



INVESTING IN THE UPSWING: SMALL CAP VALUE EQUITY

Executive Summary

Exceptionally strong small cap equity performance in recent years has inspired debate over the best way to invest in this increasingly attractive asset class. Though smaller companies are widely known for their rapid growth potential, value stocks in particular have outperformed both growth and core segments of the small cap market on both an absolute and risk-adjusted basis.

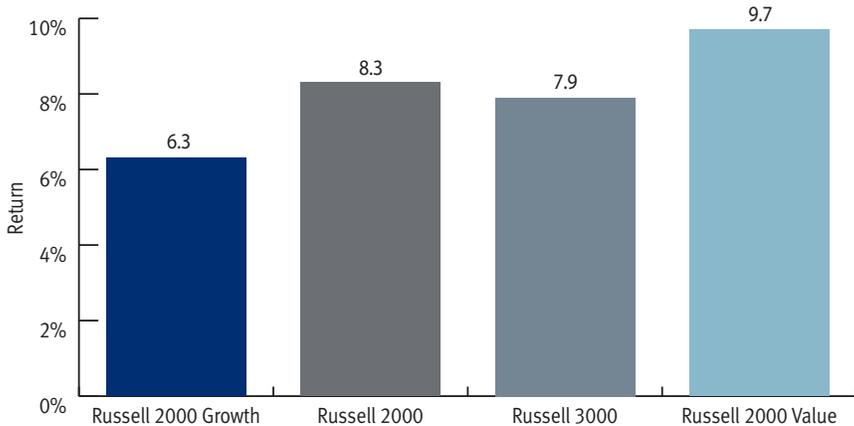
While small cap equities in general benefit from a meaningful information advantage, active managers within the value segment of the small cap market have exhibited larger and more consistent relative performance over time. In fact, small cap value managers have outperformed their respective benchmarks more often and by a larger margin than active managers in any of the small cap growth, small cap core, mid or large cap asset categories. Given this backdrop, a dedicated small cap value allocation within a balanced portfolio may lead to both higher returns and lower volatility relative to balanced portfolios that lack a small cap element or opt only for a growth or core-oriented small cap allocation.

In this paper, we provide an overview of historical small cap value performance, test the overall portfolio impact of a dedicated small cap value allocation, and discuss why the current stage of the US economic recovery makes a particularly compelling environment for small cap value investing.

Performance Advantage

Small cap stocks have generally performed strongly over the last 20 years. Small cap value stocks specifically, however, have proven to be particularly profitable relative to their growth and core counterparts as well as the broader market.

Exhibit 1
20-Year Annualized Return Comparison



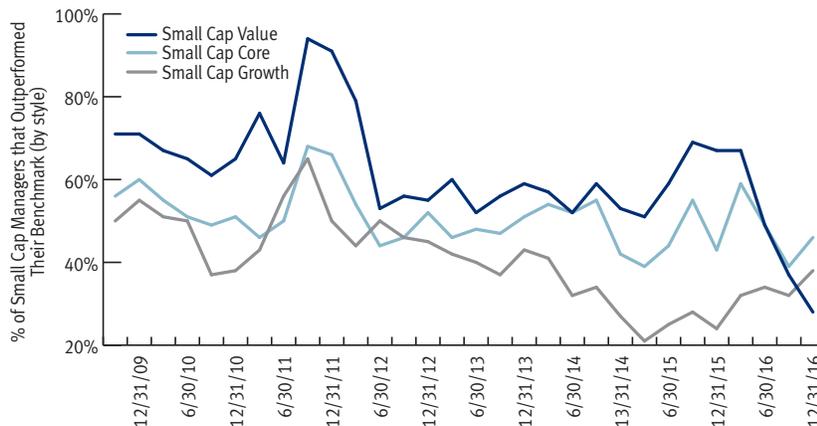
Source: Morningstar as of 12.31.16. Annualized index data from January 1997 through December 2016. Past performance is not indicative of future results.

Opportunity for Active Investors

Despite being compared to the strongest performing segment of the small cap market and measured against one of the strongest performing indexes overall, active small cap value managers have historically outperformed their respective benchmarks more consistently than any other asset class, regardless of size or style.

A portfolio manager's ability to generate alpha is significantly influenced by his or her skill in identifying and profiting from market inefficiencies. Indeed, the success of active small cap managers can be linked to the informational inefficiencies resulting from limited analyst coverage of small cap value stocks. This is particularly true when comparing smaller capitalization stocks to their mid cap and large cap counterparts.

Exhibit 2
Managers Outperforming Their Benchmarks



Source: Morningstar as of 12.31.16. Calculated on a rolling 3-year basis. Data excludes index funds, uses oldest share class and includes only surviving funds.

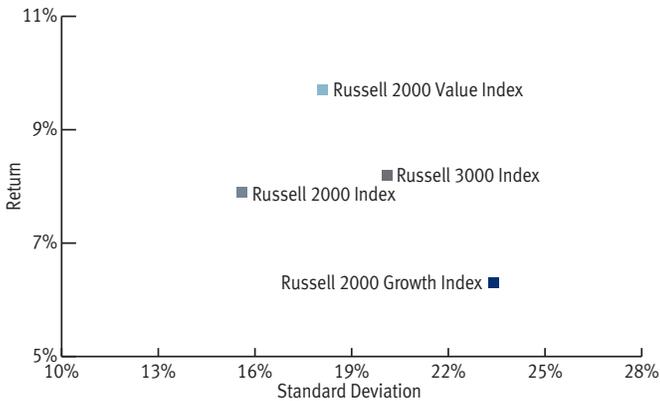
Similar Risk, Elevated Returns

Over the past 20 years, the Russell 2000 Value Index has delivered higher annualized returns versus the Russell 2000 Growth and Russell 2000 Indices with significantly less risk, a higher Sharpe ratio and a higher information ratio.

