SMALL-CAP: THE EVERGREEN ASSET CLASS

Bigger Than You Think

A Large and Diverse Equity Universe

The investment universe of small companies is both large and diverse. Small-cap equities form the largest domestic equity universe, accounting for approximately 80% of all publicly traded companies in the U.S. The universe includes more than 4,100 companies and represents more than $1.8 trillion in total market capitalization. At Royce, we divide small companies into two segments: micro-cap, those with market caps up to $750 million; and those small-cap companies with market caps between $750 million and $2.5 billion.

Market Capitalization	Number of Companies
$0 – $750 million	3,243
$750 million – $1 billion	215
$1 billion – $2.5 billion	690
$2.5 billion – $5 billion	453
$5 billion and above	747

Data provided by *Reuters* as of 3/31/14.

- Micro-Cap (Up to $750 million): The U.S. micro-cap segment consists of more than 3,200 companies with more than $530 billion in total capitalization. It offers many choices but also faces significant trading difficulties, including limited trading volumes and higher volatility.
- Small-Cap (from $750 million to $2.5 billion): The U.S. small-cap segment encompasses more than 900 companies with a total capitalization of more than $1.2 trillion. It is more efficient, offering greater trading volumes and narrower bid/ask spreads.

Evolving Universe

The last 20 years have seen substantial change in what constitutes a small company—for example, it was not long ago when small-caps were those with market caps up to $750 million, a definition that now describes the micro-cap sector. The ongoing evolution of the asset class, which includes the entrance of new companies and IPOs, makes small companies an evergreen source of investment opportunities.

Professional Asset Class

Once regarded as highly volatile and deployed opportunistically from an investment standpoint, small-cap has evolved over the last several years into an accepted asset class, one used by institutions, consultants, advisors, and individuals.

Strong Absolute Results

Although most investors are aware of the long-term performance advantages that the small-cap asset class has historically offered, fewer are familiar with the high level of absolute returns that the asset class has generated. Research shows that since the end of World War II, what we deem "the modern era," small-caps, represented by the CRSP 6-10, have generated monthly trailing

three-year average annual total returns of 10% or better 64% of the time. In 29% of all three-year periods, returns were 20% or greater. Historically strong returns from the asset class are precisely why we believe investors need continuous exposure to small-caps.

The Appropriate Benchmark Index

With such a large and diverse selection universe, what is the appropriate benchmark for our domestic small-cap portfolios? While we believe that the Russell 2000 Index is the best choice, people often ask us why we use this benchmark instead of a style index such as the Russell 2000 Value Index. Considering our own risk-conscious value approach, would it not make more sense to use a value index as the benchmark?

To us, a benchmark is a point of reference that provides a representative return for a broad-based asset class. Unlike a lot of managers, we do not manage against an index. In other words, we select companies for our portfolios because we believe that they can provide a desired rate of return, not because we think that they can beat the return provided by an index. Any time one of our Funds outperforms its benchmark, it is a happy byproduct of our investment process and nothing more.

CRSP 6-10 Three-Year Monthly Average Annual Total Returns
January 1946 through March 31, 2014

Three-Year Average Annual Total Return Averages	Percent of Periods
≥ 20%	29%
≥ 10% and < 20%	35
≥ 0% and < 10%	24
≥ -10% and < 0%	9
≥ -20% and < -10%	3
< -20%	0[1]

[1] Represents 0.1% of all periods.

General Index Versus Style Specific

There are other important reasons why we use the Russell 2000 rather than its value counterpart. First, the Securities and Exchange Commission requires that we use a broad-based index for certain performance comparisons, such as the graphs in our annual reports that show the growth of $10,000 over a certain time period. The Russell 2000 better satisfies this requirement in that it is broad (approximately 2,000 issues ranging in market cap from $129 million to $3.3 billion as of 5/31/13), has history (1979 inception), and incorporates a full range of securities, industries, and sectors.

As a broad-based index, the Russell 2000 is also more representative of our selection universe. Style indexes such as the Russell 2000 Value and Growth generally include only companies that meet certain statistical definitions as defined by the company that maintains the index. So while we use a value approach to select companies, we do not limit our selection universe to the stocks in the Russell 2000 Value Index (or the Russell 2000 Index). In fact, many times we buy what may be regarded as growth stocks, in areas such as technology and healthcare when they meet our own selection criteria. There are also sectors traditionally associated with value investing, such as Utilities, in which we typically do not make significant investments.

Valuation Discrepancies, Not Statistically Cheap Stocks

Instead of using only statistical criteria, such as low P/E and/or low P/B ratios, we employ a business buyer's approach to investing that evaluates quantitative and qualitative factors. Unlike a lot of firms, we do not begin the investment process looking for low P/E or P/B stocks. Rather, we look for well-run companies with histories of high returns on invested capital that are trading at discounted stock prices. This may also lead us to companies that have recently experienced earnings disappointments and consequently sport above-average P/E ratios—ratios more in line with those contained in growth style indexes.

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