

October 2018

Thursday's WSJ headline provided a good summary for an ugly month:

October's Wild Ride Jolts Investors

Two-day rise still leaves portfolios down sharply; bond prices also are hit in a rare double blow

By Michael Wursthorn

Stocks rebounded Wednesday, but a second consecutive day of gains did little to ease the pain of a brutal October marked by wild swings that have tested investors' faith in the nine-year bull market.

Even after the S&P 500 rallied nearly 3% over the month's final two days, the index in October still notched its biggest pullback in more than seven years. Stocks around the world lost about \$4.5 trillion in value, according to S&P Dow Jones Indices, as shares in Europe and Asia also tumbled.

The tumult left the Dow Jones Industrial Average and S&P 500 clinging to slim gains for the year as a whole. The indexes finished the month down 5.1% and 6.9%, respectively. It was the worst October for the S&P 500 since 2008.

Adding to the stock market's anxieties has been a rare simultaneous drop in bond prices that has pushed yields near their highest levels in years. The dual breakdown in stock and bond prices has upended investors' traditional safety tool kit of buying Treasuries during periods of volatility, leaving many with losses.

Traditional investment portfolios of 60% equities and 40% bonds lost more than 3% in October and are down 1.2% this year, on pace for a rare annual loss that was last seen in 2008

A laundry list of problems sent stocks reeling in October, erasing the hefty gains major indexes notched over the summer. Concerns that the U.S. economy is on the verge of overheating sent bond yields up, inducing the stock market's first bout of volatility earlier this month as investors were forced to re-evaluate the rich valuations in some pockets of the market.

Then signs of slowing corporate growth among highflying companies like Amazon and Google parent Alphabet, along with ongoing trade tensions between the U.S. and China, extended losses in stocks and bonds globally.

Shares in Europe didn't fare much better during the month, with the Stoxx Europe 600 declining 5.6%, its biggest drop in more than two years. Major indexes in Asia also notched steep losses, one of the worst being Hong Kong's Hang Seng, which suffered its biggest percentage decline since January 2016.

With losses mounting, the MSCI world equal-weighted index, which gives the stocks of 23 countries the same amount of clout regardless of market value, is down 14% from its closing high in late January.

Declines in bond prices (**which we have repeatedly warned about**), meanwhile, have exacerbated investors' pain. Annualized losses among U.S. Treasuries and investment-grade bonds are at 9.7% and 4%, respectively, the third-steepest declines since 1970, according to a recent Bank of America Merrill Lynch report. ...

From Friday's Global Investment Strategy's Weekly Report:

When Things Break

Recessions are usually caused when the Fed raises rates by enough to undermine spending on interest rate-sensitive purchases such as housing, or when higher rates prick an asset bubble just waiting to burst. Given the lack of clear imbalances either in the real economy or financial markets, the Fed may have to raise rates significantly more than the market is currently anticipating.

In fact, far from having to press the pause button midway through next year, our baseline expectation is that the Fed will expedite the pace of rate hikes in late 2019 as inflation finally starts to accelerate. Aggressive Fed rate hikes combined with an incrementally less expansionary fiscal policy will sow the seeds of a recession in late 2020 (**Wall Street's consensus view**) or 2021 (**the second time BCA Research has pushed back the start of the next recession**).

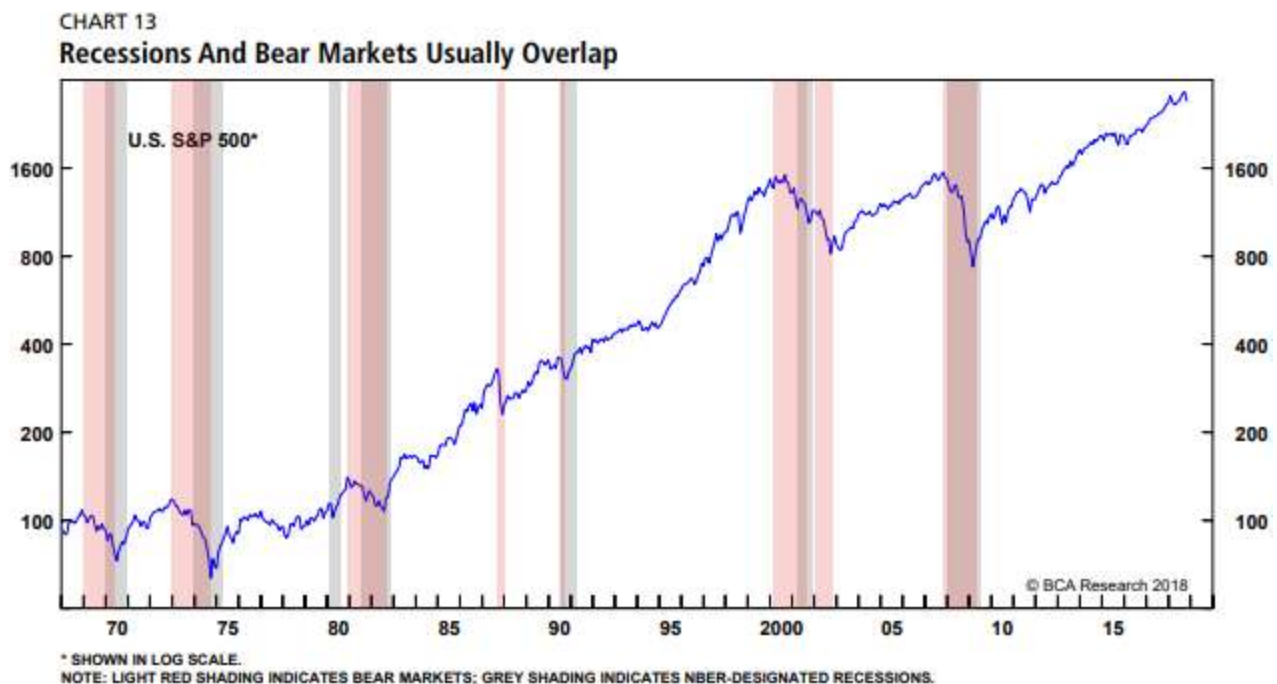
Before the next U.S. downturn arrives, the dollar will have strengthened further. A resurgent greenback will cast a long shadow over emerging markets and commodity producers. As we discussed last week, China is unlikely to save the day by launching a massive stimulus program of the sort that it orchestrated in both 2009 and 2015.

