T. Rowe Price

How active ETFs can help investors in the small- and mid-cap space

From the Field

Key Insights

- Most U.S.-listed small- and mid-cap exchange-traded funds (ETFs) track passive indices, and some of the companies within these indices have no earnings.
- Unlike 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.

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Roughly 82% of the USD 837 billion[1] small- and mid-cap exchange-traded fund (ETF) assets is managed based on passive strategies and in line with one of three primary index providers: S&P, Russell, or the Center for Research in Security Prices (CRSP). (See "Small- and mid-cap ETF assets, by largest passive index") However, the USD 10.7 trillion ETF market[2] is changing, and actively managed ETFs are quickly becoming the fastest-growing category.

At the beginning of 2023, active ETFs held only 5.3% of the market but 75% of total ETF launches.[2] By the end of 2024, that number increased to 8.4% of the market and 79% of total launches.[2] This growth hasn't necessarily reached across all asset classes, however. Investors show that they believe active management can work in the small- and mid-cap (SMID) space, but they are dramatically underserved in the ETF structure.

What is an active ETF?

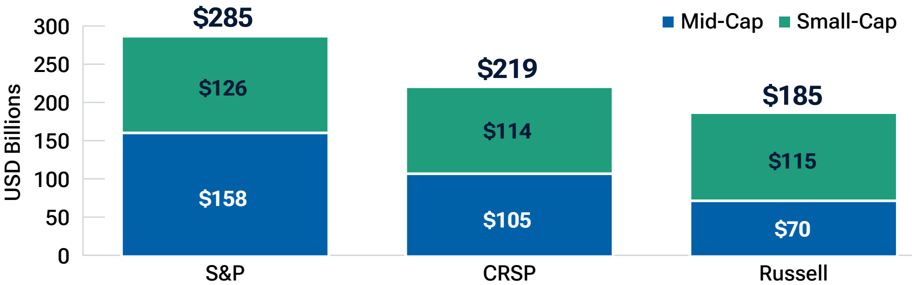
In an active ETF, fund managers make decisions, based on a predetermined investment strategy, about what securities to overweight, underweight, exclude, or include relative to the benchmark index holdings. By comparison, a passive ETF attempts to replicate the index portfolio by holding the same or similar securities, or a representative sample, at the same proportions as the index.

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

[1] FactSet (see Additional Disclosures), as of December 31, 2024.
[2] ETF Action, as of January 22, 2025.

Small- and mid-cap ETF assets, by largest passive index

(Fig. 1) The majority of small- and mid-cap ETF AUM is benchmarked across three main indices



As of December 31, 2024. AUM also includes style segments. Due to rounding, figures may not add up precisely to the totals provided.
Source: FactSet (see Additional Disclosures).

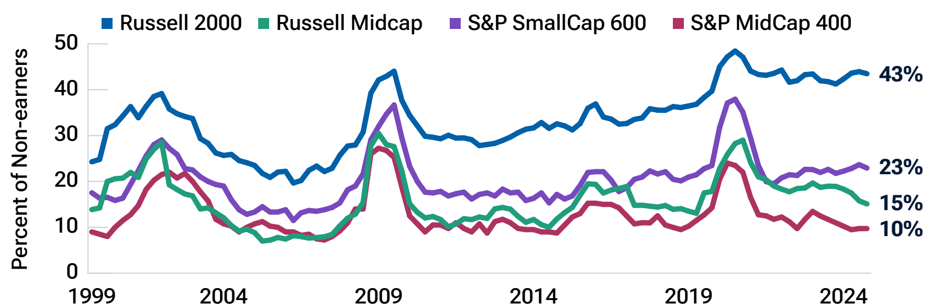
Active ETFs generally seek to outperform their benchmark index rather than simply matching the return of that index. Wherever there are inefficiencies in the markets, such as in emerging markets or mid- and small-cap sectors, there are opportunities for active management to generate higher returns. Investors interested in these market sectors may want to consider active strategies.

