Our Case For Active Management

How Have The Royce Funds Fared?

Beating the Market...

Passive management, or indexing, has gained more and more acceptance as an investment approach among investors and advisors over the last several years. This acceptance has come in no small part because numerous academics and financial publications have been quick to point out that investment managers do not consistently beat the market, i.e., regularly outperform a relevant index such as the S&P 500 or Russell 2000 Indexes or an index-based passive strategy. It also has arguably more to do with how well passive approaches have performed since the 2008 Financial Crisis.

Additional historical data supports this view, but only to a point. While many investment managers regularly fail to outpace their chosen benchmark (or a related index), there are a number of managers who have consistently outperformed the market over long-term periods. In our opinion, it is not necessary for all managers to beat the market in order for active management to be validated as an approach.

The other significant issue relates to timing—that is, determining the appropriate span with which to measure the effectiveness of an active management approach. While it would be nice to outperform an index every year, it is as unrealistic to expect that as it would be to expect that an index would outperform active management every year.

We think it is equally unrealistic to expect a high degree of outperformance in the long term without experiencing some short-term underperformance periods. This is precisely our experience: While many of The Royce Funds enjoyed consistent outperformance over rolling monthly 10-year and longer periods relative to the index, our outperformance was less consistent over shorter-term horizons. We do not mean this as a criticism of the Funds, or of active management more generally. Indeed, to limit one's evaluation period to a short-term time frame would be similar to saying that a batter must get a hit every time he steps to the plate in order to be considered exceptional and basing one's final judgement on a 10-game sample size.

In our view, full market cycles offer an ideal time frame for measuring both performance and a manager's ability because they include both an up and a down phase.

TheRoyceFunds

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However, cycles can vary considerably in length and can only be validated once they are completed. One- and three-year time horizons rarely if ever offer both peak-to-trough and trough-to-peak periods. Five-year periods, on the other hand, often include an up and a down phase, and thus provide an opportunity to fully evaluate a manager's skills. *In our estimation, then, rolling five-year periods offer a meaningful period for measurement, as do rolling 10-year (or longer) returns when they are available.*

...It Don't Come Easy

In evaluating the long-term case for active management, it is worth asking why certain managers outperform passive approaches over meaningful (that is, longer) performance periods. We believe the reasons were identified by investment counselor and author John Train in his book *The Money Masters*. Train concluded (and we agree) that the most successful investment managers generally possess three qualities: independent thought, discipline, and consistency of application.

In fact, we think that if one were to interview the most successful investment managers, one would find that each had a discipline that was easy to grasp and consistently applied it over a long enough period for it to be viable. In addition, we expect one would find that each was using his or her own approach, not copying that of another.

To be sure, we believe that a willingness to stick to one's approach, regardless of market movements and trends, is critical to long-term outperformance. This is especially important during market extremes because many active managers will most frequently exhibit style drift or other changes in their discipline when their investment style falls out of favor or is otherwise stressed. The tech bubble that kicked off the prior decade is a revealing example of a period when the tenets of value investing were being ignored at the expense of growth investing. However, those managers who stuck with a value-based discipline ultimately distinguished themselves during the cycle as a whole. Indeed, those who capitulate to the consensus are often the greatest losers.

Disciplined Focus

Beating the market is never the focus, only a happy byproduct of the successful execution of investment discipline. *Indeed, we suspect that most managers who have outperformed the market would likely describe their goal as generating high absolute returns rather than beating an index or the market.*

Inherent in this, certainly for us, is close attention to risk management. While most managers focus on the return side of the equation, we believe that the most successful also devote equal attention to risk. Managing risk is crucial because failing to do so can erode, or even destroy, returns.

Successful active management also entails a willingness to think independently in terms of position, sector, and industry weightings. It is not unusual for the most successful managers to be significantly out of sync relative to a benchmark index with respect to weightings (commonly referred to as tracking error). As Sir John Templeton famously said, "It is impossible to produce superior performance unless you do something different from the majority."

Additionally, active management offers potential benefits beyond performance. Active managers are not required to invest cash inflows at the time of receipt when market conditions or prices may not be conducive–unlike managers of passive products. They can also screen for quality and use buy/sell triggers as a means of reducing risk. While a passive manager must own everything in an index, active managers have the freedom to look for what they think are attractive stocks across the targeted universe.

