Royce Premier Fund

The Strange Case of the Current Small-Cap Cycle

Through much of this long recovery for equity prices following the market bottom on March 9, 2009, specifically the period from 2011 through the end of 2015's third quarter, many active small-cap approaches, our own included, struggled to beat their benchmarks. The initial years of the cycle (2009-2010) were strong on both an absolute and relative basis for many Royce Funds. However, the last four calendar years have seen many of our portfolios coming up short on a relative basis.

We can accept relative underperformance for a one-year period with equanimity. A three-year period is more difficult to swallow because it represents to us the threshold between the short and long terms. However, we could ultimately accept that too, provided we saw strong signs of market or economic changes that looked likely to benefit our disciplined approaches. A five-year underperformance period, on the other hand, is another matter entirely. While for the period ended September 30, 2015 the Fund's five-year average annual total return (+7.6%) fell below its own (+12.1%) and its benchmark's (+10.6%) historical rolling monthly five-year average, the same just-concluded five-year period saw a higher-than-average return for the Russell 2000 (+11.7%).

This most recent underperformance period led us to attempt to answer two critical questions that are important to us and that we know have been on the minds of our investors: First, what forces have helped to shape the current cycle and contributed to the relative advantage for the small-cap index? Second, what signs, if any, reveal that some of these forces may be ebbing or reversing?

Three specific market conditions have resulted in relative performance challenges: when small-cap stocks are generating returns well above their long-term averages, when there is lower-than-usual volatility for small-cap stocks, and/or when credit spreads—or the cost of capital—are declining. When only one of these conditions was present, our relative performance often suffered, if only in the short run. Yet for much of the past five years, each of these three conditions converged.

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Before looking more closely at these developments, we want to emphasize that our belief in the cyclical nature of financial markets is fundamental and unshakeable. We were not surprised to find, then, that all three were showing signs of abating through much of 2014 and so far in 2015. And while we cannot predict future performance patterns, we are nonetheless encouraged by many of our Funds' long-term histories, especially following similar underperformance periods.

Credit Spreads* and Royce Returns

The availability of capital for businesses expands and contracts over time. In 2008, capital was understandably both quite scarce and very expensive. Contrast this with 2013 when capital was widely available. One metric used to assess the price, or cost, of capital is the difference in yield between U.S. Treasury bonds and high-yield bonds. When this yield differential, or yield spread, is high, the cost of capital is also, which often causes problems for highly leveraged businesses.

When the cost of capital declines and the yield spread drops, it creates a potential advantage for the kind of highly leveraged stocks that we typically avoid. Yet many high-leverage stocks find homes in the Russell 2000. When the cost of capital was declining (and the yield spread was narrow), these stocks contributed to the index's stellar performance. The reverse held true when the cost of capital rose, expanding the yield spread. As a result, our relative performance has often correlated with movements in high-yield credit spreads. As shown in the following table, from 1996-3Q15 Premier slightly underperformed when the credit spread range contracted, typically had a slight excess return when this range was narrow (and more stable), and had a more decisive advantage when the range widened—that is, when the cost of capital rose.

* Credit spread data source: B of A Merrill Lynch US High Yield Master II Option-Adjusted Spread

Average of One-Year Premier Relative Returns vs. Russell 2000 by Credit Spread Rate of Change
From 12/31/96 through 9/30/15 (%)

	CREDIT SPREAD RATE OF CHANGE	AVERAGE RELATIVE RETURN
Tercile 1 (Credit Spreads Narrow)	-12.2 to -0.9	-1.2
Tercile 2 (Credit Spreads Stable)	-0.9 to 1.0	1.0
Tercile 3 (Credit Spreads Widen)	1.0 to 14.1	7.0

We are therefore encouraged by the recent increase in the cost of capital. From a peak of 21.8% at the end of 2008, yield spreads contracted all the way down to 3.4% in the early summer of 2014 and have already begun to widen. They stood at 6.6% at the end of 3Q15.

Volatility Is an Ally

Low volatility environments have historically been challenging for most active managers, including ourselves. The reason is that differentiation lies at the core of active management. We evaluate multiple aspects of a company and then judge whether or not the current stock price reflects the long-term prospects we see.

Opportunities to purchase what we deem to be attractively undervalued companies occur more frequently when stock prices are volatile. The following table shows that over the past 23+ years, Premier on average generated excess returns versus the Russell 2000 in most market environments—including those with the lowest volatility. However, the excess return spread was narrow when volatility was lowest. And for most of the last five years, volatility has been falling and has remained low, which has created a more challenging environment for active managers.

Average of Five-Year Monthly Rolling Statistics
From Premier's inception 12/31/91 through 9/30/15 (%)

	QUINTILES[1]				
	1	2	3	4	5
Russell 2000 Standard Deviation	14.11	17.78	20.43	22.30	24.09
Russell 2000 Performance	14.54	12.53	8.32	6.28	2.54
Premier Performance	15.94	13.32	12.28	12.01	6.92
Premier Excess Return vs Russell 2000	1.40	0.79	3.96	5.73	4.37

[1] Based on Russell 2000 Standard Deviation.
Please see page 4 for more information.