How active ETFs work in the small- and mid-cap space

One challenge of investing in products indexed to small- and mid-cap benchmarks is that an index investor will seek to replicate the benchmark portfolio through owning the same securities or a representative sample. However, a significant number of companies within these indices have no earnings. Even the S&P indices, which have a profitability screen for inclusion, carry a meaningful exposure to non-earners. (See "Benchmarks have exposure to non-earners")

Benchmarks have exposure to non-earners

(Fig. 2) Percent of nonearning companies in S&P and Russell indices



As of December 31, 2024.
Source: FactSet (see Additional Disclosures). Analysis by T. Rowe Price.
Past performance cannot guarantee future results.

This dynamic has long been an important part of the case for active investing in the small- and mid-cap space. 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 in, non-earners is clear. Profitable companies in the Russell 2000 Index have outperformed non-earners by 1,151% since December 31, 1999.[3]

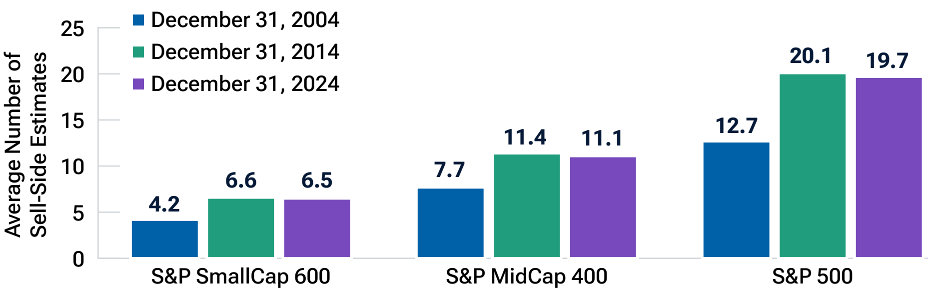
[3] FactSet (see Additional Disclosures). Analysis by T. Rowe Price.

As information has become more readily available to all investors, markets have generally become more efficient. Yet the small- and mid-cap equity markets remain relatively inefficient compared with large-cap markets. These asset classes tend to be less followed by sell-side analysts than large-cap equities, which gives investors with access to dedicated analysts the potential to derive an information advantage that can lead to increased alpha potential. (See "Average number of sell-side estimates per S&P index.")

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

Average number of sell-side estimates per S&P index

(Fig. 3) Lower analyst coverage for asset classes shows market inefficiency, information gap



As of December 31, 2024.
Source: FactSet (see Additional Disclosures). Analysis by T. Rowe Price.

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 more than 7,000 in 1998 to fewer than 3,400 today.[4] As a result, the quality of small-cap indices has deteriorated significantly. (See "Benchmarks have exposure to non-earners.") More than 40% of the Russell 2000 Index, and therefore 40% of the assets in ETFs that track the index, have experienced losses. A study by Furey Research Partners shows that the median return on equity of the Russell 2000 has fallen from 12.6% to 5.5% over the same period.[5]

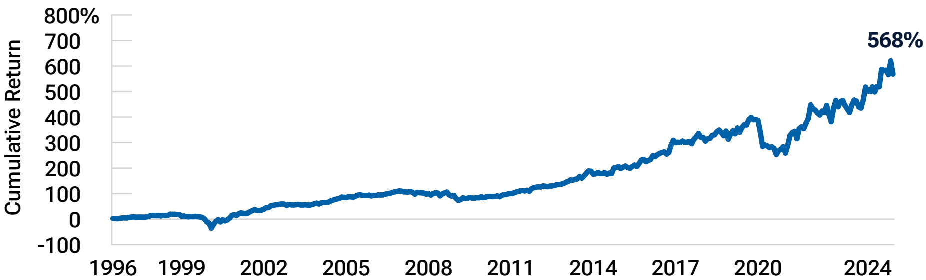
Does the quality of an ETF really matter?

