Long Idea: Royce Special Equity Fund (RYSEX, RSEIX, RSEFX, RSQCX)

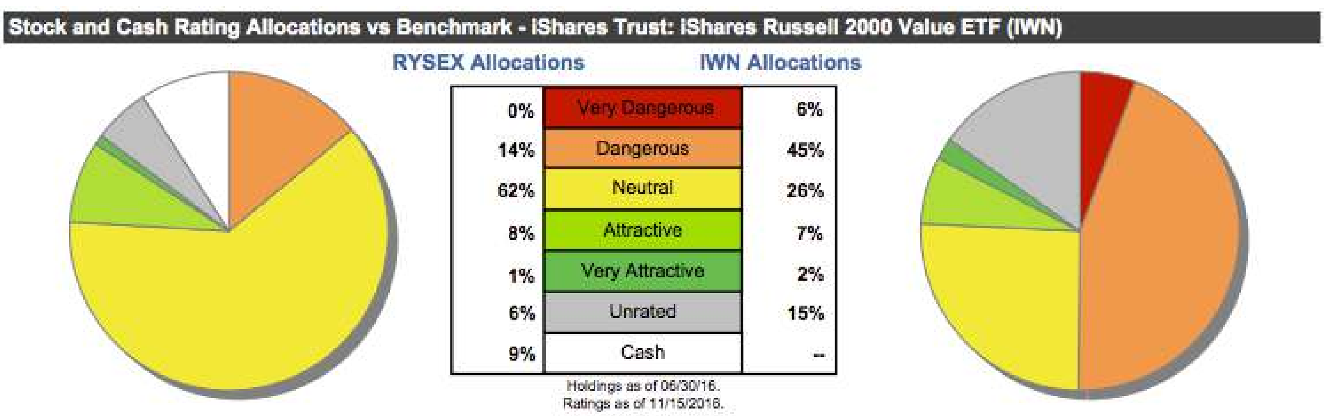
We recently warned investors about the dangers of Snow Capital Small Cap Value Fund. Despite Small Cap Value receiving a Dangerous rating in our 4Q16 Investment Style Ratings, and containing many Dangerous-or-worse rated funds, there is one fund in particular that breaks the mold and is worthy of a second look. Royce Special Equity Fund (RYSEX, RSEIX, RSEFX, RSQCX) receives our Attractive rating. Its high quality holdings and below average fees makes it this week's Long Idea.

The only justification for mutual funds to have higher fees than ETFs is "active" management that leads to out-performance. A fund can only outperform if it has higher quality holdings than its benchmark. To determine the quality of holdings, one must analyze each holding in a mutual fund, which is why our mutual fund ratings leverage our stock ratings to rate funds based on the aggregated ratings of the holdings.

Royce Special Equity investors are paying higher fees for stock selection that allocates to more undervalued stocks while limiting downside risk as compared to the benchmark, the iShares Russell 2000 Value ETF (IWN).

Per Figure 1, Royce Special Equity Fund allocates 9% of capital to Attractive-or-better rated stocks, which matches IWN. Meanwhile, Royce effectively avoids the pitfalls of the Small Cap Value style by allocating only 14% of capital to Dangerous-or-worse rated stocks. For comparison, IWN allocates 51% of capital to Dangerous-or-worse rated stocks.

Figure 1: Royce Special Equity Fund Asset Allocation



Sources: New Constructs, LLC and company filings

Furthermore, nine the mutual fund's top 10 holdings receive a Neutral-or-better rating and make up nearly 37% of its portfolio.

Because Royce Special Equity Fund holds better stocks than IWN, one can expect the outperformance required to justify higher fees moving forward.

Royce Special Equity Finds "Value" Stocks

True value investing still works despite the proliferation of technical and momentum trading. All too often, funds are labeled "value" despite allocating to some of the most expensive stocks in the market. However, we see an exception in Royce Special Equity Fund. These managers do a good job of finding truly undervalued stocks. This observation is based on our analysis of each of the fund's holdings for which we model the earnings quality and the future cash flow expectations embedded in the prices of each of the holdings.

