POSITIONING FOR A NORMALIZING ECONOMY

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"We still see, especially among cyclicals, a number of profitable, conservatively capitalized businesses that have either been ignored or have lagged. We expect this to change."

Chuck Royce

- Small caps underperformed large caps in 2014
- We will continue to look for what our analyses tell us are high-quality companies that are temporarily out of favor and attractively discounted
- Valuations seem pretty reasonable, if not attractive in certain areas, if you believe, as we do, that the economy is going to keep growing, that credit spreads will continue to expand, and that a more robust CAPEX cycle is in the offing
- The ripple effects of falling oil prices run wide, but we remain bullish on the long-term prospects for Energy

4Q 2014

Q. Why do you think large-cap stocks did so much better than small-caps in 2014?

A. I think much of large-cap's outperformance was related to reversion to the mean.

Although most stocks have been doing well since the bottom in March 2009, small-caps have been out in front — often by a sizable margin — throughout most of that period. That began to change in 2014, particularly in the second quarter when both the S&P 500[1] and Russell 1000[2] outpaced the Russell 2000[3] by a decent-sized spread. This didn't surprise us.

Small-caps had been ahead for so long and had held such a substantial edge from that trough coming into 2014 that a shift in leadership for equities seemed imminent. What's interesting to me is that small-caps gave up leadership mostly during downdrafts, which were barely noticeable for larger stocks in 2014.

Small-caps experienced losses between March and May and, more seriously, between July 5 and October 13, and these declines really set the stage for the leadership rotation we saw for the year as a whole.

Q. Considering the lower returns for small-caps in 2014, were you expecting better relative results from some sectors of the market?

A. Absolutely. We were expecting quality stocks — those with strong balance sheets, solid cash flow characteristics, and high returns on invested capital — to emerge as leaders within the small-cap asset class.

Related to this was our thought that many stocks in economically sensitive cyclical sectors would also do well considering what we see as their financial and operational strengths and relatively lower valuations. After a solid first half for many small-caps that fit these descriptions, things went south in a hurry.

Q. What is the current case for active management in the small-cap space?

A. The case hasn't really changed — it's still the same argument that we've been making for decades. The only thing that's different is that we've gone through a long period in which nearly all actively managed small-cap funds have failed to beat their respective indexes.

But I believe strongly that in an inefficient area such as small-cap, trying to understand these inefficiencies and identifying qualitative factors should make a difference over long-term and full market cycle periods.

We remain completely committed to this idea. We will continue to look for what our analyses tell us are high-quality companies that are temporarily out of favor and attractively discounted.

[1] 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. Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges.

[2] The **Russell 1000 Index** measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 92% of the total market capitalization of the Russell 3000 Index.

[3] The **Russell 2000 Index** is an unmanaged list of common stocks that is frequently used as a general performance measure of U.S. stocks of small and/or midsize companies.

Q. How do small-cap valuations look to you as we enter 2015?

A. I think the valuation picture is somewhat tricky. For example, looking at trailing 12-month earnings for many companies suggests that small-cap share prices are on the high side. But if you believe, as we do, that the economy is going to keep growing, that credit spreads[4] will continue to expand, and that a more robust CAPEX[5] cycle is in the offing, then valuations seem pretty reasonable, if not attractive in certain areas.

We still see, especially among cyclicals, a number of profitable, conservatively capitalized businesses that have either been ignored or have lagged. We expect this to change.

Q. What impact do you think lower energy prices are likely to have on stocks?

A. The market was initially rattled by the decline in energy prices, though for most consumers, lower prices for gasoline and heating oil is like getting a pay raise. But of course it wasn't just the sinking commodity price that spooked the markets, it was also concerns over currency stability in Russia, and the ruble was in trouble almost immediately.

It also raised concerns over terrorism and political stability in the Middle East and the economic prospects of certain regions in the U.S. So the ripple effects of falling oil prices run wide. But we remain bullish on the long-term prospects for Energy, especially for services companies.

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Currencies and commodities contain heightened risk that include market, political, regulatory, and natural conditions and may not be suitable for all investors.

Active Management does not ensure gains or protect against market declines.

Outperformance does not imply positive results.

[4] A **credit spread** is the difference in yield between two different types of fixed income securities with similar maturities, where the spread is due to a difference in creditworthiness.

[5] **Capital expenditures (CAPEX)**, also called capital spending, is an amount spent by a company to acquire or upgrade productive assets (such as buildings, machinery and equipment, vehicles) in order to increase the capacity or efficiency of a company for more than one accounting period.

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