It's worth pointing out that U.S. small-caps have seen increased volatility since 2014's second quarter. As this trend has continued, it has created more opportunities for us to buy at attractive prices.

How Long Can High Returns Last?

From the inception of the Russell 2000 (12/31/78) through the end of 3Q15, there were 382 monthly trailing five-year return periods. In 28% of those periods, five-year average annual total returns were greater than 15%. While such high return periods are not the norm, they have historically been challenging for active mangers such as ourselves. In fact, from Premier's inception, when trailing five-year returns for the Russell 2000 were 15% or greater, the Fund underperformed 81% of the time.

Our expectation going forward is for something closer to small-cap's five-year average annual total rolling return of 10.6%. Such periods, as can be seen in the table below, were favorable to our approach.

Five-Year Rolling Returns
Russell 2000 Average Annual Total Returns from Premier's inception 12/31/91 through 9/30/15 (%)

	< 5%	5% - 10%	10% - 15%	>15%
Number of periods	68	60	50	48
% of periods	30%	27%	22%	21%
Premier Average Excess Return	5.76%	4.98%	2.03%	-1.23%

...So What Happens Next?

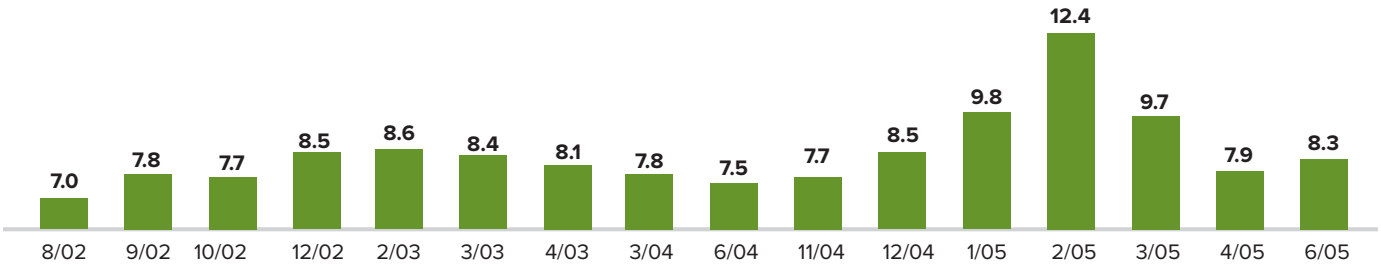
In our experience, markets are cyclical. Most trends reverse, though they can linger for longer than initially anticipated (or desired). The three trends we have examined — narrow credit spreads, lower-than-average volatility, and higher-than-usual small-cap returns—all showed signs of reversing in the latter part of 2014.

We view these shifts as part of the eventual normalization of the financial markets, by which we mean lower average annual returns with higher volatility. We see these developments as being accompanied by an eventual increase in the cost of capital, driven both by higher interest rates and wider credit spreads, which is a natural result of an ongoing economic expansion. A higher cost of capital usually has a significant and negative effect on highly leveraged businesses.

We thought it might be instructive to look at relative performance following historical underperformance periods. We identified 43 five-year spans from the Fund's inception when Premier underperformed the Russell 2000 by 1.0% or more on an average annual basis. We then looked at the relative performance, as measured by excess returns, in the subsequent five-year periods. Sixteen of the 43 had subsequent periods of five years. The Fund outpaced its benchmark in all 16 subsequent five-year periods. Moreover, the average excess return for these subsequent average annual five-year periods was a healthy 8.5% per year.

Past performance is no guarantee of future results. That being said, and looking closely at history, particularly within the context of the highly anomalous period we have just endured, we suspect that investors may be able to appreciate why we are so optimistic about the prospects for both the relative and absolute performance of our disciplined, value-oriented approaches.

Premier vs Russell 2000
Subsequent 5-Year Excess Return Following Each Monthly Rolling 5-Year Period of Relative Underperformance in Excess of 100 BPS (%)



See Fund Performance and Expenses on the back

Performance and Expenses

Average Annual Total Return (%) Through 9/30/15

	3Q2015*	YTD*	1-YR	3-YR	5-YR	10-YR	15-YR	20-YR	SINCE INCEPTION (12/31/91)
Royce Premier Fund	-12.42	-10.95	-10.06	5.87	7.57	6.96	9.38	10.41	11.10
Russell 2000	-11.92	-7.73	1.25	11.02	11.73	6.55	6.51	7.95	9.17

Annual Operating Expenses: 1.10%

*Not Annualized

Important Performance and Expense Information

All performance information reflects past performance, is presented on a total return basis, reflects the reinvestment of distributions, and does not reflect the deduction of taxes that a shareholder would pay on fund distributions or the redemption of fund shares. Past performance is no guarantee of future results. Investment return and principal value of an investment will fluctuate, so that shares may be worth more or less than their original cost when redeemed. Shares redeemed within 30 days of purchase may be subject to a 1% redemption fee, payable to the Fund, which is not reflected in the performance shown above; if it were, performance would be lower. Current month-end performance may be higher or lower than performance quoted and may be obtained at www.roycefunds.com. Operating expenses reflect the Fund's total annual operating expenses for the Investment Class as of the Fund's most current prospectus and include management fees and other expenses.

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