A Correction, Not A Bear Market

The current market environment bears some similarities to the late 1990s. The Fed is tightening monetary policy in order to keep the domestic economy from overheating. The U.S. economy is responding to higher rates to some extent, but the main effects are being felt overseas.

The Asian Crisis (**which we previously analyzed in detail**) did not end the **secular** bull market in U.S. stocks, but it did generate a few nasty selloffs, the most notable being the 22% peak-to-trough decline in the S&P 500 between July 20 and October 8, 1998. ...

The good news is that none of our recession indicators are flashing red. Since recessions and bear markets typically overlap (**Chart 13, which we have previously shared**), the odds are high that the current stock market

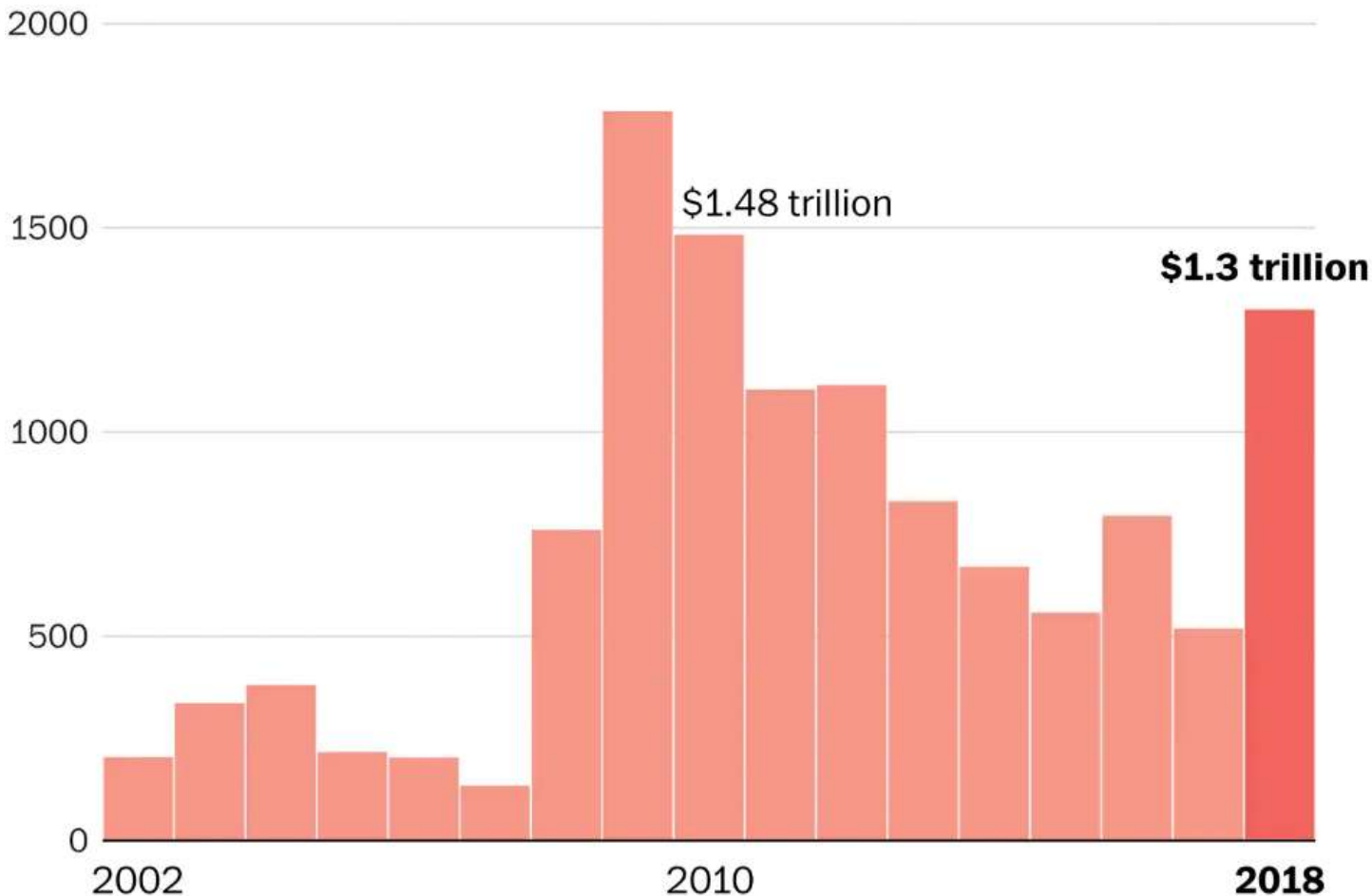


correction will be just that, a correction.