Investors define quality in many ways. To show a simple comparison, consider the Russell 2000 Defensive Index and the Russell 2000 Index. (See "Higher quality has outperformed over full market cycles.") The Russell 2000 Defensive Index represents U.S. small-cap stocks that 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 overweigh these characteristics relative to their respective benchmarks; the Russell 2000 Defensive Index is a suitable proxy for this analysis. T. Rowe Price's active approach, with a focus on quality, has been successful over time.

[4] Wilshire 5000 Index.
[5] Furey Research Partners, December 31, 1998; September 30, 2024.

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, 2024.
Source: Russell (see Additional Disclosures). T. Rowe Price analysis.
Past performance cannot guarantee future results.
For illustrative purposes only.

Active investment options remain limited

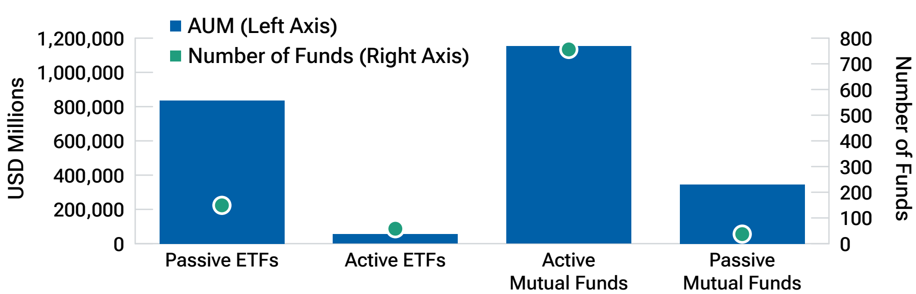
The majority of small- and mid-cap assets are invested in mutual funds over ETFs. (See "Active ETFs are underserved in the small- and mid-cap space.") An investor's decision to invest in these vehicles has several considerations:

- 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 55 basis points.)
- Another common challenge for SMID investors is capacity: 20% of the assets under management (AUM) in these mutual funds are closed.[6]
- Generally, ETFs are more tax-efficient than mutual funds. However, many investors are further limited by the perception that most ETFs are passive. Considering that the vast majority of ETF assets are passive strategies, it's easy to understand why.

[6] Morningstar (see Additional Disclosures), as of March 12, 2025.

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 December 31, 2024.
Source: ETF Action. Analysis by T. Rowe Price.

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 the first small-cap funds in the market.[7] Small- and 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. (See “Experience and strength in the small- and mid-cap market.”) The strategies developed over the many decades spent actively managing mutual funds apply directly to actively managing ETFs. All of the firm’s experience, resources, analysis, and expertise can be leveraged in the ETF space.

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	95,853
2	Fidelity Investments	68,889
3	J.P. Morgan Investment Management Inc.	46,757
4	Vanguard	43,816
5	MFS Investment Management	43,445

Active U.S. Small/Micro-Cap		
	Firm	**AUM (USD M)**
1	T. Rowe Price	75,100
2	Dimensional Fund Advisors LP	62,437
3	American Century Investments	31,224
4	Fuller & Thaler Asset Management, Inc.	25,925
5	Kayne Anderson Rudnick Investment Management, LLC	24,703

As of December 31, 2024.
Source: eVestment Alliance, LLC.

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 between 240 and 270 equities in which our managers have the highest level of confidence. These securities fall within the core-, growth-, and value-oriented spaces. While the macro environment should present opportunities in 2025, process and philosophy is driven by fundamental stock selection. The portfolio employs a bottom-up approach, where the managers select stocks they feel have potential to offer the most compelling upside.

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

Seeking new opportunities

Investors who have already considered the benefits of active management in small- and mid-cap sectors and have already invested in active funds now have new opportunities to consider in **actively managed ETFs**. Active ETFs, as with all actively managed funds, provide investors with the opportunity to benefit from professionals with the expertise and resources to make the best decisions based on the information on hand in these sectors.

Learn more about how you can add an edge with T. Rowe Price active ETFs.

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

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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.

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