The Importance of Dividends in Small-Cap Investing

Many investors still may think of "dividend-paying small-cap company" as an oxymoron, if they think of it at all. However, our research (as well as more than four decades of experience as small-cap asset managers) shows that dividends can be an integral part of a successful long-term investment strategy in the small-cap asset class.

Long-term performance patterns show that dividend-paying small companies have historically outpaced non-dividend-paying small-caps—and they also have done so with lower volatility. An asset allocation model that includes dividend-paying small-caps thus may potentially offer both some cushion against market volatility and a component of an investment's total return.

This can be especially important during negative and lower-return periods. While there is no guarantee that companies that pay a dividend will continue to do so in the future, the potential of dividend-paying companies looks promising from the results of our research.

Domestic Small-Cap Universe Breakdown
(Up to $3.0 Billion)[1]

ANNUAL DIVIDEND YIELD	NUMBER OF COMPANIES
None	2,823
>0 - 1%	180
>1 - 2%	316
>2 - 3%	242
3% and over	630
>0%	**1,368**
Total Companies	**4,191**

International Developed Country Small-Cap Universe Breakdown
(Up to $3.0 Billion)[1]

ANNUAL DIVIDEND YIELD	NUMBER OF COMPANIES
None	5,311
>0 - 1%	819
>1 - 2%	1,816
>2 - 3%	1,529
3% and over	2,416
>0%	**1,645**
Total Companies	**11,891**

[1] Data from *Reuters* as of December 31, 2015

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Underfollowed, Underappreciated

The number of domestic small-cap companies that pay a dividend is large. Of the 4,191 domestic small-cap companies (those with market capitalizations up to $3.0 billion), 1,368 were dividend payers as of the quarter ended 12/31/15; of these dividend-paying companies, 872 boasted an annual dividend yield of at least 2%.

Not surprisingly, the number of dividend-paying small-cap companies headquartered outside the U.S. is even larger. In many foreign public markets, there is typically both a stronger embrace of dividends by shareholders and a higher incidence of founding-family owners who want dividends for income.

Dividend yields for many foreign companies are also relatively generous, particularly for smaller companies. Many high-quality small companies earn more than they need in terms of reinvestment in the business. This excess profit, or free cash flow, can be a vital qualitative component in any company regardless of location, along with a strong balance sheet and an established record of earnings.

Returns

In order to distinguish the small-cap return characteristics, our study sorted the small-cap Russell 2000 Index into those constituents that pay dividends and those that do not. (The Russell 2000 constituent companies were rebalanced in accordance with Russell Investment's rebalancing practices, which consist of an annual reconstitution in June and the quarterly addition of any new index entrants via IPOs.)

In addition, the universe was resorted each month into dividend- and non-dividend payers. Performance data was then calculated using month-ending prices. Going back as far as there was reliable data—which took us back to 1993—allowed an assessment of 23 calendar years of performance, which encompassed three full market cycles.

Russell 2000 Calendar-Year Annual Total Returns[1] (%)
1993-2015

YEAR	DIVIDEND PAYERS	NON-DIVIDEND PAYERS	RUSSELL 2000
2015	-3.4	-5.9	-4.2
2014	6.3	4.5	4.9
2013	34.2	47.5	38.8
2012	16.2	15.9	16.3
2011	1.3	-6.6	-4.2
2010	25.0	28.9	26.9
2009	13.0	41.3	27.2
2008	-24.5	-41.3	-33.8
2007	-8.0	2.8	-1.6
2006	20.1	17.1	18.4
2005	3.8	5.8	4.6
2004	23.0	16.3	18.3
2003	36.6	56.6	47.3
2002	-0.2	-33.3	-20.5
2001	13.2	-5.9	2.5
2000	23.6	-24.6	-3.0
1999	-5.9	48.3	21.3
1998	-2.8	1.7	-2.5
1997	32.3	13.5	22.4
1996	22.2	11.1	16.5
1995	24.0	32.5	28.5
1994	-1.3	-3.2	-1.8
1993	18.8	17.8	18.9
Average Annual Total Returns	**10.5**	**7.5**	**8.8**
Average Annual Standard Deviation	**15.0**	**23.7**	**19.0**

[1] Data from Compustat, Royce & Associates.

Perhaps most significant was the outperformance of dividend-paying companies within the Russell 2000 relative to their non-dividend paying counterparts for the entire period measured—December 31, 1992 through December 31, 2015. The average annual total return for the 23-year period was 10.5% for small-cap dividend payers versus 7.5% for those that do not (and 8.8% for the small-cap index itself).

In addition, the index's dividend-paying small-cap companies showed higher returns in 14 of the 23 calendar-year periods examined. Contributing to this relatively higher total return was outperformance in six out of eight down market calendar-year periods.

