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Closed End Funds

Royce Micro-Cap Trust: Strong Distributions Powered By An Underserved Asset Class

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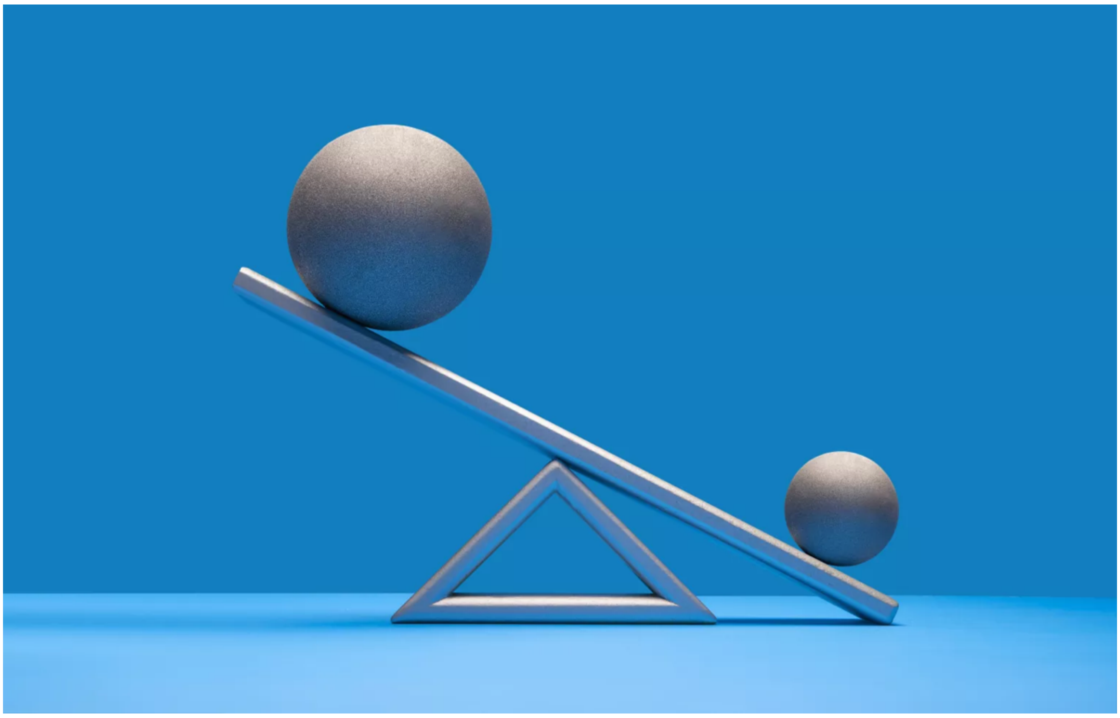
Summary

- RMT is a closed-end fund that invests in microcap equities across growth and value.
- The fund has outperformed the S&P 500 over various time frames and has a TTM yield of 5.75%.
- We dive into the fund and discuss RMT's portfolio, distribution, and outlook.



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The Royce Micro-Cap Trust (RMT) is a classic, equity oriented closed end fund with a long history of market outperformance. The fund is dedicated to Microcap stocks which are often overlooked by investors

What Is The Royce Micro-Cap Trust?

