We were happy to greet 2016 with a spirited “Hello” in the hope that certain emerging trends in the small-cap world would gain a firmer foothold in the new year.

We were very pleased, then, to see the market's pronounced shift toward companies with attractive to reasonable valuations, solid balance sheets, and strong profitability—attributes found in many of our portfolio holdings—arrive in the year’s first half. And though domestic small-caps did modestly well in the first half, an achievement that looks more commendable in the context of the high levels of volatility that all equities faced in the first half of 2016, many active managers, ourselves included, did even better.

This was a welcome change. Both the absolute and relative health of domestic equities was in evidence during the first half of 2016. The Nasdaq Composite, which is home to a large number of biotechnology companies that corrected sharply in the first half after leading the market last year, was the only major U.S. index to finish the year-to-date period ended June 30, 2016 in the red.

A few non-U.S. indexes remained marginally positive in the first half, but most concluded the semiannual period with at least minor net losses. Among those that fell further behind was one that did notably well in 2015—European small-caps, whose more diminutive size made them most vulnerable to the post-Brexit sell-off.

But to participate in these strong first-half results, investors needed the stomach for a wild ride that started with a steep and speedy initial drop followed by a far smoother, robust recovery.

The year began with a more dramatic extension of last year's decline, and we initially failed to grasp that 2015 would, in the manner of Shakespeare's best-known stage direction, “Exit, pursued by a bear.” From the June 23, 2015 small-cap peak through its year-to-date low on February 11, 2016, the Russell 2000 Index fell 25.7%, a truly ursine decline.

This seems to have been a remarkably quiet double-digit correction—a stealth bear market, as it were. Few outside the small-cap world have acknowledged it, never mind analyzed or discussed it. Yet it was the ninth biggest decline since the Russell 2000's inception in 1978, and the worst for small-caps since 2011.

It included many of the signs that typically accompany a bottoming-out process—panic selling in a number of sectors (most notably within the bio-pharma complex), small-caps losing more than large-caps, and greater resilience from value stocks—to us, the most significant development in the down phase.

This heightened volatility was triggered by the ongoing implosion of oil prices, struggles for other commodities, anxiety over possible bank defaults, and the devaluation of currency in China.

Together, these factors led to a few sessions in which hysteria ruled the equity markets. Like many bear markets (and unlike that of the more closely correlated collapse in 2011), it also solidified a rotation in leadership from small-cap growth to small-cap value.

Having invested through many previous small-cap declines (some pre-dating the Russell 2000), we sought to turn the downdraft to our advantage by looking for bargain-priced opportunities amid the volatility and stay invested for the eventual recovery.

Our commitment was rewarded as the Russell 2000 rebounded sharply from its early February low, rising 21.6% by the end of June. During these tumultuous days, a shift in leadership could be seen clearly in the earnings outlook.

We first saw evidence for it in October 2015 and noted it again in February 2016. Many companies, including several of our holdings, reported decent earnings while also not revising guidance downward. This was viewed as a positive in that expectations had been so low, particularly for companies in more economically sensitive sectors, that "pretty good" or "not
that bad" was in several instances much better news than people were expecting.

The general lack of downward earnings revisions both last fall and in the first half of this year has allowed for some recovery for these companies' shares. Brexit, of course, tossed an already highly uncertain global economy into even stormier seas. While we see the vote as more of a political event for the United Kingdom and the European Union than an important economic event for the U.S., there's no question it has made the already tenuous prospects for global growth that much shakier. Still, we do not see it having a lasting or meaningful impact on U.S. small-caps.

For the global economy, however, Brexit and other risks look likely to persist. At this writing, there are negative rates for long-term sovereign debt in Germany and Japan, ominous signals from the banks in Italy, and in both the United Kingdom and eurozone a political and economic situation that it would be an understatement to call 'unsettled.'