Another reason interest rates are rising?

U.S. government borrowing

Net marketable borrowing by fiscal year, in billions of U.S. dollars



Note: 2018 figure is based on Treasury estimates

Source: U.S. Treasury

THE WASHINGTON POST

“The race is not always to the swift, nor the battle to the strong, but that's the way to bet.” - Damon Runyon

PredictWise, whose model includes "Prediction Markets (Betfair, PredictIt, Hypermind), Polling (HuffPost Pollster), Fundamentals (Incumbency, Past Voting Results, etc.)", currently places the probability of the Democrats taking control of the House at 68%. FiveThirtyEight is at a very precise 85.2%. As reported by the Washington Examiner on Thursday: "Dave Wasserman, who is House editor of the nonpartisan Cook Political Report, tweeted Wednesday that their forecast was being updated, predicting that Democrats gain 30-40 seats,

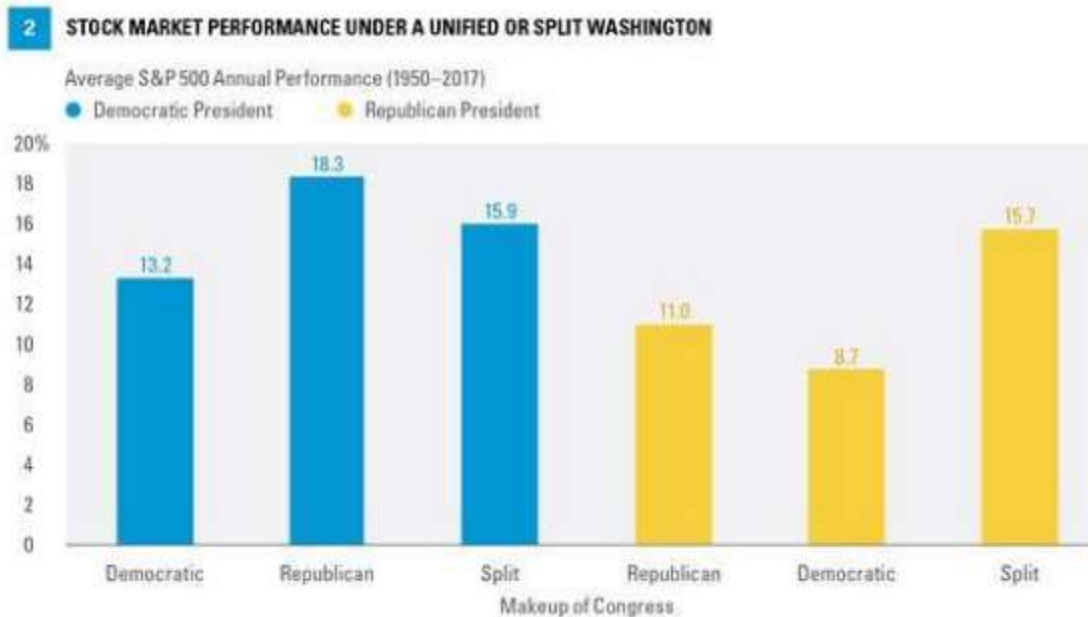
up from 25-35 seats." Assuming that the models are correct **this time**, what does it mean for stocks? From Wednesday's The Finance 202:

Uncertainty surrounding the competitive midterm elections on Tuesday appears to be among the least of investors' worries. Trump probably has been closer to the mark when he's blamed the falling market on rising interest rates (a development he has used to savage his handpicked Federal Reserve chairman). But market watchers point to a confluence of other factors, including fiscal stimulus that is wearing off, fears that companies are overvalued and a sense the economic expansion is running out of steam. The rising threat of a disruptive trade war with China is only exacerbating investors' jitters.

Would a new division of power in Washington that hands Democrats some control on Capitol Hill further weaken stocks, as Trump predicts? History suggests an answer: No.

Since 1950, the S&P 500 has averaged its best annual returns — of 18.3 percent — when a Democratic president shared power with an all-GOP Congress. That's obviously not a possibility next year.

But the current makeup in Washington, with Republicans in control of both ends of Pennsylvania Avenue, has marked the second-worst performance by the S&P 500 since the 1950's, with average annual gains of 11 percent. The stock market has only fared worse under a Republican president facing an all-Democratic Congress; and it has done nearly twice as well when a Republican president confronted split control on the Hill, as this chart from LPL Financial illustrates:



Source: LPL Research, FactSet 09/15/18

The modern design of the S&P 500 stock index was first launched in 1957. Performance back to 1950 incorporates the performance of predecessor index, the S&P 90.

All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. All performance referenced is historical and is no guarantee of future results.

