WILL THE SMALL-CAP RALLY CONTINUE?

Michael Hedstrom, director of the Closed-End Fund Association (CEFA), kicked off 2017 by having a conversation with Francis Gannon, co-chief investment officer and managing director at The Royce Funds, an independent affiliate of Legg Mason, about the small-cap market, active and passive management, and closed-end funds. The following Q&A recaps the conversation that originally took place on January 12, 2017, as part of CEFA's podcast series.

Francis Gannon

Michael Hedstrom

MH: As you mentioned in a recent commentary, 2016 was a terrific year for small-cap stocks that included some key reversals. The Russell 2000 turned around 2015's negative result, value outperformed growth and cyclicals beat defensives. Frank, can you share your thoughts on the dramatic rebound in small-caps, especially in value, and also why do you think small-caps took off with such a force after the election?

FG: Sure Michael, I think it's a multi-pronged answer if you will. The shift that we saw in the small-cap market in 2016 really started in 2015 as the Russell 2000 peaked in June of 2015. We went on to have a bear market in the small-cap market last year that bottomed in February. That 26% decline was important in actually defining many of the shifts that we've been talking about that happened last year in 2016 within the small-cap space. You mentioned many of them.

The biggest one, and I've always been a big believer that what was working in a market going into a peak and then a subsequent bear market typically doesn't continue to work coming out of a bear market, and that is a shift you saw in the market last year. Growth to value was perhaps the most important one that we saw within the small-cap market. Six of the previous seven years you had seen growth outperform value and we think this is a very important shift within the small-cap market space that we believe will continue for several years to come.

We had in June of 2015 a two standard deviation event in terms of the out-performance of growth over value and we're just beginning to see a shift from growth. From our perspective, growth to value, value continuing its out-performance is one of the big shifts you saw in the market last year and we think it will continue. Obviously the other two, one being that small-cap stocks outperformed large-cap stocks for the first time in several years, we think is significant. The final one is that we saw cyclicals actually outpace some of the more defensive areas of the market last year, which we think is significant and has the opportunity to continue over the next several years.

MH: **Can you comment on the strong performance after the election and also given the new presidency, do you see the rally in the small-cap market continuing or are you concerned about the possibility of a major correction after such a strong run?**

FG: The post-election rally was among the strongest we've seen following a presidential contest. It was marked by continued rotation away from safety — bonds and defensive stocks in particular. Investors have actually been showing and continue to show increased confidence in the potential for improved economic growth and a shift in overall policy away from monetary policy to fiscal policy. I feel that what we're hearing from many of the businesses we talk to, almost as if animal spirits are back alive and well – which is significant in terms of what happens to the economy and the prospects for economic growth going forward.

That has been extrapolated even more with small business confidence, which we saw reported earlier in the year as being at some of the highest levels we had seen in a while. That being said, the critical question here going forward, from our perspective at least, is what is already priced into the overall market. From that standpoint, I would say that we would not be surprised if you saw a correction along the way. They're normal, they're a healthy part of any particular cycle.

I would also highlight the fact that interestingly enough, we went back and looked from a historical standpoint and there have been 12 corrections in the history of the Russell 2000 of 15% or greater. The median return for the index following a correction of 15% or greater is about 98.8%. So a pretty significant advance from the lows of that particular correction of 15% or greater. At the end of the year, we are about 45% of the way there. From the low of February through the end of the year, the Russell had advanced about 45%.

Given that we think we still have room to run in terms of the market advancing, but that being said, we would not be surprised if somewhere along the way, we would see a correction. Ironically enough, the market peaked in December; for the Russell 2000, on December 9th to be exact. We have been in a bit of a corrective phase of late.

MH: **Where are you finding opportunity in the small-cap market?**

FG: I think many of the areas that we are continuing to find opportunity are more economically sensitive cyclical in nature. For a long period of time, the market has and you can argue it continues to overprice safety. Those defensive areas of the market that had done so well for a period of time, really going into the peak of the market in 2015, and have only recently within the past year started to under-perform, we think still are overvalued. We're finding opportunity and continue to focus the portfolios in those more economically sensitive cyclical areas of the market. That would include industrials, it would include financials and it would include technology in various different forms. That is kind of the opportunity set from our standpoint going forward.

MH: **In 2016, we saw large inflows into passive investments. Royce recently completed research into small-cap performance patterns that showed the historical trend of active small-cap managers outperforming the Russell 2000 Index in periods when values stocks lead. Frank, do you see an edge for active management going forward?**

FG: I do. I believe you've seen a significant shift in the overall market and I think one of the ways you're going to see that shift going forward is not only in the out-performance of value over growth, which is significant. We did do a significant amount of research on that and we found that if you went back in terms of the history of the Russell 2000, in most periods, value tends to outperform. In those periods where growth outperforms, you tend to see passive do much better than active managers. When value takes the lead, you tend to see active managers do much better. We think that you have seen that baton pass really from growth to value and therefore we see an environment going forward where active managers are going to do much better.

At the same time, I think key in that assumption, is that what we have seen over the past year in change has been volatility has been relatively steady in the overall market, but I think we have seen pockets of times where the volatility/involatility has actually gone up around Brexit, around the election. I think the advantage for active managers to take advantage of mispricing in the market around certain sectors, around certain companies as the volatility/involatility goes up going forward, we think is clearly going to advantage active managers.

MH: **Finally, Royce manages the oldest and largest small-cap closed-end fund. Why is the closed-end fund structure good for small-caps?**

FG: Well, the closed-end structure is one that we think is quite advantageous within the small-cap space. Obviously, the idea of permanent capital is one that we think is quite beneficial as investors within the small-cap space. What I mean by that is we're not subject to the daily flows that you would find in and out of a mutual fund. Therefore, a portfolio manager can execute a long term investment strategy without having to worry about the impact of investor flows. I think this, while beneficial to the portfolio manager, is also beneficial for the investor as their investment is not influenced by the buying and selling of other investors.

I think perhaps one of the most beneficial, especially in the small-cap space which tends to be a little bit more illiquid, where having permanent capital can be an advantage really plays out real time in the small-cap space. We've been doing this, investing in small-cap companies here at the Royce Fund since 1972 and as you alluded to, we do have the oldest closed-end fund within the small-cap space.

You can learn more about the Royce closed-end funds on their website at Roycefunds.com and on the Legg Mason website at LeggMason.com. Information is also available at CEFA.com – your comprehensive resource for education, data and timely insight on closed-end funds.

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