Exhibit 3
Relative Risk/Return Characteristics

Description	Beta	Sharpe Ratio	Info Ratio
Russell 2000 Index	1.08	0.39	-0.05
Russell 2000 Growth Index	1.22	0.29	-0.09
Russell 2000 Value Index	0.94	0.48	0.18

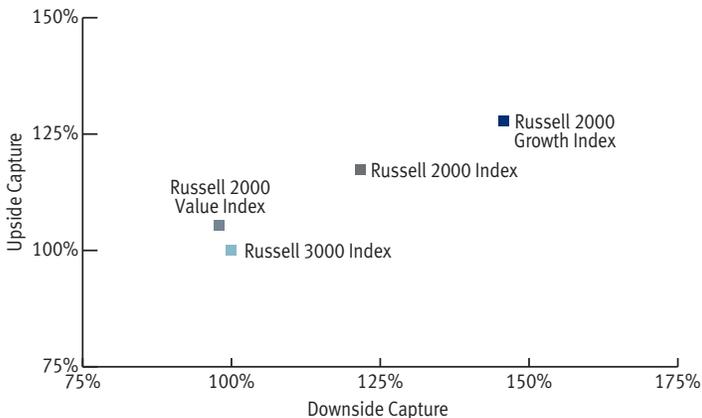
Risk/Return Profile



Source: Morningstar as of 12.31.16. Annualized index data from January 1997 through December 2016.

The relatively attractive risk profiles of small cap value stocks also translate into superior capital preservation during down markets—as evidenced by the downside capture of the Russell 2000 Value Index when compared to a broad market equity benchmark such as the Russell 3000 Index.

Exhibit 4
Downside Risk



Source: Morningstar as of 12.31.16.

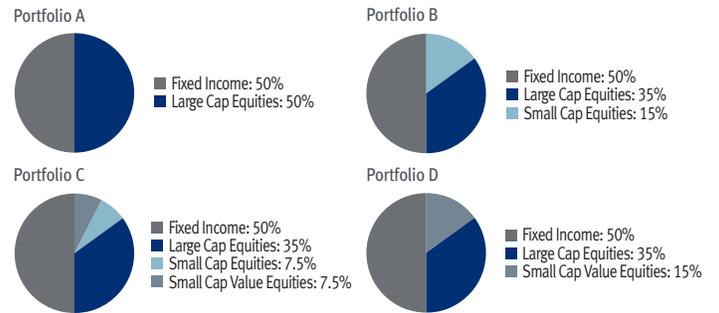
Portfolio Impact

Due to the superior risk/return profile of small cap value stocks, adding a dedicated small cap value component to a traditional diversified portfolio may offer higher average returns and lower volatility over time.

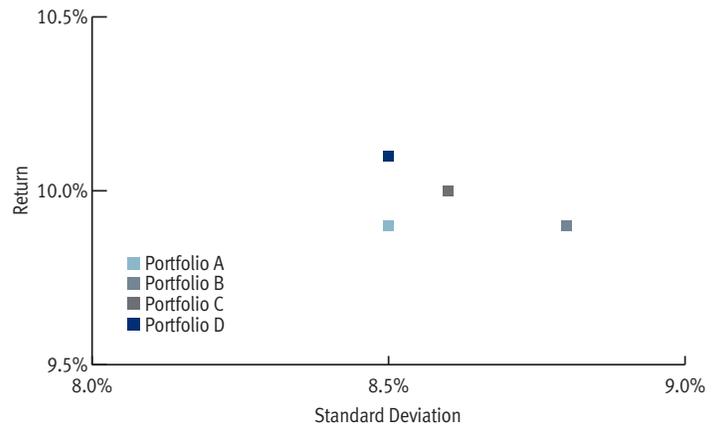
Consider the hypothetical portfolio allocations illustrated in Exhibit 5. Adding a dedicated 15% small cap value allocation to a balanced portfolio increases the average return and reduces volatility, making Portfolio D less susceptible to a severe market correction.

Exhibit 5
Asset Allocation Impacts

Hypothetical Portfolio Structures



Risk/Return Impacts



Source: FactSet as of 12.31.16. Annualized index data from December 1979 through December 2016.

Conclusion

The current stage of the US equity market makes it a particularly attractive time to consider a small cap value allocation. Because small capitalization companies derive higher concentrations of business and revenues from domestic operations, the asset class is poised to benefit as the US economy decouples from the rest of the developed world. With most economists projecting an accelerating economic expansion in the United States, rising US Treasury yields, and a fed funds rate between 0% and 3%, we believe small cap value stocks are positioned to outperform over the next several years. It is also our view that as active managers, an allocation to this asset class is warranted in all market environments as it can offer investors higher returns and lower volatility over time.

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