

Anchored in Balance Sheet

Following a time-tested three-pronged investment philosophy Jay Kaplan, portfolio manager at Royce Value Fund, seeks to generate higher returns by identifying companies with strong balance sheets, high return businesses and discount valuations. Using a contrarian approach, the manager believes that rock solid balance sheets offer brick wall protection against temporary operating problems at a company.

Q: What's your investment philosophy?

A: We follow a three-pronged investment philosophy. The first is a strong balance sheet. The second, high returns and the third is valuation. The firm has been around for more than 30 years practicing the same investment philosophy, so it's a time-tested method of investing.

Q: Why do you think these prongs are important?

A: Balance sheets are a cornerstone of what we do. As value investors, we tend to be contrarians in the way we think. We are generally willing to invest in companies where there is operating risk, where there is a problem that we believe to be more temporary than the market believes it is. We are willing to take on that risk if we are not taking on financial risk. So, if there is an operating problem that doesn't turn around the way you have liked or as quickly as you would like, when there's a bad balance sheet and financial risk, it could mean game over before there's time to fix the problem. A rock solid balance sheet takes part of that risk away and the element of time is back in your favor because the companies won't go out of business any time soon. If we have confidence in what we are doing, and stock prices go down more than they otherwise might, it allows us to buy them at continually more attractive

prices without worrying that we have Chapter 11 candidates.

Then, we look at return on assets as a measure of high return. A company has to be in a good competitive position and have a good sustainable competitive advantage to have high returns. The high returns will prove to you that it is in fact a good business.

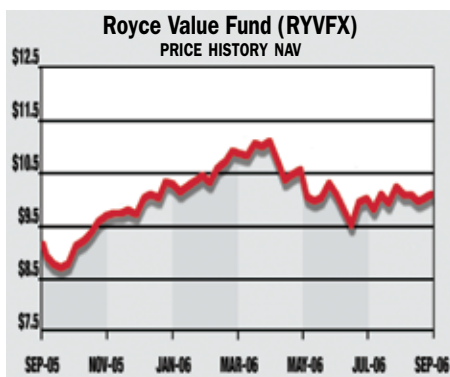
We are also looking to see that their returns on the capital invested are strong, have a track record of being strong and look like they are sustainable. If they were once strong, and now have temporarily come down for reasons that are definable with a good visible path to returning to good levels, that's something we are interested in as well.

Q: What is your definition of a strong balance sheet?

A: When we look at balance sheets we pull a measurement out of the fundamental DuPont formula and we look at assets divided by equity. In effect, it treats all liabilities the same, and it shows how much equity supports each dollar of assets, so it treats, for example, pension liabilities and long term health care liabilities the same as debt. We require that companies generally have an asset to equity ratio of two times or less. That is a very strict criterion, which makes our view of balance sheets generally more con-



JAY S. KAPLAN CFA, is a Portfolio Manager of Royce & Associates, LLC. He manages Royce Capital Fund Small-Cap Portfolio, co-manages Royce Value Fund with Whitney George, and is an assistant portfolio manager of Pennsylvania Mutual Fund and Royce Total Return Fund with Chuck Royce. He has 18 years of financial industry experience. Prior to joining Royce & Associates in November 2000, Mr. Kaplan spent 12 years with Prudential Financial, most recently as Managing Director and Portfolio Manager of the \$2 billion Prudential Small Company Value Fund. He holds a bachelor's degree from State University of New York, Binghamton and a master's in business administration degree from New York University.



servative than most our competitors.

Part of the risk in small-cap investing is the ability to survive, where a lot of companies flame out. We tend to avoid the flameouts over time because of our requirement of a strong balance sheet. Small-cap growth investing sounds exciting at cocktail parties, and there are always big winners to talk about, but the long-term statistics show that small-cap value investing has better returns over time.

Q: How do you define the high returns?

A: We generally look for a return on assets of 8% or better. One of the ways you can raise your return on equity is to raise your leverage, but since we are focused on leverage, we are trying to find good performing assets that have high returns without a lot of financial leverage.

Q: How do you look at the third tenant of your core philosophy - valuation?

A: We are trying to look at intrinsic values and to determine what a busi-

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nessperson might pay for a company. We look at capitalization rates defined as operating earnings divided by enterprise value. In general, we try to buy companies at 15% capitalization rates. It varies a little from industry to industry, but we set buy and sell targets based on operating income. We are more focused on operating income than we are on earnings per share.

Q: How would you describe your investment process?

A: Our day-to-day process is very much bottoms-up, stock by stock. We may find a stock in a company we like and it leads us to other investments in the same industry.

Q: Do you spend a lot of time meeting with the managements of companies?

A: Yes, we are very focused on companies. As a group, we spend a lot of time meeting with the managements. In small-cap land you get really good access to the people that run companies. We sit down with the executives all the time, whereas in the large-cap world you might go to an Analyst Day once a year where the CEO talks about the long-term strategy, but day-to-day, you call the Investment Relations officer to talk about the company.

As a firm, we tend to be significant owners of the stocks we invest in, so we are important to the companies and they like us to be an owner of theirs, because we tend to be relatively long-term owners. We feel we are business partners with the managements, although representing the interest of our shareholders.

Q: What's the turnover of the fund?

A: Over time, we'd expect our turnover to be 35%-45% a year. That's very low. As contrarians we approach everything that we do with a 3 to 5-year time horizon.