Regardless of the balance of power in Washington, though, the market tends to register its strongest performance of any point during a four-year presidential term in the quarters immediately following the midterms. This chart from LPL Financial, pulling in data back to 1896, shows that pattern:

1 THE NEXT THREE QUARTERS ARE HISTORICALLY BULLISH FOR STOCKS

Dow Quarterly Performance Based on the Presidential Cycle (1896-2017)

● Average Quarterly Dow Gain/Loss (Left Scale) ● % Positive (Right Scale)



Source: LPL Research, FactSet 09/15/18

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STOCKS ARE USUALLY STRONG AFTER A MIDTERM ELECTION

Date of Midterm Election	President	Result of Midterm Election			S&P 500 Return 1 Year Later
		Senate	House	Congress Makeup	
11/05/46	Harry Truman	Democratic	Democratic	Democratic	0.1%
11/07/50	Harry Truman	Democratic	Democratic	Democratic	16.2%
11/02/54	Dwight D. Eisenhower	Republican	Republican	Republican	33.2%
11/04/58	Dwight D. Eisenhower	Democratic	Democratic	Democratic	11.1%
11/06/62	John F. Kennedy	Democratic	Democratic	Democratic	24.8%
11/08/66	Lyndon B. Johnson	Democratic	Democratic	Democratic	12.9%
11/03/70	Richard Nixon	Democratic	Democratic	Democratic	12.7%
11/05/74	Gerald Ford	Democratic	Democratic	Democratic	18.7%
11/07/78	Jimmy Carter	Democratic	Democratic	Democratic	6.4%
11/02/82	Ronald Reagan	Republican	Democratic	Split	19.9%
11/04/86	Ronald Reagan	Democratic	Democratic	Democratic	1.1%
11/06/90	George H.W. Bush	Democratic	Democratic	Democratic	25.1%
11/08/94	Bill Clinton	Republican	Republican	Republican	27.1%
11/03/98	Bill Clinton	Republican	Republican	Republican	22.0%
11/05/02	George W. Bush	Republican	Republican	Republican	14.9%
11/07/06	George W. Bush	Democratic	Democratic	Democratic	6.7%
11/02/10	Barak Obama	Democratic	Republican	Split	3.7%
11/04/14	Barak Obama	Republican	Republican	Republican	4.5%
11/06/18	Donald Trump	?	?	?	?
Average					14.5%
Median					13.9%
Count					18
% Higher					18

Source: LPL Research, FactSet 10/05/18

The modern design of the S&P 500 stock index was first launched in 1957. Performance back to 1928 incorporates the performance of predecessor index, the S&P 90. All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

And going back to the Truman administration, the S&P 500 has averaged a 14.5 percent gain in the years following midterms — and finished in positive territory in each of those 18 years **as shown above**.

Follow-ups

The Story of Yesterday's Winner

Step into a time machine, set the clock back five years, and rebalance your portfolio knowing what you know today. What would you do? Buy 100% US large-cap growth stocks.

Between September 2013 and August 2018, US large-cap growth stocks compounded at a 17.6% annualized rate, versus 14.5% for the broad US equity market and 6.6% for the European market.

This is not exactly what the smart money would have predicted. We quants tend to prefer small value stocks to large growth stocks, and we prefer internationally diversified portfolios to domestically oriented ones. But the exact opposite strategy has worked for the last five years. It's been the worst of times for international small value managers and the best of times for a 60%/40% FANG/Bitcoin portfolio.

What has driven this anomalous behavior? And will it persist? Should investors pretend it's 2013 and overweight US large-cap growth? To answer this question, we studied the past five years of data to better understand exactly why US large-cap growth stocks did so well.

We found that US large-cap growth stocks outperformed due to surprisingly high US real earnings growth. Since 2013, real earnings of S&P 500 companies have grown at a rate of 4.2% per year, double the long-run average growth rate of 2.1% per year since 1926.

Figure 1: US Earnings Growth and Inflation

	Earnings Growth		Inflation
	Real	Nominal	
Full Sample (7/1926 - 8/2018)	2.1%	5.0%	2.9%
5 Years (9/2013 - 8/2018)	4.2%	5.6%	1.4%
3 Years (9/2015 - 8/2018)	3.2%	5.1%	1.9%
1 Year (9/2017 - 8/2018)	12.5%	14.8%	2.4%

Sources: Robert Shiller's website, Ken French data library, and Verdad Analysis

This surprisingly fast earnings growth led to anomalously high returns for US growth stocks. The five-year performance of US growth stocks is 1.8x the historical average of 9.8% per year since 1926. On the other hand, the five-year performance of value is generally in line with its 92-year historical average since 1926.

Figure 2: US Value vs. Growth Returns

	Market Return	Growth Return	Value Return	Value Premium	T-Statistic
Full Sample (7/1926 - 8/2018)	10.0%	9.8%	12.9%	3.2%	2.82
5 Years (9/2013 - 8/2018)	14.5%	17.6%	12.1%	-5.5%	
3 Years (9/2015 - 8/2018)	16.5%	19.9%	15.1%	-4.8%	
1 Year (9/2017 - 8/2018)	21.5%	27.8%	16.1%	-11.8%	

Sources: Robert Shiller's website, Ken French data library, and Verdad Analysis

US earnings growth has also been abnormally high relative to Europe in recent years. The trailing 12-month earnings per share of US companies are now over 50% higher than their level in 2007-08. On the other hand, the trailing 12-month earnings per share of European companies are now almost 20% below their peak in 2007-08. This divergence in profit growth represents a gap of 70 percentage points between US and European earnings per share.