Arguably even more significant is the level of performance consistency provided by dividend-paying small-cap stocks. When measured over multiple periods, namely rolling three- and five-year return periods, dividend-paying small companies performed well. In fact, dividend payers outperformed in 53% of all monthly rolling three-year periods (240 total periods) and 56% of all monthly rolling five-year periods (216 total periods).

In both three- and five-year return periods, the average return for dividend payers was significantly higher than it was for non-dividend payers. For all rolling three-year periods, dividend payers, on average, provided a 11.3% average annual total return versus 8.4% for non-dividend payers and 9.5% for the Russell 2000. Five-year average results were similar—dividend payers on average generated a 10.5% average annual total return versus 7.0% for non-dividend payers and 8.4% for the Russell 2000.

We also looked at average annual standard deviations over long-term time periods, including three- and five-year rolling return periods show below, to confirm that dividend-paying companies achieved these results while also showing lower volatility than both the small-cap index as a whole and non-dividend-paying companies. We think these results are particularly notable.

Russell 2000 Monthly Rolling Average Annual Statistics[1] (%)

THREE-YEAR	DIVIDEND PAYERS	NON-DIVIDEND PAYERS	RUSSELL 2000
Average Return[2]	11.3	8.4	9.5
Average Standard Deviation[2]	14.8	23.8	19.2
FIVE-YEAR			
Average Return[2]	10.5	7.0	8.4
Average Standard Deviation[2]	15.5	25.0	20.1

This lower volatility—as measured by standard deviation—of dividend-paying small-caps within the index is of particular importance to us. Having invested in small-cap companies for more than 40 years, we know the volatile nature of the asset class all too well. The fact that dividends-paying small-caps have historically demonstrated both lower volatility and higher returns than their small-cap peers is a powerful argument for their inclusion in small-cap allocations.

Market cycle data provided further insight into the return patterns of dividend-paying stocks within the Russell 2000. As might be expected, dividend-paying companies outperformed their non-dividend paying cohort (and the Russell 2000) over all five peak-to-trough periods.

Conversely, and not unexpectedly, they trailed in three of the four trough-to-peak periods. Dividend-paying companies outperformed in two of the three full market cycle periods.

Russell 2000 Peak-to-Trough Cumulative Returns[1, 3]

PEAK DATE	TROUGH DATE	DIVIDEND PAYERS (%)	NON-DIVIDEND PAYERS (%)	RUSSELL 2000 (%)
4/30/2011	9/30/2011	-18.7	-29.0	-25.1
6/30/2007	2/28/2009	-49.8	-55.1	-52.2
2/29/2000	9/30/2002	42.6	-64.4	-35.1
4/30/1998	9/30/1998	-17.0	-28.5	-24.3
5/31/1996	7/31/1996	-5.2	-19.0	-12.5
Averages		**-9.6**	**-39.2**	**-29.8**

Russell 2000 Trough-to-Peak Cumulative Returns[1, 3]

TROUGH DATE	PEAK DATE	DIVIDEND PAYERS (%)	NON-DIVIDEND PAYERS (%)	RUSSELL 2000 (%)
9/30/2011	6/30/2015	95.6	123.6	104.9
2/28/2009	4/30/2011	105.9	154.0	128.9
9/30/2002	6/30/2007	121.1	168.9	143.7
9/30/1998	2/29/2000	-2.6	124.5	61.7
7/31/1996	4/30/1998	67.7	46.6	56.6
Averages		**77.5**	**123.5**	**99.2**

Russell 2000 Peak-To-Peak Cumulative Returns[1, 3]

TROUGH DATE	PEAK DATE	DIVIDEND PAYERS (%)	NON-DIVIDEND PAYERS (%)	RUSSELL 2000 (%)
4/30/2011	6/30/2015	58.9	58.6	53.5
6/30/2007	4/30/2011	3.3	14.1	9.4
2/29/2000	6/30/2007	215.3	-4.3	58.2
4/30/1998	2/29/2000	-19.2	60.6	22.4
5/31/1996	4/30/1998	59.1	18.8	37.1
Averages		**63.5**	**29.6**	**36.1**

A Focus for Small-Cap Investors

Yet despite these clear performance and volatility advantages, very few fund managers focus on dividends within the small-cap universe, while in the large-cap universe total return or equity income approaches are far more common.

This fact is further borne out by Morningstar data. Of the 569 small-cap category funds identified by Morningstar as of December 31, 2015, only eight funds have dividend, income, or total return in their respective names. We expect that this will change as more financial professionals and investors become aware of the compelling historical record small-cap dividend-payers present.

[1] Data from *Compustat*, Royce & Associates. All return information relates to periods since December 31, 1992 through December 31, 2015.
[2] Average of all monthly rolling three- and five-year average annual returns and standard deviations since December 31, 1992 through December 31, 2015. Standard deviation is a statistical measure within which a fund's total returns have varied over time. The greater the standard deviation, the greater a fund's volatility.
[3] Month-end dates were used.

Important Disclosure Information

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DIV-BRO-1215