Here at home, we have seen record lows for both 10- and 30-year Treasury yields. These more recent developments can be added to the older—that is, mid-June's—list of concerns about the pace of growth in China and other important emerging markets, stabilizing but still volatile commodity prices, and the ambiguous state of the U.S. economy, in which housing and autos remain strong but consumer confidence, manufacturing, and the job market have been more mixed.

It is a daunting set of challenges, to be sure. Where we differ from some observers, however, is in our belief in the strength and resilience of the economy. This is rooted in our long-established practice of giving more weight to what we are hearing from the management teams we speak to every day than to fatalistic headlines and dire—or overly sunny—prognostications.

The corporate managers with whom we have been meeting are far more cautious and uncertain than pessimistic. Well aware of the fragility of current conditions, they have also offered some measured optimism in terms of growth picking up, however gradually or in fits and starts.

In terms of now widespread recession concerns, we also want to stress that, over its long history, the stock market has seldom, if ever, offered false positives—that is, shares do not rise when economic growth is about to contract.

And in all the tumult of the first half, most U.S. indexes rose, however modestly. The upshot is that, in the midst of heightened global uncertainty, the U.S. economy and markets look far healthier to us than what the rest of the globe has to offer.

**SIGNS O' THE TIMES—THE SIGNIFICANT SHIFT**

Most notable to us as small-cap specialists with a value orientation was how thoroughly style drove results. The Russell 2000 Value Index outpaced the large- and mid-cap indexes year-to-date through the end of June, while the Russell 2000 trailed them, and the Russell 2000 Growth was negative.

Value indexes in fact did better up and down the market cap range, from micro- to large- cap, in the first half. Although small-cap leadership began to rotate following June 2015's small-cap peak, the widening performance gap between small-cap value and growth has been the critical development within small-cap so far in 2016. This could be seen in both bear and bull phases during the first half.

The Russell 2000 Value lost far less than its growth counterpart from the end of 2015 through the February 11th small-cap low (-12.9% versus -18.9%); it was then essentially tied with the Russell 2000 Growth from that low through the end of June (+21.8% vs +21.4%).

In prior years (2009-2015), value led in many downdrafts but lagged in up markets. This renewed up market strength is a major reason behind our optimism for value stocks.

Another reason, related to value's emergent leadership, has been the relative strength of many stocks in economically sensitive, cyclical sectors. Defensive areas led within small-cap, with Utilities, Consumer Staples, Telecommunication Services, and REITs enjoying strong first halves.

Unlike 2015, however, they were joined by strong turns for Materials, Industrials, and certain non-REIT areas in Financials, with the first particularly strong. Along with Information Technology and Energy, these have been areas of collective investment interest for us over the last several years.

Yet even with the recent shift in investor preferences, which eventually sparked the turnaround for many of our holdings, expectations for many of these cyclical businesses remain low. In many cases, stocks were so deeply oversold during the
winter months that, even after having experienced some recovery, their valuations still look attractive to us. Several looked
even cheaper in late June.

WHAT A LONG STRANGE TRIP IT’S BEEN

We could use this title to describe the first half of 2016, the entire post-Financial Crisis period, and, perhaps most fitting, the
peculiar span from 2011-2015, when QE (quantitative easing) and zero (or near zero) interest rate policies inflated many
asset values but also created a barbell-shaped range of small-cap returns, with bouts of leadership from defensive,
typically high-yield stocks at one extreme and fast-growing healthcare and/or tech issues at the other. Most companies in
the middle spent the period struggling to catch up.

Equity Indexes—As of June 30, 2016 (%)