Figure 3: Change in Trailing 12-Month Earnings per Share since 2007-08 Peaks



Sources: Wall Street Journal, UBS European Equity Strategy, Datastream. As of May 9, 2018

This divergence in earnings led European equities to dramatically underperform US equities.

With these last five years of anomalously high growth rates in mind, investors have bid up the valuations of US equities, as though expecting yesterday's winner to keep on winning. US valuations are higher today than at any point since the tech bubble.

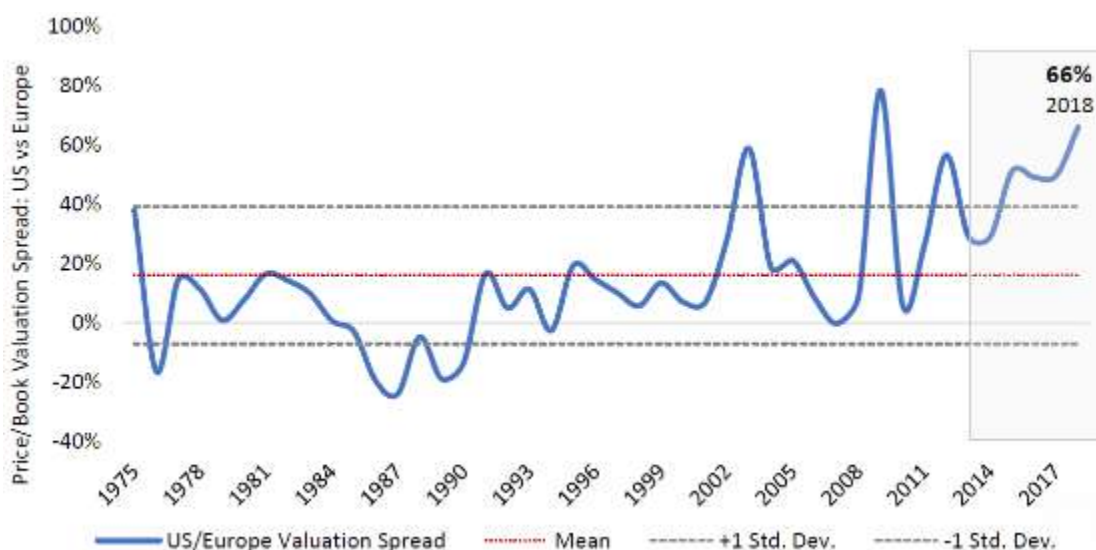
Figure 4: US Equity Valuations (1926–2018)



Sources: Ken French data library and Verdad Analysis

On a relative basis, the US equity market today is 66% more expensive than Europe in terms of price-to-book. This valuation spread is more than one standard deviation above the long-run historical average since 1975.

Figure 5: US/Europe Valuation Spread (1975–2018)



Sources: Ken French data library and Verdad Analysis

Investors responded to the surge in American corporate earnings by piling into US stocks, thereby pushing US equity valuations to notably high levels. Today, the US equity market appears expensive relative to its own history and relative to Europe.

But should investors bet on a continued growth surge? What could cause mean reversion in real earnings going forward? The past five years have been characterized by below-average inflation. Therefore, inflation could increase toward its long-run historical average of 2.9%, thereby slowing real earnings growth going forward. Alternatively, nominal earnings could revert toward their long-run average growth rate of 5.0% per year. This would reduce real earnings growth going forward, even if inflation remains at current levels. It's also possible

that both effects (higher inflation and lower nominal earnings growth) could occur at the same time over the next few years.

Investors who believe in mean reversion should be moving money out of US large-cap growth stocks and into US small value stocks and international equities. Growth rates don't trend. Rather, they follow a random walk. Therefore, we don't believe that investors should continue to bet on the high growth rates that have propelled US growth stock outperformance. Rather, investors should bet on the long-term base rates, which today—as always—favor small value and international diversification.

From The New York Times:

3 Investments That May Have Hit Their Peak

By **Paul Sullivan**

Sept. 14, 2018

This week is the 10th anniversary of the collapse of Lehman Brothers, a flash point in the financial crisis. The economy has rebounded since then and the stock market has risen to record highs, but a feeling of caution looms over many investors.

One of them is Dan Rasmussen, a contrarian investor who has marshaled data and historical returns to argue that three of the most popular asset classes for high-net-worth investors are not as desirable as they seem.

Mr. Rasmussen, founding partner of Verdad Capital in Boston, has written an [article](#) and [two reports](#) that make a case against investments in private equity, venture capital and private real estate, and he has piles of data to back up his argument.

“I want to give the advisers the intellectual ammunition to allow them to say, ‘No, I’m not going to put money into these strategies,’” he said.

But some advisers challenge this point of view, saying it is almost akin to market timing. “You could look at any asset class at any point in time and position it in a way and understand why it’s outperformed or underperformed,” said Scott Stackman, managing director of private wealth at UBS Wealth Management.

Here is Mr. Rasmussen’s argument for caution in three areas:

A model past its prime

During the financial crisis, Mr. Rasmussen worked at Bain Capital, a leading name in private equity. One of his jobs was to collect data on deals by Bain and its competitors to determine why some had done well and others had not.

The more profitable deals were the least expensive ones, he found. The cheapest 25 percent of deals accounted for 60 percent of the funds’ profits. The top 50 percent accounted for just 7 percent of profits. The difference was the price paid for the company. This was not solely for the obvious reason that paying less is better, but because private equity funds typically borrow 60 percent of the purchase price, which affects a company’s profitability.

