

Overlooked Enterprise Value

Royce Special Equity Fund uses a disciplined value approach that combines classic value analysis with accounting cynicism. The Fund focuses on companies with market capitalizations up to \$2.5 billion, attempting to find inexpensive companies with high returns on invested capital and low leverage.

What is your investment philosophy?

Our investment philosophy is based on buying sustainable businesses at a discount in an attempt to generate positive long-term returns in the fund regardless of market conditions. Investor's perception of business valuations can change but the economic value of businesses rarely changes as fast as the investor's sentiment.

The fund seeks businesses that have higher returns on capital. Our philosophy is to understand these businesses and acquire them when they are trading at prices below their intrinsic values.

What is your investment strategy?

The fund's priority is absolute return. Sometimes returns in the fund can lag the market, especially when the market is rising quickly, but when the market is declining, the fund historically has lost

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less than the market. Over a full market cycle, the fund seeks to outperform the market.

The entire strategy is anchored in every way to minimize risk. I am always looking to protect the downside and that is why margin of safety is important at the time of stock purchase. The third element of the strategy is to look at the reported financials and accounting disclosures.

How do you identify a good business from a bad?

We look at the valuation of the company as a whole and not as a multiple of historical or future earnings. We calculate enterprise value, which is market cap plus debt and preferred stock at liquidation value less cash.

The enterprise value approach allows us to compare different businesses and not worry too much about the capital structure of each company. We are driven by the value of the business as a going concern and its ability to generate return for owners of the business.

We also pay a lot of attention to accounting treatment of expenses and revenues. The present accounting rules



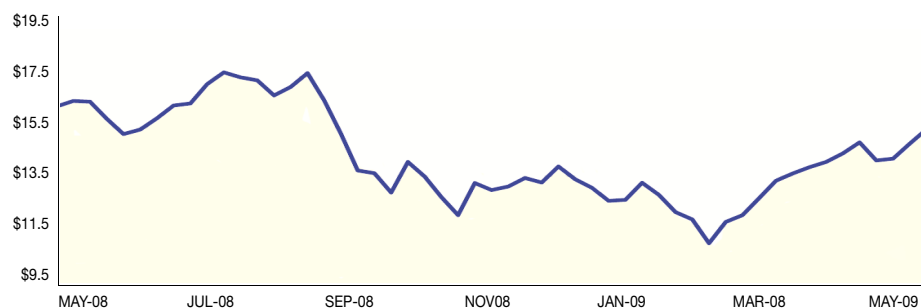
CHARLES R. DREIFUS, CFA, is a Portfolio Manager and Principal for Royce & Associates, LLC investment adviser to The Royce Funds. He serves as Portfolio Manager for Special Equity products, including Royce Special Equity Fund, an open-end mutual fund that attempts to combine classic value analysis, the identification of good business and accounting cynicism. He has 41 years of investment industry experience, with 29 years as a small and micro-cap value portfolio manager.

Prior to joining Royce & Associates in 1998, Dreifus was a General Partner and Managing Director, and a Limited Managing Director, of Lazard Freres & Co., LLC. He was also the Portfolio Manager of Lazard Special Equity Portfolio, formerly Lazard Special Equity Fund and Special Equity separate accounts. Prior to that, Mr. Dreifus was employed by Oppenheimer & Co. as a Limited Partner and as the manager of Quest For Value Fund (from May 1980 to November 1982) and by Oppenheimer Capital as an Executive Vice President.

Dreifus received a bachelor's degree from the City College of New York/Baruch School and earned a Master of Business Administration degree from Baruch College.

Performance - Price History N.A.V.

Royce Special Equity Fund (RYSEX)



	2006	2007	2008
Russell 2000 TR Index	18.37%	-1.57%	-33.79%
Royce Special Equity Fund	14.00%	4.00%	-19.00%

are flexible and management may take advantage to be either aggressive or conservative. Our research focuses on details of various components of financials and management approach in treating them.

The return on capital is the metric we focus on to understand if the business is unique enough to have a pricing power in the market. We calculate returns on invested capital by dividing earnings before interest and taxes by the total capital adjusted for cash on hand. Higher returns may signal that the company enjoys brand name recognition or some other advantage that allows it to earn more.

An important metric to me is the free cash flow generation capacity of the business because if it doesn't produce cash the business is not worth a lot. So I have a metric where I take free cash flow which I define as cash flow from operations minus capital expenditures and I divide that by the reported net income. I am looking for a number, if not above 1, then at least close to 1. I'd like to see all of net income as free cash flow because that gives you the

arsenal to do a lot of things, such as buy back stock, make smart acquisitions, or initiate or grow a dividend.

Another metric that I use is leverage. In my portfolio's case, only around 35% of total assets are currently financed by other people's money, meaning that roughly 65% of total assets are financed by shareholders' equity. That represents the kind of conservative balance sheet that I am looking for.

The two issues that were raised for companies in general during the current economic crisis were capital and liquidity. The companies we invest in have an abundance of both and in fact some are overcapitalized and it often takes the form of excess cash.

What is your research process?

