



# SIGNS OF A MARKET TURNING



**Charles M. Royce**  
Chief Executive Officer,  
Portfolio Manager



**Francis Gannon**  
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- We think there has been too much attention paid to interest rates and not enough to credit spreads and the corporate cost of capital.
- Historically, credit crunches have led to trouble for small-caps as a whole; however, we believe that companies with low leverage, high returns on invested capital, and other indicators of financial strength should have a marked advantage in a more challenging or difficult credit environment.
- We see profitability and profit growth becoming increasingly important, which will make it harder for unprofitable small-caps to maintain leadership.

“This economic cycle has been historically anomalous in terms of how stocks have behaved.”

Francis Gannon

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**Q. Why do you think the equity markets were so volatile and skittish in the second half of 2015?**

A. **Chuck Royce:** I think there were several reasons, commodities, currency, credit and China.

We saw pervasive anxiety about commodity prices, the relative strengths and weaknesses of currencies, widening credit spreads<sup>1</sup>, and China's economy, which all combined to make investors nervous and uncertain.

We also had the terrible attacks in Paris and shootings in Colorado and San Bernardino, so terrorist threats specifically and heightened risk sensitivity more generally were once again front and center in people's minds.

On the other hand, much of the news about the U.S. economy remained solid, even if it wasn't quite as good as many of us had been expecting. The result was a very jagged market in the second half of the year — one that featured strong rebounds between October and November before share prices fell again in December.

**Q. Were you surprised at all by the market's reaction to the rate increase on December 16<sup>th</sup>?**

A. **Francis Gannon:** Not really. For some time, we've held that the market would price in any anxiety over interest rates. You could see this in real time, as it were, in the two weeks leading up to the Federal Reserve's (Fed's)<sup>2</sup> actual announcement on December 16th when the market fell nearly 7% in anticipation.

I think it's important to remember that rates are still very, very low. In fact, what's more noteworthy to us than the 25 basis point<sup>3</sup> increase is the pace and rate of any subsequent increases.

And even more important is the fact that credit spreads have been widening steadily for more than a year. This has clear implications for U.S. stocks, especially with regard to how much leverage<sup>4</sup> they're carrying.

**Chuck:** We think there has been too much attention paid to interest rates and not enough to credit spreads and the corporate cost of capital. We expect the Fed to act very gradually — as it has been doing — and to telegraph their moves.

For our part, we'll be watching the credit situation very carefully because that is more likely in our estimation to be more meaningful for small-cap and for the relative performance of more leveraged businesses.

<sup>1</sup> 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.

<sup>2</sup> The **Federal Reserve Board ("Fed")** is responsible for the formulation of U.S. policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

<sup>3</sup> A **basis point** is one one-hundredth (1/100, or 0.01) of one percent.

<sup>4</sup> **Leverage** refers to the amount of debt held by a company or sector of the market.

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**Q. What were some of the most disappointing factors to you in 2015?**

A. **Chuck:** The most important factor was what didn't happen — the economy failed to accelerate with the kind of speed that would drive investors toward more economically sensitive sectors like Industrials, Materials, and industrial-type companies in Information Technology.

A certain pace of growth is important for more robust performance in many cyclical businesses, and we simply haven't seen it yet in this long, slow recovery that followed the Financial Crisis.

**Francis:** This economic cycle has been historically anomalous in terms of how stocks have behaved. Typically, we would have seen a period of vibrant growth in the early stages.

When it didn't materialize, we were prepared to wait — especially because the companies we favored were in very good financial condition and were for the most part executing effectively during a highly challenging period.

**Q. What, then, is the argument for Industrial and other cyclical sectors right now?**

A. **Chuck:** In essence, we're preaching and practicing patience right now in these more economically sensitive sectors, consistent with our long-term view.

We are very concerned about the state of the credit markets. Historically, credit crunches have led to trouble for small-caps as a whole; however, we believe that companies with low leverage, high returns on invested capital<sup>5</sup>, and other indicators of financial strength should have a marked advantage in a more challenging or difficult credit environment.

We think this is particularly true for the companies we favor in more cyclical areas. There may be pain for nearly all small-caps in the initial phase of a significant credit event, but we think financially self-supporting companies would ultimately emerge as leaders.

**Francis:** Many have definitely faced additional headwinds over the last year or so because of the global industrial slowdown and the precipitous decline of energy prices.

As much as this has tested our patience, it's given very attractive valuations, in our view, to a lot of those businesses that are both in excellent shape financially and have executed well in a tough period.

So while the global economic growth picture is admittedly not as clear as we'd like, we also think these businesses are well positioned to rebound in an investment setting in which leverage and earnings matter.

And any pick-up in economic growth, which we think is likely over the next year, would make these companies that much more attractive, as would any stability or recovery for energy prices.

<sup>5</sup> **Return on invested capital (ROIC)** is the amount, expressed as a percentage, earned on a company's total capital. It is calculated by dividing total capital into earnings before interest, taxes, and dividends.

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**Q. Why was the July shift in small-cap leadership from non-earners to earners so important?**

A. **Chuck:** It was significant in and of itself because prior to that July 17<sup>th</sup> high for small-cap companies with no earnings, those stocks had been outperforming other small-caps since the beginning of 2013.

So there's an element of reversion to the mean<sup>6</sup> that's important, as well as the related fact that historically this has signaled positive things for active small-cap managers, at least those who focus on steady profitability.

We see profitability and profit growth becoming increasingly important, which will make it harder for unprofitable small-caps to maintain leadership. We expect earnings growth, as opposed to P/E<sup>7</sup> expansion, to drive market returns.

**Q. Is that why you think the shift to small-cap value is likely to last?**

A. **Francis:** In large part, yes. In 2015 the performance edge for the Russell 2000 Growth<sup>8</sup> over its small-cap value sibling — and this is based on trailing 10-year periods through the end of November — went two standard deviations<sup>9</sup> above its average.

This placed it outside 95% of all 10-year return periods since the Russell 2000's<sup>10</sup> inception in 1979. To be sure, that looks to us like a very powerful argument for mean reversion in favor of small-cap value.

We're also anticipating lower returns for stocks as a whole. Over the last six months, three- and five-year annualized returns for the Russell 2000 have shifted from being well above their historical rolling averages to levels more in line with these averages.

We see this as a positive development. Lower-return periods have usually been better for small-cap investors focused on valuation.

<sup>6</sup> **Mean reversion** is a theory suggesting that prices and returns eventually move back towards the mean or average.

<sup>7</sup> The **price-to-earnings (P/E)** ratio is a stock's (or index's) price divided by its earnings per share (or index earnings).

<sup>8</sup> The **Russell 2000 Growth Index** is an unmanaged index of those companies in the small-cap Russell 2000 Index chosen for their growth orientation. Please note that an investor cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges. The **Russell 2000 Value Index** is an unmanaged index of those companies in the small-cap Russell 2000 Index chosen for their value orientation.

<sup>9</sup> **Standard deviation** is a measure of the dispersion of a set of data from its mean or average.

<sup>10</sup> 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.

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**Q. Are you optimistic about the prospects for active management?**

A. **Chuck:** Absolutely. The last five years have been very hard for most active small-cap managers. Yet the shifts that Frank and I have been discussing are all strong signs — at least to us — that the market is turning.

Passive portfolios are heavily weighted toward yesterday's winners, and reversals of the sort we're expecting are generally unkind to those approaches.

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