T. Rowe Price

Discover the untapped potential of active small- and mid-cap ETFs

From the Field
March 2024

Key Insights

- The majority of U.S.-listed small- and mid-cap exchange-traded funds (ETFs) track passive indices, and a significant number of the companies within these indices have no earnings.
- In contrast to mutual fund investors, ETF investors have limited options to access active strategies in the small- and mid-cap space.
- The T. Rowe Price Small-Mid Cap ETF (TMSL) offers investors a low-cost, tax-efficient, and active approach from a leading U.S. small- and mid-cap manager.

Christopher Murphy, CIMA®
Senior ETF Specialist

Sean Erb, CFA®
Lead Portfolio Analyst—Small- and Mid-Cap U.S. Equities

Roughly 84% of the USD 702 billion[1] small- and mid-cap exchange-traded fund (ETF) assets are managed passively and in line with one of three primary index providers: S&P, Russell, or the Center for Research in Security Prices (CRSP). For investors buying a passive ETF, where the fund will own everything within the index, understanding these benchmarks will provide a stronger understanding of their investment.

Know what you own

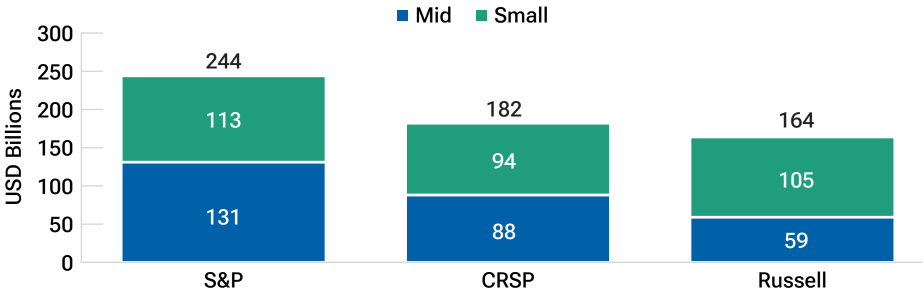
One challenge of investing in products indexed to these various small- and mid-cap benchmarks is that an investor will own everything within those benchmarks. This has long been an important part of the case for active investing in the small- and mid-cap space. These asset classes tend to be less followed by sell-side analysts than large-cap equities, which gives investors with dedicated analysts the potential to derive an information advantage that can lead to increased alpha potential.

While markets have generally become more efficient over time, as information has become more readily available to all investors, the small- and mid-cap equity markets remain relatively inefficient compared with large-cap markets.

[1] FactSet (see Additional Disclosures), as of December 31, 2023.

The majority of small- and mid-cap ETF AUM are benchmarked across three main indices

(Fig. 1) Small- and mid-cap ETF assets, by largest passive index



As of December 31, 2023. AUM also includes style segments.
Source: FactSet (see Additional Disclosures).

The importance of a dedicated investment team to support portfolio manager decision-making is as important as ever. Small-cap and mid-cap equities remain a fertile hunting ground for investment managers with the right resources to uncover alpha potential.

Non-earners are a meaningful part of a passive ETF

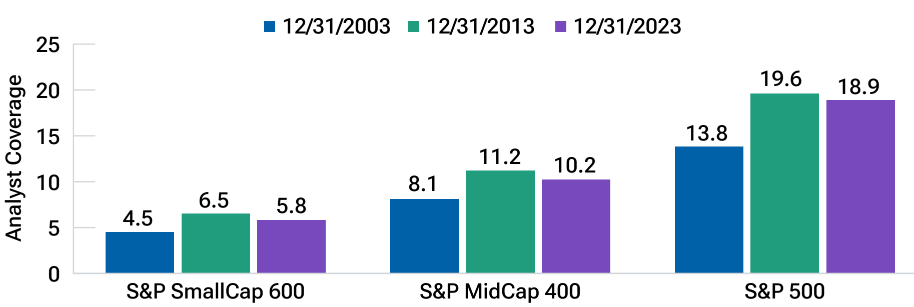
A passive ETF tracks the index, and a significant number of the companies within these indices have no earnings. Even the S&P indices, which have a profitability screen for inclusion, carry a meaningful exposure to these non-earners.