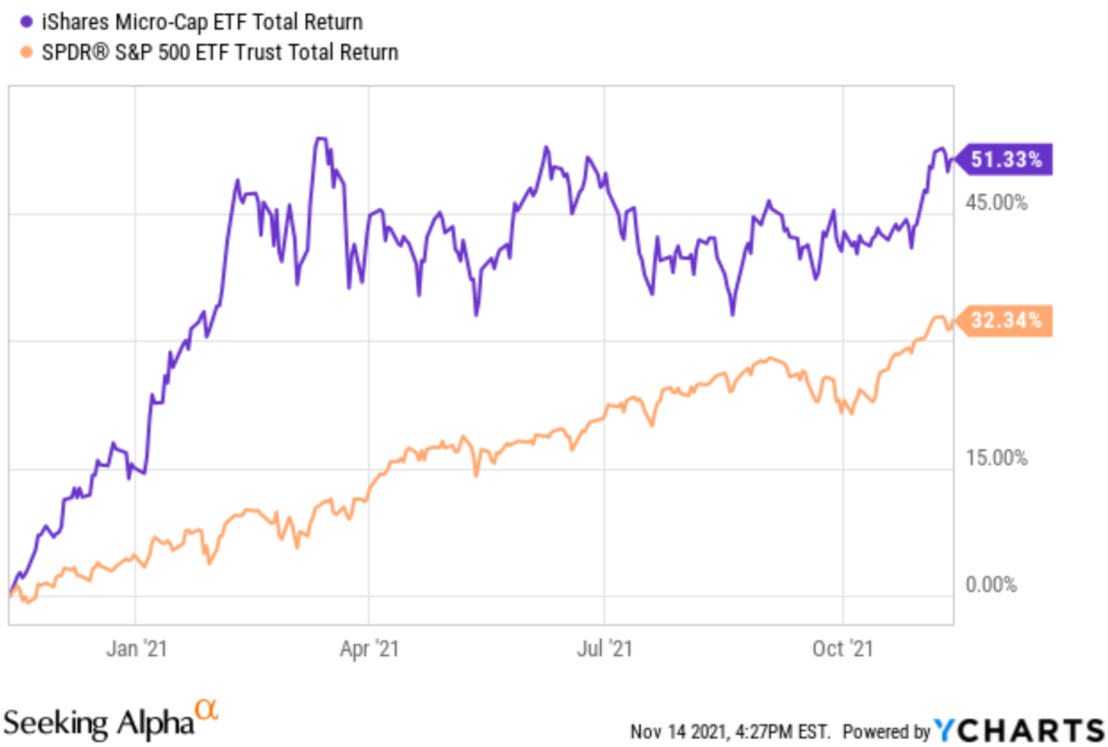
The Royce Micro-Cap Trust is an unlevered closed end fund which utilizes a portfolio comprised of common stock to drive total return. The fund has provided strong performance over all time frames through quarterly distributions and consistent performance from management. RMT is a small fund, managing just $547 million in total assets. The fund is unique, currently positioned as one of the only closed end funds which tackles the Microcap space. This focus differentiates the fund from the majority of popular equity CEFs. What's even more unique is RMT's ability to generate consistently strong distributions in an asset class where dividends are uncommon. The fund has a successful, consistent growth track record, providing for an element of consistency in the dividend.

Microcaps are the smallest companies in the investible universe when ranked by market cap. The fund is benchmarked against the Russell Microcap index, which is comprised of the 1,000 smallest equities in the Russell 2000. The benchmark dictates that companies must still meet exchange requirements, excluding pink sheets and over the counter securities. However, many of these companies still remains underserved as the broader market lacks a focus around Microcap companies. For reference, microcaps represent less than 5% of total United States market cap. Microcaps are often overlooked on the basis of generally being less established than large caps or even mid caps. As a result, performance can often be lumpy or unpredictable, which is generally unattractive for income investors, especially. However, the category also presents a unique set of benefits that investors should consider.

Given the growth orientation and unestablished track records, the category quickly begins to look similar to private equity buyout targets. Private equity investments have rapidly grown over the past decade as hungry institutional investors chase aggressive growth and new opportunities to place capital. The fund is even self-described by manager Chuck Royce with a private equity flavor.

> Our task is to scour the large and diverse universe of micro-cap companies for businesses that look mispriced and underappreciated, with the caveat being that they must also have a discernible margin of safety. We are looking for stocks trading at a discount to our estimate of their worth as businesses.
>
> Chuck Royce

As companies emerge, the growth trajectories are far higher than an established operator, such as Coca-Cola (KO) or AT&T (T). While unpredictability can be unnerving for investors, the long-term returns have often proven to be superior. Additionally, the Microcaps, like private equity, offer a meaningful opportunity to diversify investments away from the dominant names of many indexes. As indexes become more concentrated, spreading investments away from the top holdings may be prudent in the long term. Finally, microcaps offer superior liquidity as compared to private investments. Microcap stocks are traded on an exchange, offering investors a simple and reliable ability to transact. While private investment sales are expensive and take extensive time, microcaps can be traded with the click of a mouse.