Mr. Rasmussen said he admired the success Bain had in the 1980s and '90s, but began to question whether the private equity model it had helped pioneer was still sustainable.

When early private equity firms bought relatively small companies at a discount and loaded them up with debt, the amount of leverage on the company was still about four times the company's earnings before interest, taxes, depreciation and amortization, a measure of profitability known as Ebitda.

Private equity firms continued to apply this strategy, but they were paying more for the companies, and consequently the amount of debt was rising to more than six or seven times Ebitda. With leverage at 10 times Ebitda, Mr. Rasmussen found, a company's free cash was almost all going toward debt service, and it was nearly impossible to be profitable.

A recent example is Toys "R" Us, which Bain, KKR and Vornado Realty Trust acquired for \$6.6 billion in 2005. When it filed for bankruptcy in 2017, the toy company said it had \$5.3 billion in debt and was paying \$400 million in annual debt service payments.

Mr. Rasmussen said the sector would look worse if not for a few high-performing funds that pulled up overall returns.

"It's probably the worst time ever to invest in private equity," he said. "And now, it's being packaged for wealth management firms and registered investment advisers."

According to PitchBook Benchmarks, which gathers data on private equity investments, only 25 percent of funds have been outperforming the market, and have done so by a smaller amount.

Mr. Stackman of UBS said he was still putting money into private equity and hedge funds for certain clients, and reducing their investments in public equities or fixed income.

"I don't know if I'd term it as a true shift," he said. "This is our belief in how the high-net-worth clients could and should be invested."

Mr. Rasmussen said the funds that still provided high returns equal with the risk were generally smaller ones that acted more like the owners of the companies they bought and didn't just add debt to increase returns.

At his own firm, Mr. Rasmussen said, he modeled the strategy on what private equity funds were doing in the 1980s and 1990s: buying smaller companies at cheap prices and putting a reasonable amount of debt on them. In Verdad's case, Mr. Rasmussen focused on buying publicly traded companies with a small market capitalization.

Verdad's main leveraged company fund lagged its small-cap benchmark in the first two quarters of this year but kept pace with a broader global benchmark. Over the past three years, the strategy has beaten both the small-cap and global benchmarks by six percentage points.

An inconsistent pattern

The argument against venture capital is less nuanced. Top private equity funds are still delivering high returns, but venture capital funds have largely functioned as what Mr. Rasmussen calls "a rich man's lottery."

He cites data from Cambridge Associates showing that venture capital has underperformed the Standard & Poor's 500-stock index, the Russell 2000 Index and the Nasdaq over the last 15 years. And he argues that those

venture capital firms that built big names often did so with a few spectacular investments that overshadowed more mediocre ones.

The venture capital firm Benchmark, for example, invested \$6.7 million in eBay in 1997. That investment grew to \$5 billion in two years, outshining other investments.

Any venture capitalist will argue that the big winners make up for all the bets that did not pay off. Mr. Rasmussen does not dispute that; he emphasizes how difficult it is to find those funds that are going to consistently make the big winning investments.

Higher fees mean lower returns

Mr. Rasmussen draws a distinction between real estate owned by private equity firms and real estate investment trusts. And for him, the difference in returns comes down to fees. A REIT typically charges a management fee of less than 1 percent. A fund that owns real estate will charge a typical private equity fee, which can be as high as 2 percent to manage the money and 20 percent of the profits.

“By and large, it’s a pretty efficient asset class, since rental income is a fixed contract,” he said. So fees play a big role in the difference in returns.

But real estate owned in REITs, he said, could be a good buffer (**we agree**) for anxious investors because they have a low correlation to traditional equities given their stream of rental income. They’re also less risky (**depends on how you measure risk**), he wrote, than his focus, small-cap stocks. ...

Positions

DDDIX - Sold off the last position on 10/9 @ 21.99:

