



# Small Cap Growth Equity Strategy Update

| Composite Inception Date is 10/1/2001 | QTR   | YTD    | 1 YR   | 3 YR   | 5 YR   | 10 YR  |
|---------------------------------------|-------|--------|--------|--------|--------|--------|
| Small Cap Growth Equity (Gross)       | 5.06% | 9.21%  | 15.60% | 12.22% | 13.70% | 10.06% |
| Small Cap Growth Equity (Net)         | 4.80% | 8.39%  | 14.45% | 11.10% | 12.59% | 9.15%  |
| Russell 2000 Growth Index             | 6.22% | 16.81% | 20.98% | 12.17% | 14.28% | 8.47%  |

## Market Overview

Amid renewed optimism on the possible passage of favorable tax reform, improving economic growth, and continued strength in corporate earnings, US equity markets posted another strong quarter. The market continued its upward trajectory despite escalating geopolitical tensions between the US and North Korea as well as two devastating hurricanes hitting the major population centers of Texas and Florida. Following the relatively weak 1Q GDP print of +1.4%, 2Q GDP came in at a fairly strong +3.1%, the best reading since the first quarter of 2015. Other economic indicators also improved, providing solid support for a strengthening and accelerating US economy. In addition, both business and consumer confidence continued to improve along with employment growth, and investor sentiment remained high as strong equity returns caused even more investor inflows into the equity markets.

Small cap growth stocks, as represented by the Russell 2000 Growth Index, returned +6.22% during the quarter, bringing its year to date return to +16.81%. During the quarter, all sectors within the Index were in positive territory. Telecommunications (+11.17%), industrials (+9.13%) and health care (+6.69%) were the best performing sectors within the Index. Due to an increase in Treasury yields during the quarter, we noted underperformance in the bond proxy sectors, with REITs being the worst performing sector (+1.56%), followed by consumer staples (+1.70%), and utilities (+2.25%). More than half of the Index's quarterly return was generated by the industrials and health care sectors, with the largely unprofitable biotechnology industry contributing approximately 90% of the entire return of the health care sector.

## Strategy Overview

The portfolio benefited from an overweight allocation and positive security selection within the industrials sector. Security selection within the REITs and energy sectors also helped relative performance. This was offset by adverse selection within the health care, consumer discretionary, and financials sectors.

Simply having no portfolio exposure to biotech stocks detracted 96 and 244 basis points, respectively, from 3Q and YTD performance. During the quarter, as they have all year, companies having no earnings, low returns on equity, higher beta, and the fastest sales growth rates drove Index returns. Non-earning companies have contributed approximately 35% and 38%, respectively, to both 3Q and YTD Russell 2000 Growth Index returns, while stocks with low returns on equity, high beta, and high sales growth rates have also contributed significantly to both 3Q and YTD Index returns.

Over the course of several market cycles we have seen other periods in which unprofitable stocks have driven index performance, the last period being 2013 through the first half of 2015. We strongly believe that earnings growth drives stock prices, and that periods where index returns are largely driven by unprofitable stocks are not sustainable. Over the last six calendar years through 2016, our strategy has outperformed the Index five times, the exception being 2014. While 2017 has been a challenging year so far, we will not deviate from our long-standing investment philosophy and process simply to chase short-term returns.

We ended the quarter with 77 stocks in the portfolio. Our largest overweighted sectors versus the Index are industrials and financials, while our largest underweighted sectors are consumer discretionary and technology.

## Strengths

- **RBC Bearings (+0.41%):** *Industrial bearings*; Reported better than expected fiscal first quarter financial results. Revenue growth accelerated in both the aerospace and industrial segments, and the company continues to improve its gross margins through increased automation.
- **Cantel Medical (+0.40%):** *Infection prevention products*; Announced fiscal fourth quarter financial results that were above consensus expectations despite tough year-ago comparisons. Management provided better than expected fiscal 2018 sales and earnings guidance while also continuing to invest for future growth.
- **Teledyne Technologies (+0.39%):** *Diversified industrial products*; Reported better than expected second quarter financial results and raised full year earnings guidance. Organic revenue growth accelerated, and particular strength was noted in digital imaging.
- **Woodward (+0.33%):** *Industrial equipment*; Reported fiscal third quarter financial results that exceeded expectations, with notable strength in the aerospace business, driven by the ramping of key platforms and increased defense related sales.
- **Omniceil (+0.33%):** *Medication dispensing and control equipment*; Reported better than expected second quarter financial results and reaffirmed full year revenue and earnings guidance. Bookings for the company's latest generation product line have been ahead of management's expectations.

