DIVIDENDS: OUR ONGOING LOVE AFFAIR

"It's amazing what you won't find if you don't look for it, especially if it's not there." This old saw perfectly sums up the attitude of most investors when the subject is dividend-paying small-cap stocks. Through our own history of nearly four decades of investment management, we have found that investors simply do not associate the small-cap asset class with dividends. However, we have long maintained that dividends can be an integral part of a successful long-term investment strategy in the small-cap asset class. Our experience suggests that including dividend-paying smaller companies in an equity portfolio potentially offers both an effective cushion against market volatility and a strong component of an investment's total return, especially during lower-return periods.

We believe that the practice of paying dividends is an excellent measure of a company's underlying quality and an intelligent form of corporate governance. From our perspective, within the small-cap world, where the words "dividend" and "quality" are often considered synonymous, adopting a dividend-paying investment strategy could be a key to long-term outperformance. We believe that this is especially relevant in the current market, as we believe a shift to higher quality companies is at hand.

Underfollowed, Underappreciated

Understanding a company's capital allocation decisions is a critical element in our investment process. This is especially important in a market when corporate balance sheets are generally in excellent condition and, in many cases, flush with cash. Dividends are by nature the byproduct of healthy free cash flow generation. Of the approximately 4,200 domestic small-cap companies (those with market capitalizations up to $2.5 billion), 1,219 were dividend payers as of the end of the first quarter of 2011; of these dividend-paying companies, 767 had a dividend yield of at least 2%.[1]

DOMESTIC SMALL-CAP UNIVERSE BREAKDOWN (Up to $2.5 Billion)

Yield	Number of Companies
None	2,994
>0 - 1%	207
>1 - 2%	245
>2 - 3%	216
3% and over	551
>0%	1,219
Total Companies	**4,213**

FOREIGN SMALL-CAP UNIVERSE BREAKDOWN (Up to $2.5 Billion)

Yield	Number of Companies
None	9,848
>0 - 1%	819
>1 - 2%	1,356
>2 - 3%	782
3% and over	1,845
>0%	4,802
Total Companies	**14,652**

[1]Data from *FactSet* as of March 31, 2011

From our perspective, within the small-cap world, where the words "dividend" and "quality" are often considered synonymous, adopting a dividend-paying investment strategy could be a key to long-term outperformance.

Not surprisingly, the number of dividend-paying companies located outside of the United States 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. Yields in many foreign markets are also quite 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, is a vital qualitative component that we look for in companies regardless of location, along with a strong balance sheet and an established record of earnings.

Surprisingly Strong Returns

Historically, small-cap companies have been known for better long-term returns. However, they have also been known for higher volatility, especially on the downside. Dividends, on the other hand, tend to cushion or limit downside participation and therefore generally contribute to better down market performance. Better down market performance often leads to better overall results, as our research shows.

In order to better understand the return characteristics of small-cap companies, we sorted the small-cap Russell 2000 Index into those 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, we re-sorted the universe each month into dividend- and non-dividend payers. Performance data was then calculated using month-ending prices. We went back as far as we had reliable data—to 1993—and were able to assess 18 calendar years of performance, which encompassed three full market cycles, along with the peak-to-current period as well.

Perhaps most compelling was the outperformance of dividend-paying companies within the Russell 2000 relative to their non-dividend paying counterparts for the entire period measured, 1993-2010. The average annual total return for the 18-year period was 10.6% for small-cap dividend payers versus 7.0% for those that do not (and 8.7% for the Russell 2000). In addition, the dividend-paying small-cap universe outperformed in 10 of the 18 calendar year periods assessed. Contributing to this attractive total return was outperformance in most, although not all, down market calendar-year periods.

RUSSELL 2000 AVERAGE ANNUAL RETURNS[2]

Year	Dividend Payers	Non-Dividend Payers	Russell 2000
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	**10.6%**	7.0%	8.7%

[2] Data from *FactSet*, Royce & Associates

Arguably even more telling is the level of performance consistency provided by dividend-paying small-caps. When measured over multiple periods, namely rolling three- and five-year return periods, dividend-paying small companies performed reliably well. In fact, dividend payers outperformed in 62% of all monthly rolling three-year periods (184 total periods) and 66% of all monthly rolling five-year periods (160 total periods). In both three- and five-year return periods, the average return for dividend payers was significantly higher. For all rolling three-year periods, dividend payers, on average, provided a 10.1% average annual total return versus 5.9% for non-dividend payers and 7.7% for the Russell 2000. Five-year average results were even better—dividend payers on average generated a 10.7% average annual total return versus 5.6% for non dividend payers and 7.9% for the Russell 2000.