13D Activist Fund Class I DDDIX | ★★

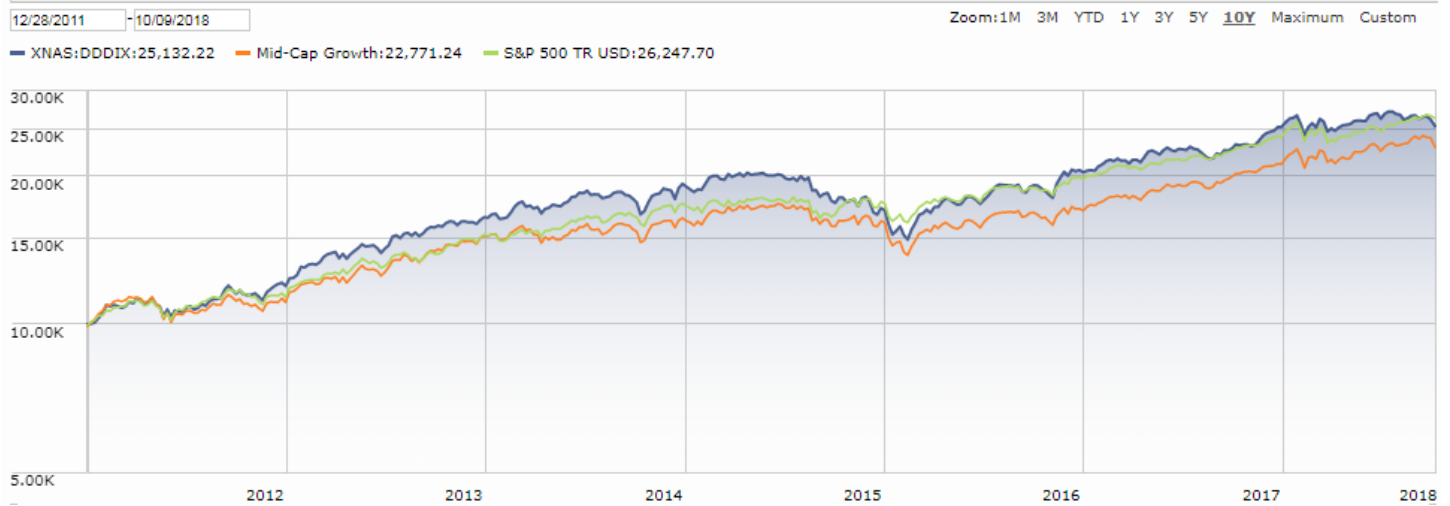
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NAV \$ 21.99	1-Day Total Return ↓ -1.08%	TTM Yield 0.00%	Load None	Total Assets \$ 376.5 mil	Expenses 1.51%	Fee Level High	Turnover 80%	Status Open	Min. Inv. \$ 1.0 mil
USD NAV as of 09 Oct 2018 1-Day Return as of 09 Oct 2018		30-Day SEC Yield --	Category Mid-Cap Growth	Investment Style Mid Growth					

Growth ▼ Benchmark ▼ Event ▼ Moving Avg US Dollar ▼ [Reset](#)



JE - Added 2% positions in this Canadian IVA System pick on 10/9&10 @ 3.079-.099 for 4 clients:



Insider Buying:

Trade Date	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
09/28/2018	1	MCCULLOUGH PATRICK D		10,000
09/26/2018	1	ROSS M DALLAS H		38,100
09/25/2018	2	PICKREN JAMES, ROSS M DAL		61,900
09/24/2018	1	MUNNELLY MARGARET		3,000
08/27/2018	1	PERLMAN BRETT A		10,000
08/21/2018	1	JETPORT INC		100,000
06/29/2018	1	PERLMAN BRETT A		14,000
06/18/2018	10	LEWIS JAMES, MERRIL DEBOF		745,146
06/05/2018	1	HOLLANDS H CLARK		5,000
05/18/2018	1	BROWN JIM		10,000

PRDSX - Purchased for 2 new clients:



From Morningstar:

A proven process coupled with a superb record and low fees make this an excellent small-cap option.

by Linda Abu Mushrefova
06/18/2018

Quantitatively driven T. Rowe Price QM U.S. Small-Cap Growth Equity is an excellent option for investors seeking low-priced exposure to the MSCI U.S. Small Cap Growth Index. Portfolio manager Sudhir Nanda has been a member of T. Rowe's quantitative equity group since 2000. He brings a wealth of experience to the strategy and is further supported by nine quantitative analysts and a five-member dedicated IT team. The team is expected to grow in the near term as it has taken on additional responsibility. Additionally, T. Rowe's group of fundamental analysts can be used as needed. Resources are sufficient at this strategy and have scaled well in response to a growing product lineup.

The strategy uses a disciplined approach that systematically ranks names within the fund's investable universe based on three broad metrics: valuation, profitability coupled with capital allocation and earnings quality, and momentum. Valuation accounts for 40%-45% of the score, quality 35%-40%, and the remainder in momentum. Given the relatively low emphasis on momentum, the fund's resulting turnover is well below the small-growth Morningstar Category peer average, which is a positive for investors. Further, the team typically invests in about 300 names. The diverse portfolio, coupled with a low-turnover approach, afford this strategy greater capacity than its typical peer.

The fund has been remarkably consistent from October 2006 through March 2018. It outperforms its peers 100% of the time based on rolling three-, five-, and 10-year returns. The team's ability to outperform on an absolute basis while taking on less risk than its bogies can be attributed to their thoughtful approach. Specifically, security selection has driven performance, and the disciplined portfolio construction process has helped keep risk in check.

Finally, fees are low, which means the team faces a lower hurdle to produce alpha for investors. For investors seeking small-cap exposure, this is a great option that we expect will continue to deliver over the long term; it is deservedly upgraded to a Morningstar Analyst Rating of Gold.

Process Pillar: Positive | Linda Abu Mushrefova 06/18/2018

A quantitative model that has been in place since manager Sudhir Nanda came aboard in 2006 drives this strategy. It gives the heaviest weighting to valuation, which accounts for 40%-45% of a stock's ranking, and likes to value companies on cash flow, as Nanda has found that to be the most stable and efficacious measure. The next-largest weighting, at 30%-35%, goes to earnings quality and profitability and capital allocation, which seeks to identify names with high return on equity, companies that are buying back stock or have a solid dividend policy, and where cash flow exceeds income. Price momentum also figures in the models, but it's the smallest piece; that results in low turnover relative to peers, somewhat atypical for a quant strategy. Their disciplined approach earns a Positive Process Pillar rating.