## Weaknesses

- **NuVasive (-0.52%):** *Medical devices*; Announced changes in some key management roles, including the CFO and COO positions. The company also announced it received a subpoena in regards to an investigation being conducted by the US Department of Health and Human Services.
- **PRA Group (-0.36%):** *Specialty finance*; Reported disappointing second quarter financial results. Management noted that the European market remains extremely competitive and in the US they are incurring additional expenses as they invest in new call centers.
- **Cardtronics (-0.34%):** *Consumer financial services*; Reported second quarter financial results that exceeded expectations and reaffirmed full year revenue and earnings guidance, however investors were disappointed by management's initial 2018 commentary noting slowing same-store transaction growth. The company also faces some headwinds in Australia.
- **Treehouse Foods (-0.30%):** *Private-label food products*; Reported second quarter earnings results that modestly exceeded expectations, however full year earnings guidance was reduced due to the challenging retail grocery landscape with muted volume trends and limited pricing power.
- **Hibbett Sports (-0.27%):** *Specialty retail*; Reported disappointing fiscal second quarter earnings results and lowered full year earnings guidance, citing a challenging retail environment that caused same-store sales declines and gross margin pressure.

## Outlook

We are impressed with the positive economic and stock market results achieved so far this year despite the lack of significant legislation passed by Congress. With several key legislative agenda items potentially being taken up by Congress later this year, such as tax reform, infrastructure spending, and tax repatriation, the opportunity for the economy to keep expanding for the remainder of 2017 and 2018 is promising. However, there is the possibility that few, if any, of these agenda items will be passed, which would cause uncertainty in the equity markets. Adding to the uncertainty, President Trump will likely appoint a new chair to the Federal Reserve sometime prior to year-end, to replace Janet Yellen. Financial markets will be closely watching this appointment to determine if the new Fed chair has hawkish or dovish monetary policy tendencies and whether the central bank will continue the recent pattern of slowly increasing the Fed funds rate. Given the high equity market valuations we are now seeing, there appears to be little wiggle room for policy miscalculations. Finally, we believe there seems to be a greater than usual amount of complacency among investors in the equity markets and a negative economic, financial, or political shock would not be viewed favorably.

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Past performance is not indicative of future results.

Returns include the reinvestment of all income. All returns for periods greater than one year are shown on an annualized basis.

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## GIPS® Compliant Presentation as of September 30, 2017

| Year     | Composite Return Gross of Fees | Composite Return Net of Fees | Benchmark Return | # of Portfolios | Composite Dispersion | Composite 3-Year Standard Deviation | Benchmark 3-Year Standard Deviation | Composite Assets | Total Firm Assets |
|----------|--------------------------------|------------------------------|------------------|-----------------|----------------------|-------------------------------------|-------------------------------------|------------------|-------------------|
| 2007     | 7.33                           | 6.67                         | 7.05             | 16              | 0.10                 | 11.06                               | 14.23                               | 793.2            | 207,926.9         |
| 2008     | -33.47                         | -33.94                       | -38.54           | 15              | 0.15                 | 18.21                               | 21.26                               | 482.2            | 164,090.1         |
| 2009     | 33.94                          | 33.02                        | 34.47            | 14              | 0.19                 | 22.19                               | 24.85                               | 626.5            | 228,136.6         |
| 2010     | 27.44                          | 26.59                        | 29.09            | 14              | 0.04                 | 24.43                               | 27.70                               | 954.6            | 252,397.6         |
| 2011     | 5.21                           | 4.48                         | -2.91            | 13              | 0.12                 | 20.06                               | 24.31                               | 775.8            | 244,857.4         |
| 2012     | 21.60                          | 20.82                        | 14.59            | 14              | 0.18                 | 16.52                               | 20.72                               | 919.5            | 279,416.3         |
| 2013     | 43.90                          | 42.47                        | 43.30            | 16              | 0.26                 | 14.01                               | 17.27                               | 1,852.6          | 296,003.0         |
| 2014     | 0.61                           | -0.39                        | 5.60             | 14              | 0.03                 | 12.38                               | 13.82                               | 1,481.8          | 302,064.4         |
| 2015     | 1.99                           | 0.97                         | -1.38            | 15              | 0.22                 | 13.13                               | 14.95                               | 1,378.7          | 276,979.3         |
| 2016     | 15.81                          | 14.66                        | 11.32            | 16              | 0.16                 | 14.00                               | 16.67                               | 1,841.9          | 289,538.6         |
| YTD 2017 | 9.21                           | 8.39                         | 16.81            | 18              | 0.13                 | 13.07                               | 14.90                               | 2,020.4          | 319,111.8         |

