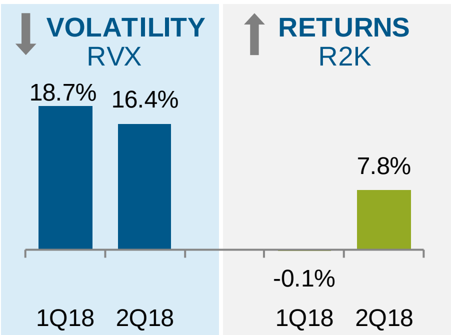
LEGG MASON ROYCE
SIX THINGS YOU NEED TO KNOW ABOUT SMALL-CAP

2 July 2018

Despite its wild finish, 2Q18 was still markedly more bullish and less volatile than 1Q18—it also saw a shift in small-cap style leadership that we'll be watching closely.

Francis Gannon
Co-Chief Investment Officer, Managing Director
11 Years at ROYCE, **25** Years of experience

2Q18—Lower Volatility, Higher Returns



The CBOE Russell 2000 Volatility Index (RVX) measures market expectations of near-term volatility conveyed by Russell 2000 stock index options prices.

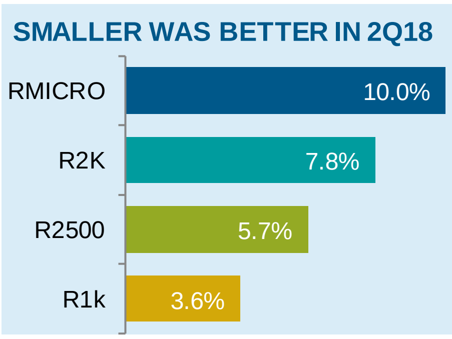
Although it finished on a wild and bearish note, 2Q18 was both markedly more bullish and less volatile than 1Q18. The quarter also saw a late shift in style leadership within small-cap that bears watching.

Returns for U.S. stocks were solidly positive in spite of several challenging developments, including tariff and trade war talk, a strengthening dollar, market and economic softness in China, slower growth in Europe, and negative news out of Brazil and Argentina.

To varying degrees, all of these developments conspired to make the last weeks of June by far the most volatile of the entire second quarter.

And while results for the major domestic stock indexes were positive in the face of the late downward pressure, most international indexes slipped deeper into correction mode during 2Q18. Indeed, the combination of a modest slowdown in international growth, rising emerging market instability, a stronger dollar, and heightened trade war concerns led investors to prefer all things domestic.

Smaller Was Better



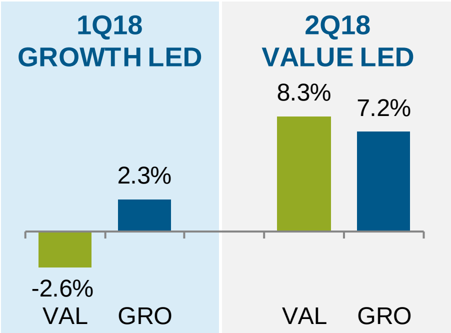
The headlines were arguably more volatile than the markets through most of 2Q18. To be sure, much of the fundamental news was positive. Economic growth in the U.S. continued to accelerate, while most companies continued to post excellent earnings, aided by lower tax rates.

Their greater reliance on U.S. growth left small- and micro-cap stocks much better positioned for superior performance relative to large-caps in the quarter. Another related plus for small-caps was the strengthening dollar, which has often coincided with relatively stronger small-cap results in the past.

All of this made smaller better across the market cap spectrum. Performance was best in 2Q18 for micro-caps, followed by small-, mid-, and large-caps.

As much as domestic economic growth helped to drive results, some of small-cap's relative advantage can also be attributed to cyclicality and reversion to the mean: both the Russell 2000 and Russell Microcap Indexes underperformed the Russell 1000 Index for calendar 2017 before beginning to move past large-caps earlier in 2018.

Value Makes a Late Move, Tops Growth



Based on a strengthening U.S. economy and related widespread corporate profit growth, it made sense that the Russell 2000 Value Index finished 2Q18 ahead of the Russell 2000 Growth Index.

It was also not surprising that small-cap breadth expanded in the quarter. The equal-weighted Russell 2000 outperformed the capitalization-weighted index, and in doing so reversed another trend from 1Q18.