The model output is a weighted average rank of 1-10. Names that rank 1-4 are bought, and those scoring 7-10 are sold. The team can override the model, but this is not the norm. In addition to the model, Nanda can also source T. Rowe's fundamental analysts when the models rank two similar stocks similarly. He also seeks their help within biotech, as the models don't work as well in this space. The team invests in about 300 names ensuring diversification, and its approach affords it higher capacity than its typical peer. The team stays fully invested.

The team ensures that sector bets are kept to a minimum relative to the MSCI U.S. Small Cap Growth Index, but it's not an index-hugger. Security selection drives performance for this strategy, and single-name risk is minimal given the fund's 300 holding portfolio. The maximum position size for a single name is 1%, and

position sizing is determined by a combination of alpha potential, risk of the stock, and benchmark weighting. The team does not use an optimizer for this strategy, so portfolio construction is more qualitative in nature.

Sudhir Nanda likes to enter into a position gradually, typically initiating a position at 5-10 basis points and subsequently adding 1 or 2 basis points at a time. The sell discipline is similar, but the team will sell positions outright if required to by an extraordinary event. The goal is to account for less than 7% of average daily trading volume.

If a name is set to leave the fund's index, the team does not typically exit the position immediately. Either the name has become a value stock or has grown into a mid-cap. If it has become a value stock, the team will continue to hold it if it still scores well. If it has become a mid-cap, the team will hold on to it if it is still attractive but will no longer add to the position. The team tends to hold on to its winners and has a slightly higher average market cap than the benchmark as a result.

Performance Pillar: Positive

Since Sudhir Nanda took over the strategy in October 2006, it has topped its small-growth category peers and its MSCI U.S. Small Cap Growth Index benchmark with remarkable consistency. For example, it bests peers over rolling three-, five-, and 10-year periods 100% of the time. For the same time periods it tops its benchmark 89%, 95%, and 100% of the time, respectively. It has delivered superior absolute performance while taking on relatively less risk than its bogies and earns a Positive Performance rating.

The managers' disciplined approach ensures that sector bets are kept to a minimum and that performance is consistently driven by security selection. Their diversified portfolio of more than 300 names ensures that risk is spread out. Their below-average risk taking contributes to their impressive risk-adjusted performance, which has landed the fund in the top quintile of its category over the trailing five- and 10-year time periods.

While long-term performance has been stellar, the fund may lag in frothier markets owing to its quality and valuation bias. For example, the fund has lagged peers over the trailing one- and two-year periods. While it may sacrifice some of the upside, it more than makes up for this with its downside protection. Overall, this is a great relatively low-risk option in the small-cap space.

People Pillar: Positive

Sudhir Nanda became the lead manager here in October 2006 and has delivered for investors during his tenure. He also serves as the head of the quantitative equity team at T. Rowe Price. He has been with the firm, specifically as a member of the quantitative team, since 2000. Prior to joining, he was an assistant professor of finance at Penn State University, Harrisburg. He brings a wealth of experience to the strategy, earning it a Positive People rating.

In addition to Nanda, the team consists of nine quantitative analysts, one portfolio specialist, and a five-person dedicated IT team that helps to maintain and support the model that drives this team's strategies. The analyst team continues to expand as they have taken on additional responsibilities with another analyst slated to join in the upcoming months. Additional resources have been added at a moderate pace as a result of new product launches. For example, as of June 2017, Sudhir Nanda, Prashant Jeyaganesh, and Vinit Agrawal have assumed portfolio management responsibilities for T. Rowe Price QM U.S. Small & Mid-Cap Core Equity TQSMX. That's a lot of new responsibility, but Nanda says the team has been building models for similar strategies for

years in the course of doing quant work for T. Rowe's fundamental portfolio managers, and the team is able to scale its work efficiently. Nanda invests \$100,001-\$500,000 in this fund.

Parent Pillar: Positive | 10/01/2018

T. Rowe Price remains best-in-class, earning a Positive Parent rating. The firm's success is rooted in its fundamental approach to active management and deep analyst bench. Investors benefit from managers' generally long tenures at the firm, well-planned manager transitions, reasonable costs, and attention to capacity. Many top executives, including CEO Bill Stromberg, rose from the analyst ranks, which helps keep a focus on investors at the forefront, even as the firm expands its distribution footprint outside the United States and bolsters its technology resources. The investment side has received resources, too. The multi-asset team has grown in size, reflecting its importance to the firm's future beyond the esteemed target-date lineup. Despite headwinds facing active managers, T. Rowe remains a powerhouse within U.S. and international equities. Fixed income is an area to watch. Several long-tenured managers have recently retired or will do so soon. Sound succession planning has smoothed the transitions, but the firm needs to ensure the bench remains deep. While high-yield and municipal bonds remain bright spots, the fixed-income team has not yet shown sustainable success in inching beyond its conservative bottom-up approach at some core strategies. Plus, the firm's foray into alternatives is unproven. Overall, though, T. Rowe Price retains the sensible and investor-focused culture that has long driven its success.

Price Pillar: Positive

This small-cap offering is priced very attractively relative to peers, earning it a Positive Price rating.

The no-load shares account for about 71% of assets and rank in the top quintile of similarly distributed peers. Its prospectus net expense ratio of 0.81% falls well below peers' median of 1.17%. The remaining two share classes, which were launched in 2016, also fall below average. The Adv and I share classes charge 1.04% and 0.66%, respectively. The Adv share class accounts for less than 0.5% of assets, with the remainder in the I share class. Investors seeking small-cap exposure should consider this low-cost option.