**Description of the Firm:** For the purposes of Global Investment Performance Standards (GIPS®), RBC Global Asset Management is the asset management division of Royal Bank of Canada (RBC), operating under the following brands: RBC Global Asset Management (RBC GAM) in Canada, the U.S. (institutional), the U.K. and Hong Kong; Phillips, Hager & North Investment Management (institutional); and BlueBay Asset Management (institutional). With offices around the world, RBC GAM offers a full range of global investment solutions in cash management and fixed income, equity, balanced, alternative and specialty investment strategies through mutual funds, hedge funds, pooled funds and separately managed accounts. The RBC GAM group of companies has more than C\$388 billion (US\$289 billion) in assets under management as at December 31, 2016. RBC purchased Phillips, Hager & North Investment Management, including the assets of BonaVista Asset Management, on May 1, 2008, and BlueBay Asset Management on December 17, 2010. A complete list and description of the firm's composites and performance results is available upon request.

**Compliance Statement:** RBC GAM claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS® standards. RBC GAM has been independently verified for the periods January 1, 2002 through December 31, 2016. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS® standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS® standards. The U.S. Equity - Small Cap Growth composite has been examined for the periods January 1, 2002 - December 31, 2016. The verification and performance examination reports are available upon request.

**Composite Description:** The Small Cap Growth Equity Composite consists of accounts that invest primarily in small capitalization growth stocks of high quality companies, and may or may not have exposure to the different economic sectors of the indices shown.

**Benchmark:** The Benchmark for this composite is the Russell 2000 Growth Index. The Russell 2000 Index measures the performance of the 2000 smallest companies by market cap in the more broadly based Russell 3000 Index, which in turn represents 98% of the US equity market cap. The Russell 2000 Growth Index measures the performance of those Russell 2000 companies with higher price to book ratios, forecasted earnings growth rates, and historical sales per share. Index returns are provided for comparison purposes to represent the investment environment existing during the time periods shown. An index is fully invested, includes the reinvestment of dividends and capital gains, but does not include any transaction costs, management fees, or other costs. Holdings of each separately managed account in a composite will differ from the index. An investor may not invest directly in an index. The Russell 2000 is also used as a secondary benchmark.

**Gross of Fees:** Gross of fees performance returns are presented before management fees, but after all trading expenses. Returns are presented net of withholding taxes on dividends, interest income and capital gains where applicable.

**Net of Fees:** Net of fee performance is calculated using the maximum stated annual fee of 1.0% applied monthly. Prior to January 1, 2013 net of fee performance was

calculated using actual fees. Beginning May 1, 2005 one account in the composite has an additional performance-based fee. Prior to October 1, 2004, one non-fee paying account was included in the composite which represented 100% of the assets as of December 31, 2001, 2% of assets as of December 31, 2002, and less than 1% of assets as of December 31, 2003.

**Performance Calculations:** Results are based on all fully discretionary accounts meeting the composite definition, including those accounts no longer with the firm. Returns are shown in US Dollars, and include the reinvestment of all income. Additional information regarding policies for valuing portfolios, calculating performance, and preparing presentations is available upon request. Past performance is not indicative of future results.

**Composite Dispersion:** The composite dispersion of annual returns is indicated by the performance of individual accounts representing the equal weighted standard deviation of returns. Dispersion of returns is calculated for portfolios included in the composite for the full year.

**3-Year Standard Deviation:** Periods with less than 3 years of data will show "n/a".

**Derivatives, Leverage and Short Positions:** None of these strategies are currently employed by any accounts in this composite.

**Cash Flow Policy:** As of April 1, 2015 the significant cash flow policy was removed from the composite. Prior to that date, composite policy required the temporary removal of any portfolio incurring a client-initiated significant cash inflow or outflow of at least 10% of portfolio assets. The temporary removal of such an account occurred at the beginning of the month in which the significant cash flow occurred and the account re-entered the composite the first full month of being fully invested.

**Fee Schedule:** 1.00% on first \$10 million; 0.95% on next \$15 million of assets; 0.85% on next \$25 million of assets; and 0.75% on assets exceeding \$50 million. Advisory fees are described on this page and in Form ADV Part 2A. RBC GAM reserves the right to negotiate all advisory fees.

**Minimum Account Size:** Beginning January 1, 2011 there is no minimum for this composite. From October 1, 2004 through December 31, 2010, the minimum account size for this composite was \$1 million. Prior to October 1, 2004 there was no minimum account size.

**Creation Date:** This composite was created on and has an inception date of October 1, 2001.

**Composite History:** Performance prior to December 31, 2001 represents the Small Cap Growth Equity track record established by the Portfolio Management Team at a prior firm. Beginning January 1, 2002 composite performance represents accounts managed at RBC GAM using the same philosophy and process.

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