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PRICE POINT
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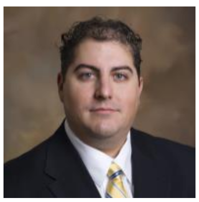

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SHRINKING U.S. EQUITY OPPORTUNITY SET POSES CHALLENGES FOR SMALL-CAP INVESTORS

KEY POINTS

- The steady decline in the number of U.S. publicly traded companies has created challenges, particularly for small-cap stock investors.
- Small-cap stock indices have experienced a structural deterioration in quality, which is reflected in the number of companies with negative earnings and lower returns on equity and invested capital.
- The sluggish pace of initial public offerings in recent years has failed to offset the loss of attractive smaller companies in the public market.
- The reduction in quality and liquidity of more companies included in the small-cap indices amid relatively high valuations poses significant risks for passive investors.
- T. Rowe Price small-cap equity managers take a disciplined approach to identifying opportunities within the diminishing number of reasonably priced quality companies.

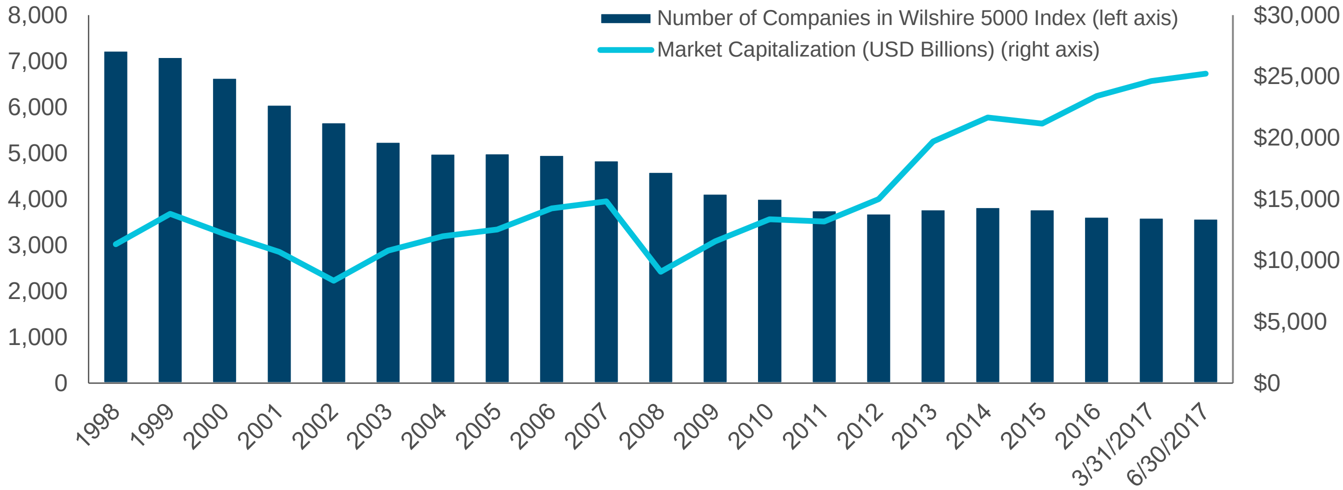
The stock market's impressive gains in recent years have masked a less encouraging trend—the number of public companies has been cut by more than half over the past two decades. This incredibly shrinking stock market poses challenges for investors, particularly those investing in small-cap stocks.

The number of public companies in the Wilshire 5000 Total Market Index—widely regarded as the best single measure of the U.S. equity market—has fallen from a peak of 7,562 in July 1998 to just 3,465 as of June 2017. The Wilshire 5000 has not included 5,000 stocks since the end of 2005.

Not only are fewer public companies issuing shares, the total number of shares traded on the market has declined. Record-low interest rates and slow economic growth have encouraged companies to buy back their own shares, further reducing the availability of equity shares that remain public.

Figure 1: Decline in Publicly Traded Companies

As of June 30, 2017



Source: Wilshire Associates

The shrinking opportunity set can also be traced to several other trends: increased merger and acquisition (M&A) activity and private-equity deals, increased regulation, the rise of shareholder activism, a significant decline in recent years in the number of companies going public, and a number of corporate failures.

The low cost of capital and paucity of economic growth also have motivated M&A deals. Larger companies have been buying out smaller ones at hefty premiums in an effort to meet growth targets, aided by low interest rates. Strategic buyers are not the only buyers: Private-equity funds have ample capital to deploy as well.

Motivation also exists on the sellers' side. An increased regulatory burden and the compliance costs stemming from the Sarbanes-Oxley Act of 2002 have also dampened the desire to go—or remain—public. The ongoing cost of being a publicly held company, including legal, compliance, and technology expenses, can approach US$10 million—a rather daunting hurdle for a company with US$300 million in revenue, for example, and perhaps only US$25 million to US$30 million in profits.

The rise of activism by hedge funds and other investors putting pressure on management to achieve better results is encouraging some public companies to sell out to private investors while also discouraging private companies from going public. Corporate leaders don't want to subject themselves to such scrutiny, especially when they can often obtain money to expand elsewhere.