In contrast, strong active managers will generally focus on higher-quality companies and will underweight non-earners in their portfolios. Even when active managers do choose to own non-earners, they are vetted, and the manager will typically have a view on their path to profitability. The value in avoiding, or at a minimum being underweight, non-earners is clear. Profitable companies in the Russell 2000 have outperformed non-earners by 994% since December 31, 1999.[2]

[2] FactSet (see Additional Disclosures). Analysis by T. Rowe Price.

Lower analyst coverage for asset classes shows market inefficiency, information gap

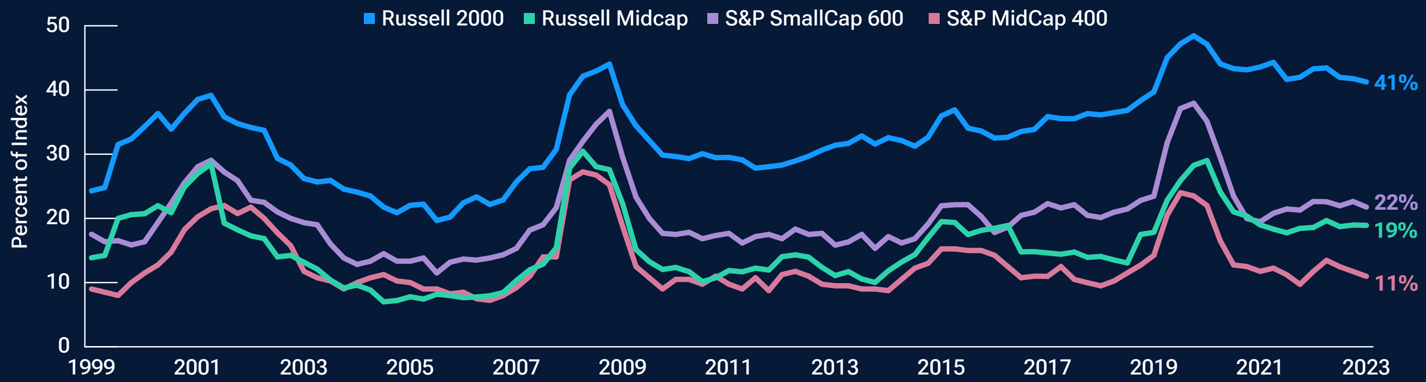
(Fig. 2) Average number of sell-side estimates per S&P index



As of December 31, 2023.
Source: FactSet (see Additional Disclosures). Analysis by T. Rowe Price.

Benchmarks have exposure to non-earners

(Fig. 3) Percent of non-earning companies in S&P and Russell indices



As of December 31, 2023.
Source: FactSet (see Additional Disclosures). Analysis by T. Rowe Price.
Past performance is not a reliable indicator of future performance.

Index quality has also deteriorated

As the cost of being a public company has risen and the number of companies staying private for longer continues to grow, we have seen a decrease in publicly traded companies in the U.S., from over 7,000 in 1998 to less than 4,000 today.[3]

As a result, the quality of small-cap indices has deteriorated significantly, highlighted by Figure 3, where more than 40% of the Russell 2000 Index, and the ETFs that track it, are currently losing money. A study by Furey Research Partners shows that the median return on investment of the Russell 2000 has fallen from 12.6% to 6.4% over the same period.[4]