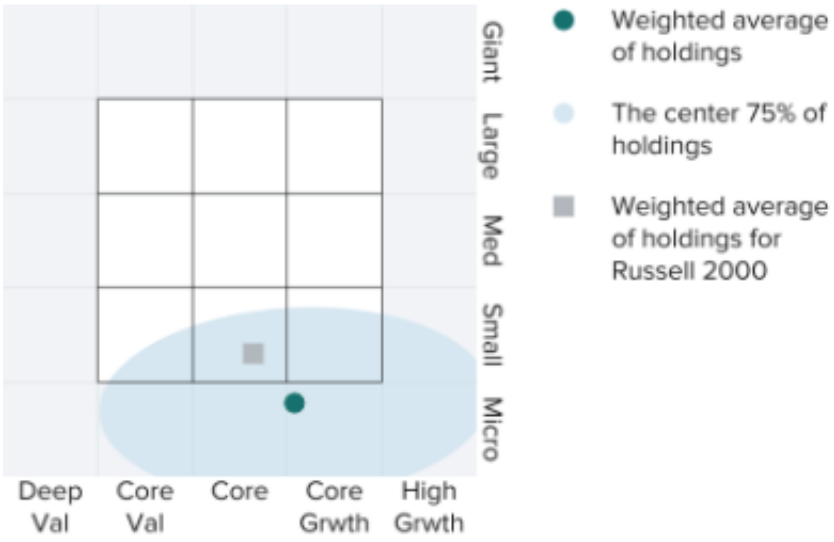


All of these reasons to invest boil down to an unusual opportunity. Given the unfamiliarity of many players in the space, microcaps seem daunting at first glance. RMT has a multi-decade history of strong performance from a dedicated management team, providing a sense to relief.

Let's dive into the portfolio and see why RMT has been so successful.

Portfolio

RMT's broad focus within microcaps results in allocations to growth and value styles. The fund focuses almost entirely on firms that have a market cap smaller than $1 billion. The average market cap of the fund is $788 million, small even amongst most small cap focused funds. For reference, the Russell 2000 has an average market cap of over $2.5 billion, putting into perspective the true micro focus of RMT. The fund has a bias towards growth, but it's modest given the balanced approach from management.



Source: RMT

From a sector allocation standpoint, RMT is consistent with the broader market. The largest allocations lie in Information Technology (23.0%) followed by Industrials (18.7%). The sector allocations seem consistent with the overall management style of the fund as many growth opportunities lie in the technology and industrial realms amongst smaller companies. Additionally, it's worth mentioning that the fund has nearly 300 individual positions. However, 95% of the portfolio is allocated to the top 200 holdings, mostly as a result of high turnover and illiquidity in some microcap equities.

SECTORS	XOTCX (%)	RUSSELL 2000 (%)
Information Technology	23.0	14.1
Industrials	18.7	14.4
Health Care	16.0	20.2
Financials	11.8	15.4
Consumer Discretionary	10.3	11.5
Energy	6.8	4.5
Materials	5.2	3.8
Communication Services	4.3	3.5
Real Estate	2.4	6.9
Consumer Staples	2.1	3.2
Utilities	0.3	2.4
Outstanding Line of Credit, Net of Cash and Cash Equivalents	-1.0	-

Source: RMT

As expected, the fund's top ten holdings do not have many familiar faces. PAR Technology (PAR) is the largest holding followed by AutoCanada (OTC:AOCIF). No individual position represents more than 3.00% of the total fund.