This is particularly important in the small-cap universe, which includes more illiquid, under-followed companies with greater price discrepancies than the world of large-caps. In addition, during periods of market dislocation such as 2008, active managers have the ability to capture valuation opportunities beyond their respective indexes—an opportunity set that would be lost if one were limited to owning only the constituents that comprise an index. For example, the Russell 2000, while quite broad, only includes about 2,000 of the more than 4,000 companies that make up the small-cap universe (which we define as those with market caps up to $3.0 billion). We believe that the small-cap asset class is ideally suited for active management given its enormous size, lack of institutional focus, and limited research availability.

So How Have We Fared?

As experienced small-cap specialists, we have more than a rooting interest in the issue of active versus passive management. In addition, we have always shared a common goal with our investors: consistently above-average long-term results on both an absolute and risk-adjusted basis. *In fact, more important than any argument that we could make in support of active small-cap management are the returns in the tables below, which we believe make a powerful case for long-term active small-cap management and an even stronger one for our own disciplined approach.*

Royce Funds[1] vs. The Benchmark[2]

Monthly Rolling Average Annual Return Periods and Relative Results Since Fund Inception or Most Recent 20 Years through September 30, 2016

	Average Annual 10-Year Rolling Return				Average Annual 5-Year Rolling Return			
FUND	PERIODS BEATING THE INDEX		FUND AVG (%)[3]	INDEX AVG (%)[3]	PERIODS BEATING THE INDEX		FUND AVG (%)[3]	INDEX AVG (%)[3]
U.S. EQUITY								
Dividend Value	28/29	97%	8.3	7.5	59/89	66%	9.0	7.7
Heritage	113/121	93%	10.4	6.9	148/181	82%	11.1	7.4
Low-Priced Stock	76/121	63%	9.4	6.9	130/181	72%	9.7	7.4
Micro-Cap	60/76	79%	8.5	6.3	92/136	68%	8.8	7.5
Opportunity	103/119	87%	10.3	6.9	137/179	77%	11.6	7.5
Pennsylvania Mutual	100/121	83%	9.5	6.9	136/181	75%	10.2	7.4
Premier	120/121	99%	11.0	6.9	140/181	77%	11.1	7.4
Small-Cap Leaders	26/40	65%	8.7	7.9	63/100	63%	8.1	7.1
Small-Cap Value	46/64	72%	9.8	7.9	77/124	62%	10.1	8.3
Smaller-Companies Growth	38/64	59%	9.3	7.9	56/124	45%	9.8	8.3
Special Equity	87/101	86%	9.4	6.7	106/161	66%	10.7	8.0
Total Return	81/121	67%	8.6	6.9	124/181	69%	9.4	7.4

[1] Included are all Royce Funds with at least 12 years of history.
[2] The Russell 2000 Index is the benchmark for most funds. Royce Micro-Cap Fund is compared to the Russell Microcap Index from the inception of that index.
[3] Average return shown is the average of all month-end trailing five- and 10-year total returns.
Past performance is no guarantee of future results. For more information on performance please see page 4.

See Fund Performance and Expenses on the back

Performance and Expenses

As of September 30, 2016

FUND	3Q2016[1]	YTD[1]	1-YR	5-YR	10-YR	15-YR	20-YR	40-YR/ SINCE INCEPT.	INCEPTION DATE	ANNUAL OPERATING EXPENSES (%) GROSS	NET
	AVERAGE ANNUAL TOTAL RETURNS (%)										
U.S. EQUITY											
Dividend Value	4.51	9.25	11.99	12.02	7.00	N/A	N/A	8.27	5/3/04	1.14	1.14
Heritage	6.78	12.59	16.15	11.20	6.39	9.39	12.03	12.36	12/27/95	1.01	1.01
Low-Priced Stock	10.39	7.98	11.72	3.74	3.39	7.38	9.27	9.96	12/15/93	1.29	1.25
Micro-Cap	8.99	8.21	12.82	5.26	4.01	8.37	9.25	10.71	12/31/91	1.50	1.50
Opportunity	13.11	16.75	18.62	15.80	6.75	10.56	N/A	11.84	11/19/96	1.17	1.17
Pennsylvania Mutual	6.47	14.58	16.54	12.10	6.28	9.60	10.14	13.18	N/A	0.93	0.93
Premier	6.71	13.66	15.01	10.13	7.55	10.78	10.66	11.25	12/31/91	1.13	1.13
Small-Cap Leaders	6.16	12.58	14.26	10.33	6.49	N/A	N/A	9.16	6/30/03	1.24	1.24
Small-Cap Value	4.43	7.89	6.19	8.61	5.78	10.51	N/A	9.38	6/14/01	1.23	1.23
Smaller-Companies Growth	5.56	2.02	3.50	12.26	5.21	11.70	N/A	10.88	6/14/01	1.33	1.25
Special Equity	5.71	14.49	13.78	11.50	7.60	10.52	N/A	8.82	5/1/98	1.15	1.15
Total Return	5.87	14.99	17.13	13.04	6.64	9.32	9.75	10.62	12/15/93	1.22	1.22
INDEX											
Russell 2000 Index	9.05	11.46	15.47	15.82	7.07	9.26	8.06	N/A	N/A	N/A	N/A
Russell Microcap Index	11.25	9.38	13.47	16.37	5.50	8.85	N/A	N/A	N/A	N/A	N/A