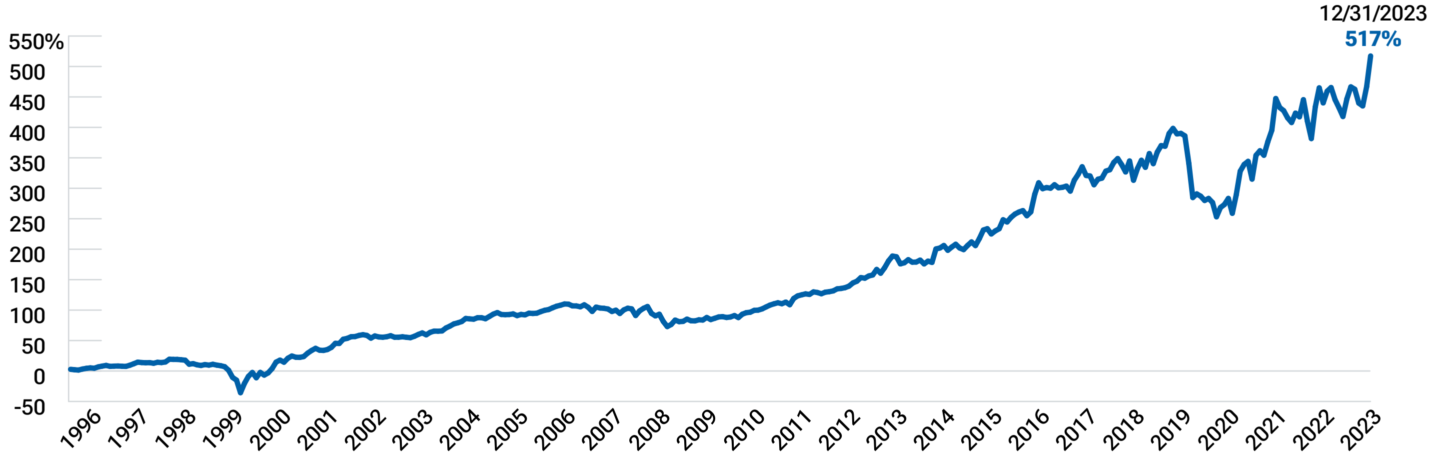
Does the quality of an ETF really matter?

Investors define quality in many ways. To show a simple comparison, we can look at the Russell 2000 Defensive Index and the Russell 2000 Index (Figure 4). The Russell 2000 Defensive Index represents U.S. small-cap stocks that

[3] Wilshire 5000 Index.
[4] Furey Research Partners, December 31, 1998; September 30, 2023.

Higher quality has outperformed over full market cycles

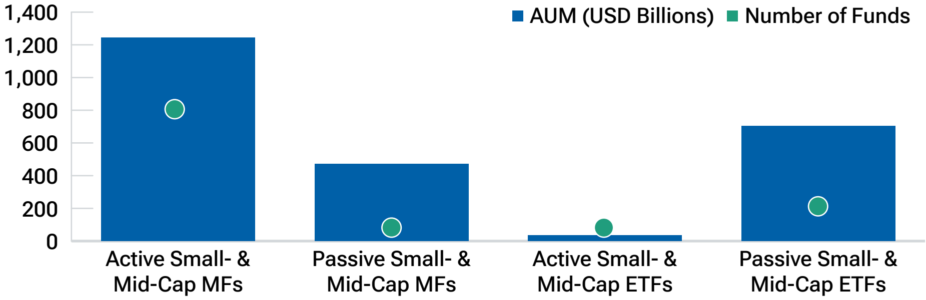
(Fig. 4) Cumulative excess return of Russell 2000 Defensive Index versus Russell 2000 Index



As of December 31, 2023.
Source: Russell (see Additional Disclosures). T. Rowe Price analysis.
Past performance is not a reliable indicator of future performance.
For illustrative purposes only.

Active ETFs are underserved in the small- and mid-cap space

(Fig. 5) Small- and mid-cap products by active and passive investment styles



As of January 31, 2024.
Source: Bloomberg Intelligence. Analysis by T. Rowe Price.

exhibit a combination of high return on assets, low debt to equity, low earnings variability, and low long- and short-term total return volatility. These factors are all associated with quality. At T. Rowe Price, our analysts and portfolio managers do not specifically screen for stocks with these characteristics, but our fundamental bottom-up stock selection process typically leads us to names with these and similar attributes. T. Rowe Price small-cap strategies tend to be overweight these characteristics relative to their respective benchmarks; the Russell 2000 Defensive Index is a suitable proxy. T. Rowe Price's active approach, with a focus on quality, has been successful over time.

Active investment options remain limited

The majority of small- and mid-cap assets are invested in mutual funds over ETFs (Figure 5). An investor's decision to invest in these vehicles has several considerations:

- The average mutual fund expense ratio is 111 basis points, while an ETF option tends to be lower priced. (The T. Rowe Price Small-Mid Cap ETF (TMSL) has an expense ratio of 0.55%.)
- Another common challenge for small- and mid-cap (SMID) investors is capacity: 15% of the assets under management in these mutual funds are closed.[5]
- Generally, ETFs are more tax-efficient than mutual funds. However, many investors are further limited by the perception that most ETFs are passive. Considering the vast majority of ETF assets are passive strategies, it's easy to understand why.