The selection process involves distilling a set of names down as a result of the research process. I try to get a sense of the veracity of the financials. The companies that we look at are also generally underfollowed by brokers and investors.

In most cases, we have a conversation with management because there is something in the document that comes up which requires further explanation. In this post Sarbanes-Oxley era, there is more disclosure, so there is an opportunity for active portfolio managers to take advantage of it to try to generate better returns.

The whole research process is geared toward building confidence in the company's business model. We ask questions such as, "Why does this company have high returns? Is the market incorrect? Are the latest earnings in the last twelve months generated by the market cycle or are they the product of company management? Are earnings likely to go down and if they do by how much and what will the stock be worth at that time?"

The research process is really a way of trying to protect us in case we make an error or overestimate the sustainability of earnings. I am trying to buy stocks where the expectations are non-existent. If the company does worse than I think it should, the stock will go down but the penalty is less severe than in situations where expectations are high. We are looking for upside, but we definitely want to limit the downside.

Some of the companies we invest in become takeover targets. The businesses that we are attracted to tend to be mundane businesses that are stable and predictable and rarely catch the eye of momentum investors or make headlines in the media. Many times these businesses are controlled by founding families that have managed to grow them through several business cycles. These families generally take a conservative approach, yet ultimately they want to increase their wealth.

Could you explain the portfolio construction?

The portfolio is built from the bottom up, and most of the companies that we own have market caps of less than \$2.5 billion. The fund is best suited for long-term investors who are as interested in preserving capital as they are in growing it. My average holding period tends to be four or five years, so the portfolio turnover is very low. Also, I know my limitations. I don't buy companies in businesses that I don't understand.

Our investment discipline helps us to limit what we pay for stocks, which acts as one of our biggest risk control measures. It is rare for the fund to outperform in a very strong, quick upside move in the market and rare that it will be down more than the market on the downside.

Can you give examples of two or three companies that met your investment criteria?

If you go to our website (roycefunds.com) and look at the fund's holdings, I'd like to believe that each company has the attributes that we've discussed.

What role do earnings forecasts play in your evaluation of a business?

I think that, if the business hasn't changed and the management hasn't changed, the best indicator of future earnings is past earnings. Historical earnings give us an indication into a company's future earnings potential.

Since we rarely pay for future earnings prospects, and even to the historical earnings stream, we are looking to apply a discount to gain a margin of safety, the volatility in the fund is lower than the market.

Why is a long-term outlook so important?

Markets can bid up stock prices in short-term swings, but unless valuations meet our investment criteria we are not going to participate. I believe that this discipline has proven itself and until it is proven not to work over a full market cycle I will keep the faith. Everything we do is based in economic reality.


Do macroeconomic considerations factor in your thought processes?

The businesses that we invest in are conservatively financed and generally do not have much leverage on their balance sheets. So when the economy goes through tough times these businesses tend to benefit because they have the wherewithal to increase market share and expand at the expense of weak competitors.

Macroeconomic factors do play a role in what I do and how I think. For example, when the economy is declining, consumer stocks tend to be out of favor and industrial stocks with steady earnings also get ignored. These market trends sometimes can help us to find companies that are generating solid returns on capital and because they are out of favor they may meet our valuation criteria.

I always stick to my discipline when it comes to valuation, which I believe helps to protect us on the downside in the event if I am wrong in my assumptions about the future.

What are views on earnings growth?

I am a student of the market. I have always had difficulty putting a P/E ratio or somehow suggesting company 'x' that grows 10% a year is worth 'y' times its earnings. My companies tend to be in prosaic businesses. Their organic growth rate more times than not is anemic. It is there, but it is not great. 

Royce Special Equity Fund

Symbol **RYSEX**
 Website www.roycefunds.com
 Address Royce & Associates, LLC
 745 Fifth Avenue
 New York, NY 10151
 Telephone 800-221-4268
 Inception 05/01/1998

PORTFOLIO	
Total Net Assets *	\$518.6
Avg Mkt Cap (\$ Weighted) *	\$1,054
Average Price/Earnings Ratio	14.0x
Average Price/Book Ratio	1.7x
2008 Turnover Ratio	27%

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 DAILY REINV IX - 3 YEARS) USING A RISK-FREE RATE OF RETURN OF 3.10%	
Jensen Alpha	6.39
Beta	0.81
R-Squared	0.74
Ann Std Deviation	17.77
Sharpe Ratio	-0.10

RETURNS VS. S&P 500 DAILY REINV INDEX		
	RYSEX	Index
1 Year (Cum.)	-11.09%	-32.57%
3 Year (Ann.)	-0.17%	-8.24%
5 Year (Ann.)	2.45%	-1.90%

RETURNS VS. RUSSELL 2000 TR INDEX		
	RYSEX	Index
1 Year (Cum.)	-11.09%	-31.79%
3 Year (Ann.)	-0.17%	-10.14%
5 Year (Ann.)	2.45%	-1.18%

FEES AND EXPENSES	
Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee**	1.00%
Total Expense Ratio	1.15%

PORTFOLIO MANAGER	
Charles R. Dreifus	1998

*millions **6 months after purchase
 05/31/2009; Source: Company Documents; Lipper

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