Q: Do you benchmark against any index?

A: Because our process is very bottom up and because of our criteria, there will be areas where we'll be very underexposed most of the time. With that in mind, we don't closely benchmark against index weightings although we do hold our performance up against the Russell 2000 index. We focus on absolute returns and downside protection, and we do not focus on sector weightings against the index.

Q: How many holdings do you have in the fund?

A: We have about seventy holdings.

Q: How do you manage against taxes?

A: We try to be tax efficient, particularly when it comes to short-term gains. We spend more time worrying about the short-term gains than the long-term gains.

Q: How do you find ideas?

A: Ideas can come from a number of different sources - running screens, presentations, and meetings with the management teams. And the most interesting source of ideas is the intellectual database at our firm.

Since small-cap stocks tend to be less liquid than large-cap stocks, during those times of news related volatility, you tend to find that liquidity goes up a lot for a very short period of time. So when there are news items, our stocks will move a lot and trade a lot and it's a very short window of a day or two. We are laser focused on small-cap stocks, and when there are market-moving events, we make intelligent decisions very quickly and with a great depth of knowledge, and that's a huge competitive advantage for us.

Q: How do ideas turn into holdings, and then how do you harvest them?

A: I'll take Cimarex Energy (XEC) as an example of how market knowledge helps. Our firm owned oil service firm, Helmerich and Payne (HP), a drilling

contractor. We believed that long-term the price for oil was rising and we knew the company. They decided at one point to divest their exploration and production business and they merged it with a company called Key Energy. I saw and met the people at Key Energy, as it was one of those companies that we had in our institutional database. After the merger Key Energy was renamed Cimarex Energy. As a result of that transaction, and our knowledge of the business, we then took a look at this newly created company. We liked its prospects and the fact that it was under followed because it was a division of one company merging with a small under followed company, so no one really knew it. We met the people, got comfortable with their strategy, their assets, their business model, and we wound up taking a big position. The company and the stock are a lot larger now than a few years back. That was an example of a company that met our financial metrics, a company that came into existence where on one side we had been impressed with the people from a distance, but on the other side of the transaction we had been invested with the people and knew the business, so all those things came together to get us interested in this new opportunity, and it still is a winning investment.

Q: When you look at an Exploration & Production company like that, and when you look at asset to equity ratios, how do you verify the assets that are under the ground are worth what they are priced at?

A: That's the wild card, but that's true of any commodity company. It's true of any financial services company, because the financial statements are all really estimates there too, and at some point anybody who tells you differently is maybe deluding themselves. Unless you are an engineer who has access to the actual raw data, then you have to believe the people and look at the track record

of write-offs. Like a financial services company or an insurance company or a bank, you can never really know.


Q: But as a strict value investor, even though the assets declaration may be in balance sheet, wouldn't you pass on this investment even though they may be good, but in the end, you're relying on somebody's word and not on numbers that could be verified?

A: It can be somewhat verified by others, it can be verified by their independent outside engineering firm.

We monitor the balance sheets as we go forward and it's the same thing with companies that we own that may do large acquisitions, but do them in such a way where the balance sheet no longer fits our criteria, in that case we may divest our holding.

Q: How do you measure and control risk?

A: We look at risk as a function of losing money rather than a function of variation versus the index. We do that by diversifying. A big part of how we view risk gets back to the balance sheet criteria again. That helps us in a big way from having the big wipe-outs, and that, combined with diversification, and good businesses is one of our risk control measures.

We are not benchmarking the index, and we are not looking at spreads versus the index, and tracking errors versus the index. We are not trying to manage tracking error and we are not using the Barra risk management tools to see how the portfolio differs from the index on size and on leverage and on valuation and all those things that you do when you are very institutionally index focused. We are more about picking stocks and not losing money. It's a different way of looking at the world but it works. 

Royce Value Fund

Symbol	RYVFX
Website	www.roycefunds.com
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Tel. No.	800-348-1414
Inception	06/14/01

PORTFOLIO

Total Net Assets*	\$384.6
Avg Mkt Cap (\$ Weighted)*	N/A
Average Price/Earnings Ratio	N/A
Average Price/Book Ratio	N/A
Turnover Ratio	44%

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$2,000
Min Subsequent Investment	\$50
Min Initial IRA Investment	\$1,000

RISK (AGAINST S&P 500)

Alpha	0.40
Beta	1.27
R-Squared	0.56
Ann Std Deviation	13.04
Sharpe Ratio	1.34

RETURNS VS. S&P 500 INDEX

	RYVFX	Index
1 Year (Cum.)	22.05%	10.79%
3 Year (Ann.)	22.21%	12.30%
5 Year (Ann.)	18.70%	6.97%

RETURNS VS. LIPPER SM-CAP CORE INDEX

	PDFDX	Index
1 Year (Cum.)	22.05%	6.96%
3 Year (Ann.)	22.21%	15.44%
5 Year (Ann.)	18.70%	13.18%

FEES AND EXPENSES

Max Sales Charge - Front**	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	N/A
Total Expense Ratio	1.28%

PORTFOLIO MANAGER

Jay Kaplan	Jun-2001
Whitney George	Jun-2001

*millions **for amount less than \$100,000

Data through: 9/30/06

Source: Company Documents; Lipper

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