[1] Not Annualized

Important Performance and Expense Information

All performance information in this piece reflects past performance, is presented on a total return basis, reflects the reinvestment of distributions, and does not reflect the deduction of taxes that a shareholder would pay on fund distributions or the redemption of fund shares. Past performance is no guarantee of future results. Investment return and principal value of an investment will fluctuate, so that shares may be worth more or less than their original cost when redeemed. Investment and Service Class shares redeemed within 30 days of purchase may be subject to a 1% redemption fee payable to the Fund. Redemption fees are not reflected in the performance shown above; if such fees were reflected, performance would be lower. Current month-end performance may be higher or lower than performance quoted and may be obtained at www.roycefunds.com. All performance and expense information reflect results of the Fund's Investment Class shares. Gross operating expenses reflect each Fund's gross total annual operating expenses and include management fees, any 12b-1 distribution and service fees, other expenses, and any applicable acquired fund fees and expenses. Net operating expenses reflect contractual fee waivers and/or expense reimbursements exclusive of any applicable acquired fund fees and expenses. All expense information is reported as of the Fund's most current prospectus. Royce & Associates has contractually agreed to waive fees and/or reimburse operating expenses through April 30, 2017 to the extent necessary to maintain net annual operating expenses (excluding brokerage commissions, taxes, interest, litigation expenses, acquired fund fees and expenses, and other expenses not borne in the ordinary course of business) to no more than 1.24% for the Investment Class of Royce Low-Priced Stock and Smaller-Companies Growth Funds. Acquired fund fees and expenses reflect the estimated amount of the fees and expenses incurred indirectly by any applicable Fund through its investments in mutual funds, hedge funds, private equity funds, and other investment companies.

All performance and risk information presented in this material prior to the commencement date of Investment Class shares on 9/14/07 for Royce Dividend Value Fund, 3/15/07 for Royce Heritage, Low-Priced Stock, Small-Cap Leaders, Small-Cap Value, and Smaller-Companies Growth Funds. Service, Consultant, R, and K Class shares bear an annual distribution expense that is not borne by the Fund's Investment Class. The Royce Funds invest primarily in securities of micro-cap, small-cap, and/or mid-cap companies, which may involve considerably more risk than investments in securities of larger-cap companies (see "Primary Risks for Fund Investors" in the respective prospectus). The Funds may also invest to varying degrees in foreign securities which may involve political, economic, currency, and other risks not encountered in U.S. investments. Please read the prospectus carefully before investing or sending money. Russell Investment Group is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. Russell® is a trademark of Russell Investment Group. The Russell 2000 Index is an unmanaged, capitalization-weighted index of domestic small-cap stocks that measures the performance of the 2,000 smallest publicly traded U.S. companies in the Russell 3000 Index. The Russell Microcap Index includes 1,000 of the smallest securities in the small-cap Russell 2000 Index. The Russell Global Small Cap Index is an unmanaged, capitalization-weighted index of global small-cap stocks. The Russell Global ex-U.S. Small Cap Index is an unmanaged, capitalization-weighted index of global small-cap stocks, excluding the United States. Index returns include net reinvested dividends and/or interest income. The performance of an index does not represent exactly any particular investment, as you cannot invest directly in an index. Distributor: Royce Fund Services, Inc.

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