<table>
<thead>
<tr>
<th></th>
<th>1YR</th>
<th>3YR</th>
<th>5YR</th>
<th>10YR</th>
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</thead>
<tbody>
<tr>
<td>Russell 2000</td>
<td>-6.73</td>
<td>7.09</td>
<td>8.35</td>
<td>6.20</td>
</tr>
<tr>
<td>Russell 2000 Value</td>
<td>-2.58</td>
<td>6.36</td>
<td>8.15</td>
<td>5.15</td>
</tr>
<tr>
<td>Russell 2000 Growth</td>
<td>-10.75</td>
<td>7.51</td>
<td>8.51</td>
<td>7.14</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>3.99</td>
<td>11.66</td>
<td>12.10</td>
<td>7.42</td>
</tr>
<tr>
<td>Russell 1000</td>
<td>2.93</td>
<td>11.48</td>
<td>11.89</td>
<td>7.51</td>
</tr>
<tr>
<td>Nasdaq Composite</td>
<td>-2.89</td>
<td>12.48</td>
<td>11.79</td>
<td>8.35</td>
</tr>
<tr>
<td>Russell Midcap</td>
<td>0.56</td>
<td>10.80</td>
<td>10.90</td>
<td>8.07</td>
</tr>
<tr>
<td>Russell Microcap</td>
<td>-12.06</td>
<td>8.20</td>
<td>4.31</td>
<td></td>
</tr>
<tr>
<td>Russell Global ex-U.S. Small Cap</td>
<td>-5.77</td>
<td>4.06</td>
<td>1.91</td>
<td>3.82</td>
</tr>
<tr>
<td>Russell Global ex-U.S. Large Cap</td>
<td>-9.94</td>
<td>1.63</td>
<td>0.36</td>
<td>2.17</td>
</tr>
</tbody>
</table>

This was bad news for active small-cap management, as comparative returns during this otherwise robust five-year period
make clear. In what seemed at times like a perverse inversion of the usual patterns of stock market behavior, there were
penalties in the form of lower relative returns for those managers who, like us, generally emphasize qualities such as
earnings, profitability, low leverage, and steady dividends (as distinct from high yields).

We are pleased to say that so far in 2016, things have changed. Investors have been showing greater interest in the
attributes that had been out of fashion for too long—steady dividends, profits, and effective capital allocation, to name a
few.

And as share prices began to rise following the February low, these qualities stayed in demand. We remain confident that
an extended period of even slow economic growth should be enough to boost the shares of many companies in sectors
such as Industrials, Financials, Information Technology, Materials, and Energy—all of which are home to cyclical
businesses with earnings and, in some cases, high ROIC (returns on invested capital).

Those that also have reasonable to attractive valuations are the companies that we expect to lead small-cap going
forward.

Recent data from Furey Research Partners reinforces this point It showed that at the end of June 2016 small-caps were
the cheapest they have been versus large-caps in the last 13 years, that value is cheap relative to growth, and that
cyclicals are cheap compared with defensive stocks.

In addition, we have seen anomalous markets before—including the large-cap led “Nifty Fifty” of the 1970s, the sudden
-crash in 1987, and the Tech Bubble in 2000. As challenging as each of these was, the stock market eventually resumed
more historically typical performance patterns.
These resumptions often signaled better times for risk-conscious, research-driven small-cap investors as well. So we feel as though there are many reasons to feel good about the long-term potential for both profitable small companies and small-cap value. Not that the equity world is without very real risks. The added layer of Brexit-bred uncertainty to an environment in which interest rates are still historically low could continue to push small-cap investors to safety and/or high yield at one extreme and lead to a fresh run at speculative growth at the other.

We see four factors, however, that in our view should prevent a repeat of the pattern that dominated 2011-2015.

First is the first-half success for cyclicals, particularly during the recovery phase when many helped to give small-cap value its post-bottom lift.

Second, valuations for many defensive stocks look stretched to us, which should enhance the appeal of many of our holdings.

Third, credit spreads remain wider than they were a year ago at this time, even with the 10-year Treasury making new lows. As long as the cost of capital remains higher, it should help profitable, lower leverage businesses.

Finally, there is reversion to the mean— the middle of 2015 marked a two standard deviation event in terms of a performance edge for the Russell 2000 Growth versus its small-cap value sibling.

On balance, then, we see ongoing leadership for small-cap value. So while we still expect returns for stocks to be low, we also think that leadership for value—now in place for more than a year—has ample room to run.

We will be tireless in our collective efforts to run with it.

**Important Disclosure Information**

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