POSITIONS	% OF NET ASSETS (SUBJECT TO CHANGE)
PAR Technology	2.9
AutoCanada	2.8
Mesa Laboratories	2.8
Transcat	1.8
Onto Innovation	1.6
nLIGHT	1.5
Major Drilling Group International	1.5
Aspen Aerogels	1.4
CIRCOR International	1.3
Sprott	1.2

Source: RMT

The fund is well constructed with a nice balance between growth and value. Additionally, there is a degree of balance as 79% of the portfolio is invested domestically, while the remaining 21% is allocated to international investments.

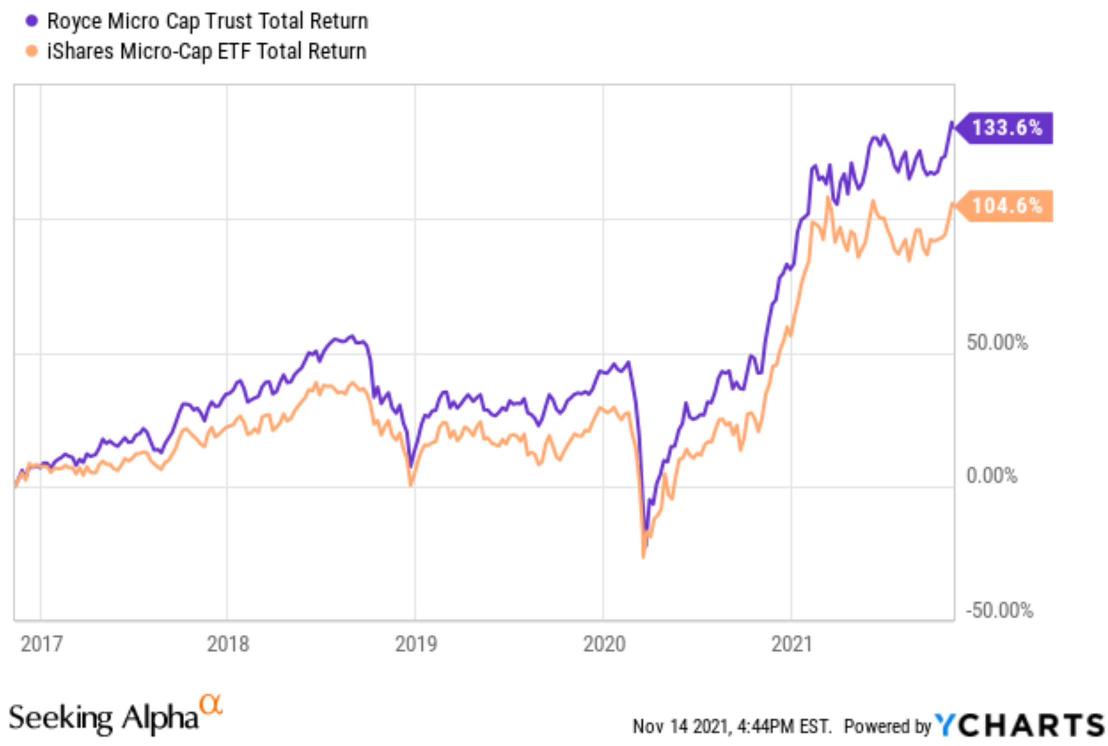
The fund also trades at a reasonable valuation. The fund is comprised entirely of publicly traded securities, meaning there is high visibility into the value of individual holdings. However, closed end funds are more complex in their valuation than traditional ETFs and mutual funds. CEFs trade independently of net asset value. Share price fluctuate freely based on pressure from the market despite a very transparent net asset value. Given that RMT is entirely comprised of public securities, calculating the fund's underlying value is simple. As a result, investors may purchase shares higher or lower than the combined market value of the underlying assets.

Source: Morningstar

RMT has historically traded at a discount to net asset value, offering investors to allocate capital at a discount to the portfolio's face value. This is often more attractive than a premium for obvious reasons. That said, the consistency of the discounted valuation with respect to history means it may be unlikely that shareholders will realize the benefit of the discount through compression.