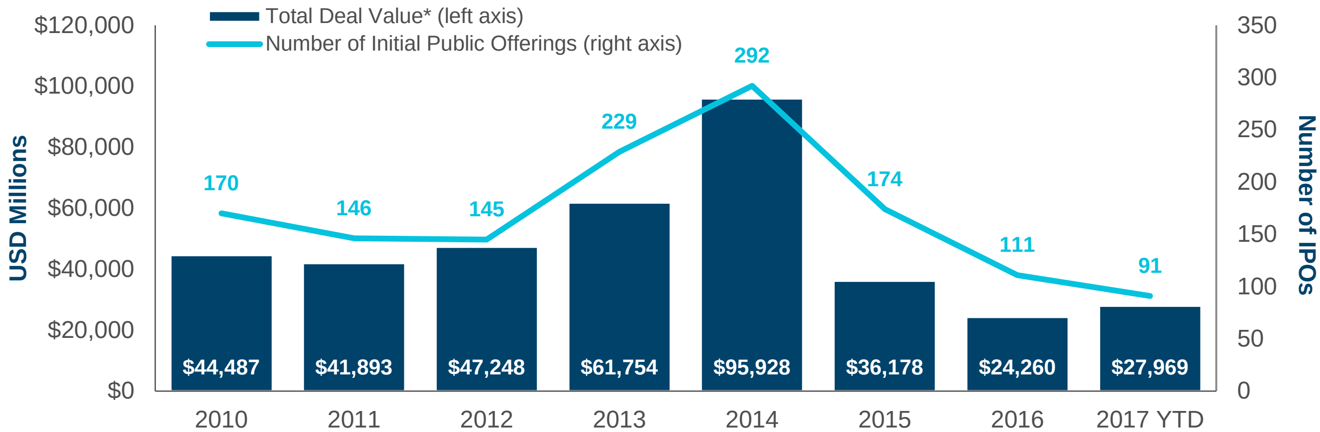
As more public companies are acquired or sell out to private investors, there has been a dearth of new initial public offerings (IPOs) to replace them. IPO activity has fallen by more than half since peaking in the late 1990s and has seen a steady decline in recent years, though the pace has accelerated this year.

This decline in IPO activity has been partially fueled by a surge in venture capital investment in recent years, which has enabled startups to expand and attain access to capital while avoiding the scrutiny and transparency of the public market. By the time some firms go public, they already have grown beyond the reach of small-cap managers.

Reflecting these developments, the median age of companies executing an IPO has increased from 7.8 years during the 1976–1996 period to 10.7 years in the 1997–2016 period, a 37% increase, according to Credit Suisse. Meanwhile, as of August 2017, there were 120 U.S.-based so-called unicorns—venture-backed startups valued at more than US$1 billion—compared with 40 in 2013, according to PitchBook, a company that tracks global venture capital, private-equity, and merger and acquisition activity.

Figure 2: U.S.-Listed Initial Public Offerings

As of June 30, 2017



*Deal value represents the total value raised in the IPOs.

Source: Dealogic

A SHRINKING, LOWER-QUALITY POOL FOR SMALL-CAP INVESTORS

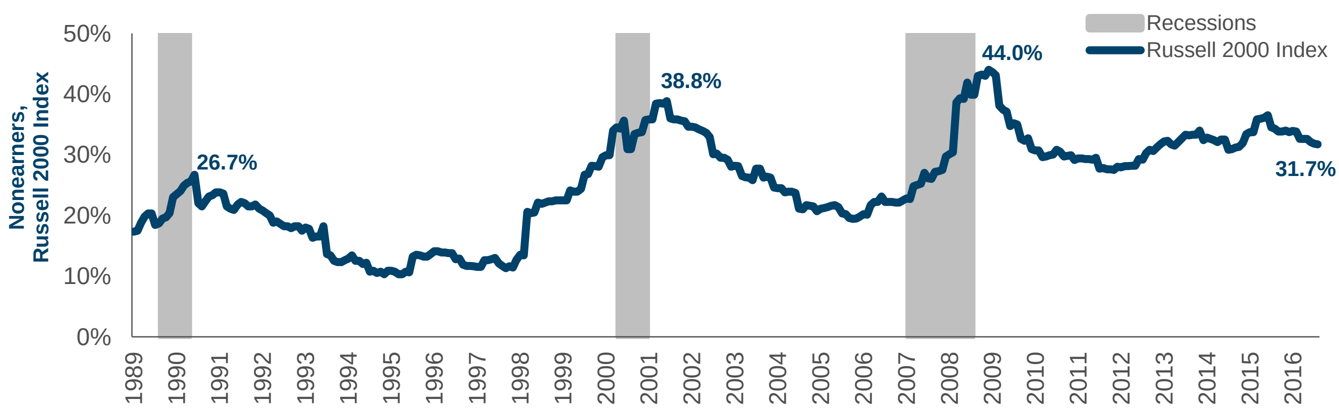
The shrinking equity market has had a disproportionate impact on the small-cap Russell 2000 Index. While the index is rebalanced annually in June to include 2,000 names, the companies added to the index in recent years have tended to be smaller, more illiquid, and of lower quality than the firms they replaced.

