

Conference Call Series

The following are notes based on a conference call on January 26, 2010. The call featured Jack Fockler and Whitney George of Royce & Associates ("Royce"). During the call, they provided a review of the financial markets and their performance in 2009, as well as their outlook for 2010.

Recent Market Environment

- Fockler explained that in 2009, the U.S. equity market posted its best calendar year return since 2003. During the year, small-caps gained 27.2%, modestly outperforming the S&P 500 Index. From the market's bottom on March 9, 2009 through December 31, 2009, small-caps rose more than 80%, outperforming their large-cap counterparts.
- Despite the strong results in 2009, Fockler said the market remains roughly 25% lower than its 2007 peak.
- George said that we have just completed a "lost decade" for large-cap stocks, as the return of the S&P 500 Index was negative for ten years--the first time this has ever occurred. If nothing else, he said there's opportunity in the equity markets just through a reversion to the mean.
- Fockler pointed out that during the last decade, the small-cap Russell 2000 Index posted a 3.5% average annual return. He also described how small-caps stocks have outperformed their larger-cap counterparts 85% of the time over 10-year periods when returns are below normal or even negative. In contrast, large-caps outperformed small-caps about 75% of the time when returns are above normal.

Portfolio Positioning

- In describing their investment process, George said that Royce is foremost a risk manager. Royce seeks to own high quality companies with strong balance sheets. They would rather own a stock for the long run versus trying to trade their way to generating performance. Royce uses an absolute return model and they establish buy and sell prices for every stock in their portfolios.
- George explained that they look to buy stocks when they're offered at very attractive valuations. They also diversify their portfolios across industries, and increasingly across the globe, to help manage risk.
- Fockler said that 2009 was an outstanding year for the Royce Funds, both in absolute and relative performance terms.
- George explained that Royce had a competitive advantage during the financial crisis, because they had a stable capital base in 2008. As a result, they had the ability to buy stocks as their prices were plunging in late 2008 and early 2009. Given this, they were further able to fully participate during the market's subsequent rally.
- From a portfolio positioning perspective, George said they've had an overweight in natural resources as far back as 2003. Typically, their holdings in this space are North American oriented and they emphasize natural gas and service companies.
- George described how they have exposure to mining companies, they made these purchases when their valuations were "extraordinarily cheap" relative to what Royce thought they were worth based on their assets and future earnings power.
- According to Fockler, roughly 20% of the revenues in the Russell 2000 Index are now derived from non-U.S. sources. In the international market, Royce initially focused on companies that had overseas headquarters but did the bulk of their business in the U.S. They now also invest in companies that are located abroad and conduct the majority of their business abroad as well.

MANAGER INSIGHTS

Outlook

- From a market leadership perspective, George said he has been a proponent for investing in harder assets for the better part of the last decade. The stocks of these companies recovered very dramatically in 2009. George believes that their fundamentals remain largely intact, in part due to continued strong demand from emerging market countries.
- George explained that the outlook for financials was somewhat cloudy, given the talk of new regulations, taxes and reforms.
- Consumption patterns in the U.S. are likely to change and George believes that household savings rates need to increase. While that has positive implications for asset managers, it could be a negative for consumer service areas such as retailers and restaurants.
- George said that his biggest concern for the market going forward is what happens with interest rates. But he thinks that equities look very promising over the next five years. He said it's anyone's guess whether large- or small-caps are the performance leaders.
- Merger and acquisition (M&A) activity is picking up in the small-cap world. George said that earnings disappointments will create M&A opportunities and buyout offers will create cash-out moments.
- George said that, as stock pickers with an established discipline that has added value over a long period of time, they are very excited about the opportunities going forward. It is his belief that Royce will generate solid nominal returns over the next decade.

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Investment Risks

Investments in small- and medium-capitalization companies may involve a higher degree of risk and volatility than investments in larger, more established companies. Investing in mutual funds involve risks, including possible loss of principal. Common stocks generally provide an opportunity for more capital appreciation than fixed income investments but are subject to greater market fluctuations.

MANAGER INSIGHTS

Definitions

The Russell 2000 Growth Index measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values. Please note an investor cannot invest directly in an index.

The S&P 500 Index is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S. Please note an investor cannot invest directly in an index.

Mergers & Acquisitions ("M&A")