However, the USD 8.1 trillion ETF market[6] is changing, and actively managed ETFs are quickly becoming the fastest-growing category. At the start of 2023, active ETFs held only 5.3% of the market.[6] By the end of 2023, active ETFs accounted for 21.9% of net new flows into all ETFs.[6] Yet this growth hasn't necessarily reached across all asset classes. Investors show that they believe active management can work in the small- and mid-cap space (Figure 5), but they are dramatically underserved in the ETF structure.

The T. Rowe Price approach to small- and mid-cap investing

When Thomas Rowe Price, Jr., launched his first small-cap fund in 1960, it was among

> Actively managed ETFs are quickly becoming the fastest-growing category [in the ETF market].

[5] Morningstar Direct (see Additional Disclosures), January 8, 2024.
[6] Morningstar (see Additional Disclosures), January 2, 2024.

Experience and strength in the small- and mid-cap market

(Fig. 6) Active U.S. mid-/SMID-cap and U.S. small- and mid-cap managers

Active U.S. mid-/SMID-cap

	Firm	AUM (USD M)
1	T. Rowe Price	90,079
2	Fidelity Investments	70,839
3	J.P. Morgan Investment Management Inc.	43,499
4	Vanguard	40,905
5	MFS Investment Management	39,378

Active U.S. Small/Micro-Cap

	Firm	AUM (USD M)
1	T. Rowe Price	79,596
2	Dimensional Fund Advisors LP	54,918
3	Kayne Anderson Rudnick Investment Management, LLC	23,540
4	Fidelity Investments	22,883
5	J.P. Morgan Investment Management Inc.	22,073

As of December 31, 2023.
Source: eVestment Alliance, LLC.

the first small-cap funds in the market.[7] Small-/mid-cap investing is core to the T. Rowe Price DNA, and our investment success has led the firm to become the largest active manager of U.S. small- and mid-cap equities in the world (Figure 6).

T. Rowe Price ETFs: An active approach to portfolio building blocks

TMSL favors stocks that appear inexpensively valued relative to their respective industries and equity universes with substantial free cash flow and a high return on capital with attractive relative valuation, improving earnings and cash flow, high return on capital, attractive operating margins, and sound balance sheet and financial management. The portfolio typically invests in 240–270 issuers that represent highest-conviction ideas within the core-, growth-, and value-oriented spaces. As down-cap equities spent most of 2023 out of favor in an extremely narrow market, higher-quality names fell into the investment universe. This provided the opportunity to construct a portfolio of quality companies with durable growth and strong fundamentals in the space—further distinguishing TMSL from lower-quality passive peers.

[7] Source: Morningstar (see Additional Disclosures). Analysis by T. Rowe Price.

INVEST WITH CONFIDENCE®

T. Rowe Price identifies and actively invests in opportunities to help people thrive in an evolving world, bringing our dynamic perspective and meaningful partnership to clients so they can feel more confident.

Additional Disclosures

Important Information

This material is provided for informational purposes only and is not intended to be investment advice or a recommendation to take any particular investment action.

The views contained herein are those of the authors as of March 2024 and are subject to change without notice; these views may differ from those of other T. Rowe Price associates.

This information is not intended to reflect a current or past recommendation concerning investments, investment strategies, or account types, advice of any kind, or a solicitation of an offer to buy or sell any securities or investment services. The opinions and commentary provided do not take into account the investment objectives or financial situation of any particular investor or class of investor. Please consider your own circumstances before making an investment decision.

Investments in securities issued by small-cap and mid-cap companies are likely to be more volatile than investments in securities issued by larger companies.

ETFs are bought and sold at market prices, not NAV. Investors generally incur the cost of the spread between the prices at which shares are bought and sold. Buying and selling shares may result in brokerage commissions which will reduce returns.

Information contained herein is based upon sources we consider to be reliable; we do not, however, guarantee its accuracy.

Past performance is not a reliable indicator of future performance. All investments are subject to market risk, including the possible loss of principal. All charts and tables are shown for illustrative purposes only.

T. Rowe Price Investment Services, Inc.

ID0006829 (03/2024)
202403-3435451