RUSSELL 2000 AVERAGE ANNUAL MONTHLY ROLLING THREE-YEAR RETURN STATISTICS[3]

	Dividend Payers	Non-Dividend Payers	Russell 2000
Average of all Periods	10.1%	5.9%	7.7%

RUSSELL 2000 AVERAGE ANNUAL MONTHLY ROLLING FIVE-YEAR RETURN STATISTICS[3]

	Dividend Payers	Non-Dividend Payers	Russell 2000
Average of all Periods	10.7%	5.6%	7.9%

Market cycle data gave us further insight into the return patterns of dividend-paying stocks within the Russell 2000. As might be expected, dividend-paying companies outperformed non-dividend paying companies and the Russell 2000 over all four 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 and now trail in the peak-to-current period.

RUSSELL 2000 PEAK-TO-TROUGH CUMULATIVE RETURNS[3,4]

Peak Date	Trough Date	Dividend Payers	Non-Dividend Payers	Russell 2000
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		-7.4%	-41.7%	-31.0%

RUSSELL 2000 TROUGH-TO-PEAK CUMULATIVE RETURNS[3,4]

Trough Date	Peak Date	Dividend Payers	Non-Dividend Payers	Russell 2000
2/28/2009	3/31/2011	101.3%	145.5%	123.0%
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		71.9%	121.4%	96.3%

RUSSELL 2000 PEAK-TO-PEAK CUMULATIVE RETURNS[3,4]

Peak Date	Peak Date	Dividend Payers	Non-Dividend Payers	Russell 2000
6/30/2007	3/31/2011	1.0%	10.3%	6.6%
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		64.0%	21.3%	31.1%

Not Chasing Yield

When analyzing companies that pay a dividend, we do not typically seek companies with the highest dividend yields. Instead, we think about dividends as part of the menu of items in a company's capital allocation toolkit. There are several things a company can do with its free cash flow: It can reinvest in the company, make acquisitions, pay down debt, buy back stock or pay dividends.

So when we look at dividends, we frame it in the context of what offers the best risk-adjusted use of capital for the company—could giving some of the money back be part of that? If the business lacks an effective way to use that money, it may be best to give it to shareholders. In our view, dividends act as a form of corporate governance, a mechanism to further align the interests of management with those of shareholders. When companies decide to pay a dividend, we see that as a commitment on their part. Companies almost never want to cut or eliminate dividends.

However, yield is not everything. If we simply chased companies with the highest dividends, it would probably lead us to businesses under stress where the market does not believe those dividends are sustainable and therefore may be cut or reduced. It may also lead us to Master Limited Partnerships, REITs or Utilities, areas that we tend to avoid. So we do not hunt for the highest dividends. Most of our

[3] Data from *FactSet*, Royce & Associates
[4] Month-end dates were used

holdings that pay dividends tend to be even more conservatively managed than many of our other stocks because the companies tend to be more mature.

Not an Area of Focus

Despite an abundance of small-cap companies that pay dividends, very few fund managers focus on dividends within the small-cap universe. Most focus on capital appreciation instead of total return, 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 553 small-cap objective funds identified by Morningstar as of March 31, 2011, only four funds have dividend, income, equity income or total return in their respective names (two of which are Royce Funds). Yet dividends in the small-cap universe perform the same role that they do in the large-cap area—they tend to reduce a stock price's downside volatility and allow an investor to start the year with a positive return as a result of the dividend.

Setting the Stage for Quality

We have recently suggested that higher-quality companies, regardless of market capitalization, would lead as the economy moves from recovery to expansion, and our conviction has not wavered. We continue to believe that stocks with high-quality characteristics throughout the market will continue to lead, especially as the economic recovery matures. While we remain particularly confident about the long-term prospects for stocks, we do not see the kind of returns on an annualized basis that we saw in 2009 and 2010. Instead, we see annualized returns in the high single digits for the decade as a whole.

Owning dividend-paying smaller companies should be of greater importance at this point in the economic and stock-market cycle, as higher-quality companies offer investors many advantages, particularly when compared to their lower-quality siblings. In our view, high-quality stocks currently look undervalued, are defensive by nature, and seem likely to perform better as the economy transitions from recovery to expansion. We believe that we are beginning to see a shift in market leadership to high-quality stocks.

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