Figure 2 contains our detailed fund rating for RSEIX, which includes each of the criteria we use to rate all funds under coverage. Note that Figure 2 is very similar to our Stock Rating Methodology, because the performance of a fund's holdings equals the performance of a fund. The results of this analysis reveal important information for investors in Royce Special Equity funds.

Figure 2: Royce Special Equity Fund (RSEIX) Rating Breakdown

Royce Fund: Royce Special Equity Fund (RSEIX) Closing Price: $22.05 (Nov 15, 2016)

Analyst Notes : Downgraded from Very Attractive 11/8/16 | Cause: Price Increase: Higher Market Expectations

	Portfolio Management						
	Quality of Earnings		Valuation			Asset Allocation	
Overall Rating	Econ vs Reported EPS	ROIC	FCF Yield	Price to EBV	GAP	Cash %	Total Annual Costs
Very Dangerous	Misleading Trend	Bottom Quintile	<-5%	>3.5 or -1<0	>50	>20%	>4%
Dangerous	False Positive	4th Quintile	-5%<-1%	2.4<3.5 or <-1	20<50	8%<20%	2%<4%
Neutral	Neutral EE	3rd Quintile	-1%<3%	1.6<2.4	10<20	2.5%<8%	1%<2%
Attractive	Positive EE	2nd Quintile	3%<10%	1.1<1.6	3<10	1%<2.5%	0.5%<1%
Very Attractive	Rising EE	Top Quintile	>10%	0<1.1	0<3	<1%	<0.5%
Actual Values							
RSEIX	**Neutral EE**	**10%**	**3%**	**1.5**	**23 yrs**	**9%**	**1.3%**
Benchmark Values							
S&P 500 (SPY)	Positive EE	18%	2%	2.6	27 yrs	-	0.1%
Russell 2000 (IWM)	Positive EE	6%	-0%	3.4	41 yrs	-	0.2%

Sources: New Constructs, LLC and company filings

Our findings from our discounted cash flow valuation of the fund reveal the market implied growth appreciation period (GAP) is 35 years for the iShares Russell 2000 Value and 28 years for the S&P 500 - compared to 23 years for RSEIX. In other words, the market expects the stocks held by RSEIX to grow economic earnings for five years less than the stocks in the S&P 500 and 12 years less than the Russell 2000.

The return on invested capital (ROIC) of the Royce Special Equity Fund is 10%, double the Russell 2000 Value's 5% ROIC.

Essentially, despite being more profitable, the market expects the stocks held by RSEIX to grow economic earnings for a shorter period of time than those held by IWN.

Lastly, the price-to-economic book value (PEBV) ratio for the S&P 500 is 2.6 and 3.5 for the Russell 2000 Value. The PEBV ratio for RSEIX is only 1.5. This ratio means that the market expects the profits for the S&P 500 and Russell 2000 Value to more than double and triple respectively, from their current levels. Meanwhile, the market expects the profits of the companies held by RSEIX to grow by only 50% from current levels, per Figure 2 above.

Higher profitability coupled with lower market expectations is the cornerstone of value investing, and Royce Special Equity Fund allocates capital to stocks that fit the true "value" description.

This Fund Charges Below Average Fees

With total annual costs (TAC) of 1.29%, RSEIX charges less than 63% of Small Cap Value mutual funds under coverage. Coupled with its quality holdings, below average fees make RSEIX (and the other classes of shares) more attractive. More details can be seen in Figure 3, which includes the three additional classes of the Royce Special Equity Fund, which also receive our Attractive rating. For comparison, the average TAC of the 264 Small Cap Value mutual funds under coverage is 2.32%, the weighted average is lower at 1.59%, and the benchmark, IWN, charges total annual costs of 0.28%.

Figure 3: Royce Special Equity Fund's Cost Comparison

Ticker	Total Annual Costs (TAC)	Expense Ratio	Difference Between TAC & Expense Ratio
RSEIX	1.29%	1.04%	**0.25%**
RYSEX	1.41%	1.15%	**0.26%**
RSEFX	1.68%	1.39%	**0.29%**
RSQCX	2.59%	2.18%	**0.41%**

Sources: New Constructs, LLC and company filings

In our recent Danger Zone report, the difference between SNWAX's expense ratio and its TAC was 2.79 percentage points. While not perfect, Royce Special Equity Funds' expense ratio does a much better job of representing the true costs of investing in the fund.