The index includes older names that have been there for years, as well as those that have fallen out of the mid- and large-cap universes. This has masked a steady increase in lower-quality firms populating the bottom tier of the Russell 2000 companies.

The erosion in the index's quality is reflected in Figure 3, which shows that about one-third of the companies in the index have not earned money in the past 12 months, a level normally only seen in recessions. Companies with negative earnings are more likely to struggle to generate the cash needed to maintain solvency internally and may need to raise capital by increasing leverage or issuing additional stock to fund their operations.

Figure 3: Percentage of Russell 2000 Nonearners

As of July 31, 2017



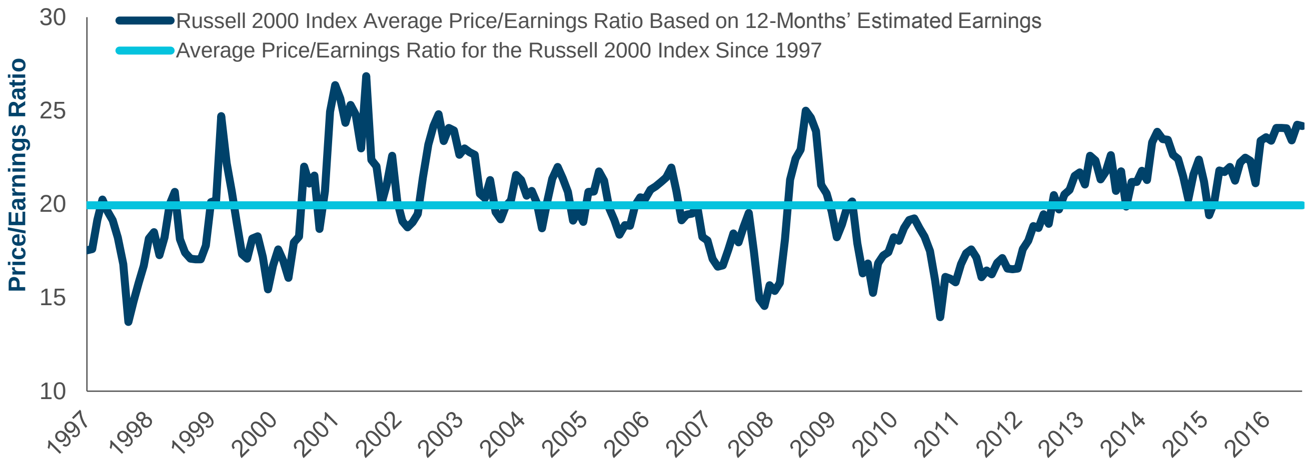
Source: Strategas Research Partners

Meanwhile, debt levels, as measured by debt-to-equity ratios, have risen over the past decade. Returns on equity and invested capital of the companies in the Russell 2000 today also are dramatically lower than they were 20 years ago. While active portfolio managers may look more skeptically at the lower-quality members of the index, passive products such as exchange-traded funds and index funds have been the natural buyer of their shares, aided by the flood of money into passive products. This has helped drive up the shares of mediocre companies as much as, and sometimes even more than, those of their stronger competitors, posing significant risk for passive investors.

That risk is magnified by relatively high valuations for small-cap stocks. At the end of July 2017, the forward price/earnings ratio on the Russell 2000 Index stood at 24x, well above the historical average. In the next sustained market downturn, passive products seeking to sell to fund outflows may have trouble finding buyers for the lower-quality, less liquid stocks in the rush to the exits.

Figure 4: **Valuations for Small-Cap Stocks Are Above Long-Term Average**

As of July 31, 2017



Source: FactSet

SEPARATING THE WHEAT FROM THE CHAFF

Of course, this shrinkage in number and overall quality of the small-cap market amid higher valuations also poses challenges for active investors who are trying to separate the wheat from the chaff and not overpay for it.

In this environment, small-cap equity managers at T. Rowe Price have remained disciplined in our approach to identifying reasonably priced, quality companies with strong management teams that help generate above-average, persistent free cash flow.

We remain confident that our focus on higher-quality stocks could provide some downside risk management in a potential downturn and that our fundamental and patient approach could potentially become rewarding over time.

In our core-oriented portfolios, we will continue to apply a contrarian investment philosophy while remaining style agnostic, investing in both growth and value stocks. By focusing on the magnitude and durability of a company's growth trajectory, we may find growth stocks that appear expensive today but may look more reasonable after three to five years.

In value situations, we typically seek companies facing challenges that we view as transitory. By taking a longer view, we can invest in quality companies when short-term issues cause their stock prices to dip and reap the rewards as those issues resolve.

While investing in small-cap stocks has become more challenging, we are fortunate to benefit from a broad and deep team of equity research analysts—and the firm's experience from investing in smaller companies that has spanned almost six decades—to ferret out the most attractive opportunities in a shrinking market.

INVEST WITH CONFIDENCE®

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

To learn more, please visit troweprice.com.