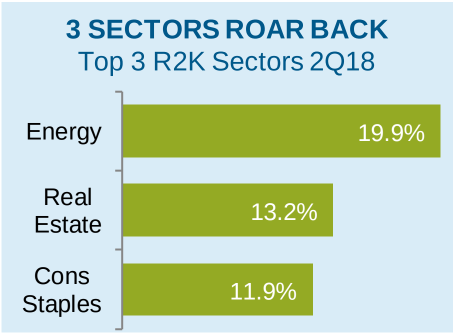
What was surprising was that more defensive sectors led, rather than those more economically sensitive areas (more on that below).

Whether or not value's leadership is a more lasting shift, of course, remains to be seen. Having gone through a few favorable moves for value over the last few years that proved short-lived, we are simultaneously wary and optimistic.

It seems clear to us that the stage remains set for a longer outperformance phase for small-cap value. The combination of economic growth, rising interest rates, and value's long-term historical advantage all argue strongly in favor of a more sustained period of leadership.

The conundrum is that these conditions have been present for the last year-and-a-half—a period in which growth has led in five of six quarters.

Energy Hits the Pedal

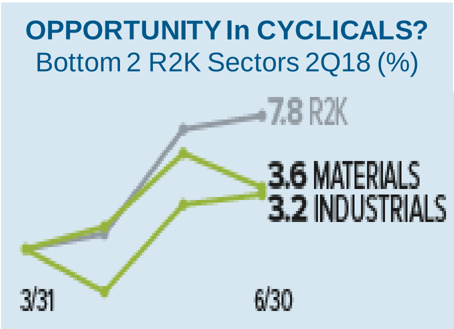


The top-performing sector in the Russell 2000 was Energy by a significant margin, as the rebound in commodity prices and production made a positive impact on stocks in both the oil, gas & consumable fuels and energy services industries. Defensive sectors Consumer Staples and Real Estate rounded out the top three. These areas were three of the index's four worst performers in 1Q18, along with Consumer Discretionary, which also came back strong in 2Q18.

It's also likely that Consumer Staples, Real Estate, and Consumer Discretionary looked particularly attractive to investors anxious about international growth because all three derive a higher-than-average percentage of their revenues from domestic sources.

We suspect that the sector leadership of Consumer Staples and Real Estate will be short lived as each is more interest-rate sensitive and less responsive to a stronger economy, which is precisely the opposite of how we think portfolios should be positioned going forward.

Cyclicals in Neutral



Perhaps the most unexpected result of the quarter was the ongoing lackluster performance for two key cyclical sectors, Industrials and Materials, which sat at the bottom of the small-cap sector performance standings.

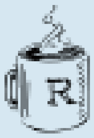
Both faced headwinds—dollar strength often leads to weaker commodity prices, which especially hurts Materials, and European growth fell off from its previously fast pace. Moreover, trade war anxiety and a weakening Chinese economy provided additional rationales for investors to be cautious with these stocks—or avoid them completely.

We are on the opposite side of this pessimistic assessment. Our contrarian confidence comes from meetings with company managements who are communicating greater assurance and optimism than we have heard in some time. Their positive expectations are consistent with both PMI (Purchasing Managers' Index) and ISM (Institute of Supply Management) numbers that continue to show strong manufacturing, production, and order trends here in the U.S.

Thus, we believe that some of the most undervalued opportunities within the asset class can be found in these low-expectation cyclical sectors—many of which boast what we think are excellent earnings and cash flow profiles.

Our Perspective: Lean Cyclical And Stay Active

OUR PERSPECTIVE



**LEAN CYCLICAL
+
STAY ACTIVE**

Particularly in an era of rising interest rates, we are sticking with the view that select small-cap cyclicals with solid balance sheets are best positioned for small-cap leadership.

We see stronger earnings and cash flow prospects in several cyclical industries than we do in growth and/or defensive areas—as well as confident management teams.

We think it's worth noting that the three changes in the market environment that we expect—lower returns, higher volatility, and value leadership—have all historically been coincident with active management leadership.

The quarter provided some enticing glimmers of further progress on the long road to normalization, most notably via modest increases in bond yields and the reemergence of value's leadership. We anticipate that other aspects of normalization will emerge as the year goes on.

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Clarion Partners
ClearBridge Investments
EnTrustPermal
Martin Currie
QS Investors
RARE Infrastructure
Royce & Associates
Western Asset Management

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* As of 31 May 2018.

R2K- Russell 2000 index, RMICRO – Russell Microcap Index, R2500 – Russell 2500 index, R1k – Russell 1000 index, VAL= value, GRO = Grow

IMPORTANT INFORMATION

Source: Royce & Associates, as of 2 July 2018.

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