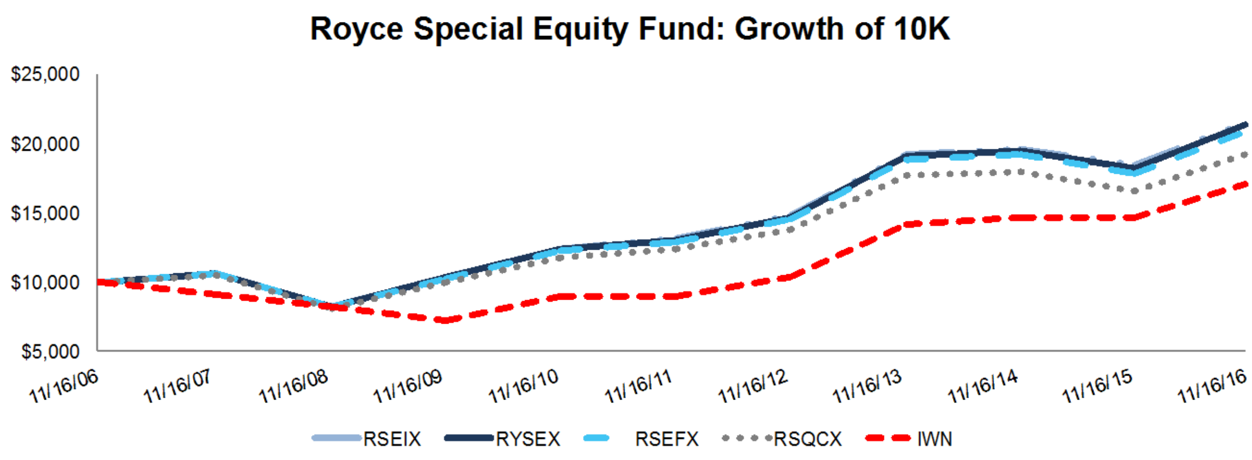
To justify its higher fees, the Royce Special Equity Fund must outperform its benchmark (IWN) by the following over three years:

1. RSEIX must outperform by 1.01% annually.
2. RYSEX must outperform by 1.13% annually.
3. RSEFX must outperform by 1.41% annually.
4. RSQCX must outperform by 2.31% annually.

The outperformance that excessive fees require (for investors to get their money's worth) is not only minimal, but has been surpassed over the past decade, per Figure 4. We also recognize that past performance is no indicator of future success, but Royce Special Equity Fund's quality holdings have clearly led to outperformance. Year-to-date, RSEIX is up 24%, slightly outperforming IWN, which is up 22%.

Ultimately, the underlying fundamentals of Royce Special Equity Fund's holdings, with low market expectations, provide excellent opportunity for outperformance moving forward.

Figure 4: Royce Special Equity Fund Vs. IWN



Sources: New Constructs, LLC and company filings.

The Importance of Holdings Based Fund Analysis

The analysis above shows that investors have options if they're looking to invest in the Small Cap Value style. Furthermore, Royce Special Equity is able to justify its fees through high quality asset allocation, which is the only reason to pay fees above the ETF benchmark to begin with.

More Fund Research That Does A Deep Dive Into Holdings

Each quarter we rank the 10 sectors in our Sector Ratings for ETF & Mutual Funds and the 12 investment styles in our Style Ratings For ETFs & Mutual Funds report. This analysis allows us to find funds that investors using traditional fund research may overlook. As we know, past performance is no indicator of future success, which is why the backbone of our ETF and mutual fund ratings is the quality of the holdings. After all, the performance of the holdings drives the performance of the fund.

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Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, sector, style, or theme.

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How New Constructs Creates Value for Clients

We find it. You benefit. Cutting-edge technology enables us to scale our forensics accounting expertise across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.

Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our forward-looking fund ratings are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating (details here) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

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