatility and stock performance, but the risk of poor corporate governance, accounting fraud, or operational issues is more limited.

Australia has been a point of emphasis for the fund over the last few years, so I'm glad that you brought it up. An example would be Downer EDI, an engineering and infrastructure servicing company in Australia. They'll help a company like BHP or Rio set up a new mine by doing the engineering, as well as doing maintenance and servicing. That stock has done well for us, but it doesn't have a direct link to China. When BHP and Rio suffer a downturn, Downer is probably going to have a downturn as well, but maybe not as much.

Q: ***What is your approach to researching stocks and companies all over the world?***

A: We believe that rigorous research is the foundation for building good portfolios. As a firm, we have about 75 research analysts around the world and managing the International Growth & Income Fund is very much a team effort. Of course, they're not dedicated to this fund only, but it's a critical resource to draw upon and a very effective way to canvass and research the investment landscape.

In terms of the sector versus regional issue, our analysts have a hybrid structure. We have a team of industry analysts, but in some cases they tend to be more global in nature. For example, our resources analyst takes a global view, while the mandate of a telecom analyst might be more regional. We also have regional analysts who cover some of the stocks that maybe don't fit neatly into one of the industry categories. We have analysts in Japan, Asia, Latin America, and Europe. They are the most important source of ideas and coverage at the fundamental level.

We also have some quantitative inputs, which I mostly use to get things on my radar screen and to focus. We combine the valuation and the factors driving stock performance into a single score for each stock. A low score doesn't mean that we wouldn't look at the stock and a high score doesn't mean that we'll buy it, but it helps us focus.

At the end of the day, the process is very much fundamental. We're looking at the quality of earnings, the company's prospects, and the valuation. Do we think that the management team is competent and has some integrity?

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What are the industry dynamics? How competitive is the industry? What are the threats of new entrants? These are the important questions.

Q: ***How do you make that assessment? Do you travel to meet management teams or visit the companies?***

A: In many cases, yes. Ideally, we would meet the management team of every company before we invest in it. We would talk to all the suppliers and customers and that would probably take about a year and a half. At the end, we would have an incredibly deep understanding of the company, but 99 times out of 100, by that time the stock would have moved up and it would be too late to invest in it.

Investing is a very interesting pursuit because on the one hand, the rigor can really pay off, but on the other hand, the market is intelligent. There are a lot of smart people that are constantly working to gain an edge over you. Sometimes one has to trade off the rigor and the thoroughness against the opportunity cost.

So if we find an idea, I'll research it and our analysts will research it. We'll talk to people and we'll certainly want to meet the management team whenever we can. But if we're not able to meet the management for three months and everything else points to a great investment case, I wouldn't wait, because of the opportunity cost.

And with value investing, often you just need the management to be competent enough to let the natural tendencies of the company and industry dynamics work themselves out for earnings to recover. If the management is stellar, the stock will probably be an expensive one because it's discounting that tremendous management talent.

Q: ***How do you approach portfolio construction? What is the number of stocks in the portfolio, the turnover?***

A: I tend to own more stocks because I want to make more decisions to generate more alpha. The big resource base of the firm enables me to spread whatever skill I have over more investment cases. I tend to own between 100 and 200 stocks, usually in the high 100's. There's no magic number, but that's just where it comes out.

If this was a domestic fund, the number of stocks would probably be lower, but I do believe in mitigating risk internationally. It doesn't mean following benchmarks, but means spreading out the geographic risk because of the country and regional effects. Owning stocks in each market and across sectors leads to owning more names.

Turnover is fairly low, typically around 30% per year, because we allow time for the valuation anomalies to play out. Our expertise and skill lie in a longer-term approach, so we're typically holding stocks for two or three years and sometimes longer. Of course, that low turnover also tends to keep transaction costs down and I'm a big believer in doing that.

> "I believe in diversified portfolios not just for risk control, but also because diversification can increase alpha. Performance is a function of the skill in choosing good investments, but it's also a function of the number of times one exercises that skill."

about Raymond Mills

Ray Mills is a Vice President of T. Rowe Price Group, Inc. and serves as the Portfolio Manager of the T. Rowe Price International Growth & Income Fund. He is also an Advisory Committee member of the T. Rowe Price Balanced Fund and the Personal Strategy Funds. Ray earned a B.S. in Honors from Virginia Tech, an S.M. from the Massachusetts Institute of Technology, and a Ph.D. from Stanford University, graduating summa cum laude. He has also achieved the Chartered Financial Analyst accreditation.

Q: ***What is your view on managing risk?***

A: The most fundamental way to manage risk is to buy the right investments. I clearly want to buy a stock where the price is going up, but I also look very hard at the downside. I want to invest in stocks where there's an asymmetry, where the upside is not only more probable, but also potentially larger than the downside.

That's another place where dividends and share buybacks come into play. For example, Royal Bank of Scotland has been out of favor, but the company is growing its earnings. It's well managed and has a dividend yield of around 4%. It has operations in the UK and in the U.S., which are relatively stable. I think that the risk/reward is asymmetrical and the chance for this stock to do well is greater than to suffer a large fall.

Stock-level positions are paramount, and sector and regional positions are important, but there are other factors worth considering, such as how much style exposure do we have, do we own smaller or larger companies, do we have exposure to momentum stocks, etc. For example, value stocks in general have done better than growth stocks over the last few years and it pays to at least know where your bets are. We do fairly sophisticated risk analysis to know what our exposures are to the different factors in the market beyond just industries and sectors. ■

TICKER Staff

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