T. Rowe Price

In a world of flux, fundamentals (and active stock picking) matter

From the Field

Key Insights

- In an environment of increasingly wider U.S. market and economic outcomes, high-quality, "durable compounder" companies are best placed, in our view.
- Relatively few companies consistently compound shareholder wealth at superior rates of return, year on year, over time.
- Those that have done this, what we call durable compounders, tend to have strong franchise quality and sustainable, secular advantages that competitors struggle to replicate.

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The global macroeconomic and geopolitical outlook remains in a state of considerable flux as we progress into 2025. Administration change and policy uncertainty in the U.S. have added to a growing sense of nervousness about the near-term market outlook. The backdrop presents a distinct challenge for investors looking for assets with the potential to generate attractive returns while still offering a measure of downside support.

We believe the best approach in a more challenging environment is to try to find high-quality, durable compounder companies. Characteristics of these types of companies include a track record of consistent double-digit earnings growth; enough pricing power to pass on higher costs should inflation prove sticky; and can potentially provide insulation from tariffs in the event of an escalating trade war.[1]

Consistent compounders of wealth are rare

In our experience, relatively few companies have been able to consistently compound shareholder wealth at superior rates of return, year on year, over time. Most companies are erratic or inferior creators of long-term wealth, very much beholden to favorable market and economic conditions to excel.

> “We believe that companies with strong franchise quality have a sustainable, secular advantage that competitors generally have difficulty duplicating.

[1] There is no guarantee that past favorable dynamics of a company will persist in the future.

Identifying quality durable compounders

(Fig. 1) Looking for sustainable, "all weather" attributes

As of March 2025.
For illustrative purposes only. These represent typical attributes but can vary. There is no guarantee that favorable attributes will persist in the future.
Source: T. Rowe Price.

We believe that companies with strong franchise quality have a sustainable, secular advantage that competitors generally have difficulty duplicating. These characteristics include a favorable industry construct like a duopoly, leading innovation, strong brand recognition, customer loyalty, distribution networks, and/or data leverage. Companies with these features are typically most prevalent in industries where capital intensity is relatively low and where consistent, growing demand can support pricing power. Durable compounder companies exist in various sectors of the economy, with opportunities spanning the financials, consumer discretionary, communication services, health care, and technology sectors.

Strong, durable compounding companies are less common in more capital-intensive industries, such as traditional telecommunications, utilities, oil and gas exploration and production, and commodities. These businesses tend to be highly cyclical due to their high fixed-cost structures, making them more economically sensitive and often dependent on commodity prices to drive earnings. As a result, they do not usually deliver consistent earnings and predictable returns on invested capital (ROIC).

Meanwhile, some high-growth businesses may also experience negative earnings and free cash flow as they invest heavily in the early stage of the "S curve"[2] business life cycle. They may also be vulnerable to rapid innovation, intense competition, and even displacement if they lack many of the durable characteristics mentioned earlier.

Why focusing on fundamentals matters

The key financial characteristic of durable compounders is that they usually enjoy sustainable, high ROIC generated by a combination of recurring revenues, high gross margins, and pricing power due to their favorable market positioning. Importantly, durable compounders have historically tended to perform relatively well during economic downturns, given their more predictable and steady operational cash flows. Profits have tended to be less sensitive to economic conditions and so may provide more consistent performance in times of uncertainty. This "low cyclicality of top-line demand" characteristic stems from dominant market positioning and strong brand loyalty and so has the potential to insulate durable compounders from the negative cyclical impacts of a weaker economic environment.

[2] Graphic depiction of the growth trajectory of a business—in an S-shaped pattern—over a typical life cycle, from slow, early-stage growth as the company builds its footprint, to a period of rapid growth acceleration as products/innovations gain recognition and capture market share, before slowing once more as the business matures and demand tapers as products/innovations are replicated or superseded.

Durable compounder examples

(Fig. 2) Key characteristics in focus

	Company Characteristics	Near-Term Industry Trends
Hilton Hotels and Resorts	– One of the largest players in the global hotel industry – Asset-light business model and could continue to take market share via new unit growth – Strong customer loyalty and significant pricing power – If services inflation remains sticky, should be able to pass on higher costs to consumers	– Key demand driver is the business cycle—the outlook has stabilized/improved – Room pricing has continued to benefit from tight supply and higher-for-longer inflation – The new U.S. administration is driving positive sentiment in property development, which should support new unit growth
Chubb	– A leading player in the property and casualty (P&C) insurance industry – Has been growing its business globally and taking market share – Effective management focused on maintaining a healthy balance sheet	– Underwriting premiums have been benefitting from a pricing upcycle in the P&C insurance area – Potential for increased interest income from investment portfolios due to higher interest rates relative to pre-COVID rates
Visa	– One of the largest global payments networks, a business with high margins – Has benefitted from significant barriers to entry that reinforce its pricing power – Supported by the strong secular tailwind of electronic payments ubiquity – Business has displayed continued pricing power, and strong free cash flow conversion	– Improving volume trends in the U.S. – The prevailing narrative of a secular slowdown in electronic payment adoption/penetration does not appear to be panning out

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Source: T. Rowe Price.

Another key characteristic of a durable compounder relates to the quality and focus of its management. Management teams that have demonstrated a history of disciplined capital allocation and efficient use of free cash flow are another important aspect of pursuing durable compounders.

Companies equipped for challenges ahead

The challenge for equities in the near term will be to continue to grind higher in an environment of increasingly wider outcomes and poor visibility due to U.S. policy upheaval. Market valuations are high despite a range of macroeconomic and political risks. This all makes for a more uncertain period over the next 12 months—an environment in which company earnings may be more vulnerable and some businesses may struggle to deliver top-line growth.

We believe that durable compounder businesses are best equipped to navigate the near-term landscape. These tend to be high-quality companies that were built on recurring revenues, strong industry positioning, high margins, and low capital intensity.

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