Performance & Distribution

RMT has delivered strong performance over all time horizons. The fund has been able to outperform broader equity indexes over long time periods as a result of strong performance from underlying managers. Furthermore, broad economic tailwinds such as advantageous financing and a fundamentally strong economy have benefited the asset class.



RMT has outperformed its broader index benchmark ETF, the iShares Micro-Cap ETF (IWC) in terms of total return over a five year period.

The fund has successfully delivered the outperformance it seeks while reducing underlying volatility to shareholders. It is important to note that this outperformance comes with no added leverage. The lack of leverage protects investors during times of volatility, when sell offs can force levered funds to liquidate positions.

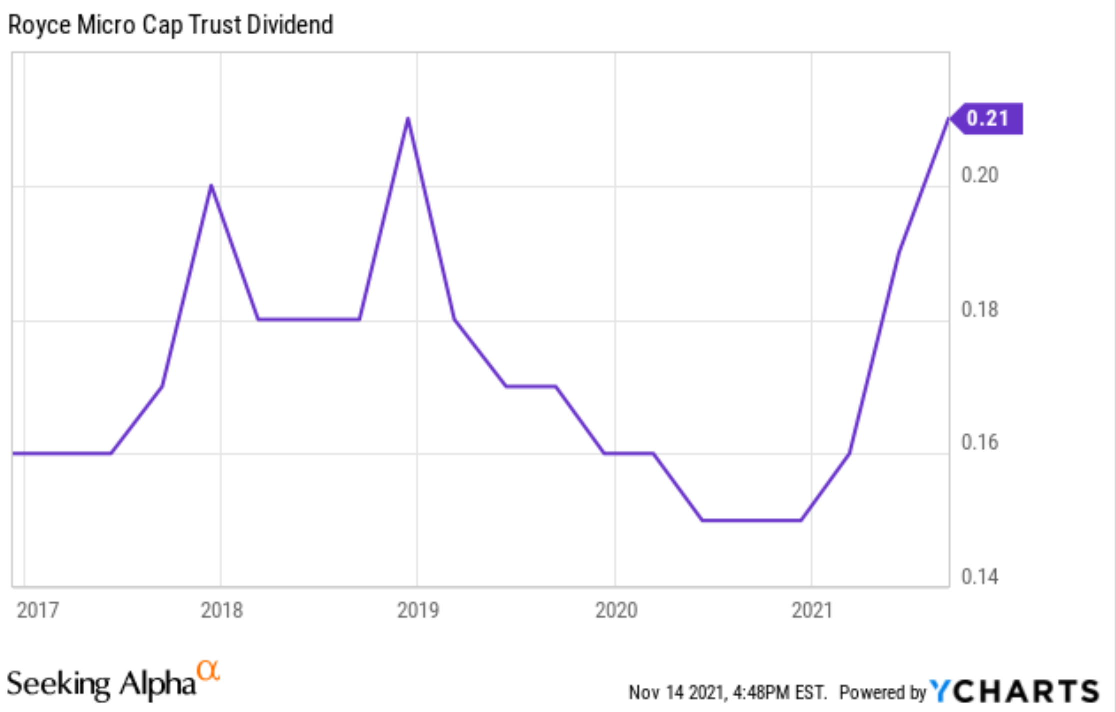
The bulk of RMT's performance stems from the fund's quarterly distribution. Based on current share prices, RMT has a TTM yield of 5.75%. However, RMT's distribution is structured differently from most closed end funds. The majority of CEFs utilize a managed distribution policy, meaning the fund declares a flat, monthly or quarterly distribution. The fund's goal is generally to maintain this high distribution, despite changes in the market. Shareholders receive predictable monthly or quarterly income, while managers are responsible for perpetually filling this distribution bucket. As market performance varies, funds are exposed to varying degrees of risk to the distribution should it not be covered by income or capital gain. Going further, leveraged funds can be forced to liquidate positions at market lows in order to maintain liquidity requirements for their lenders. RM's distribution structure is different, providing substantial protection to the fund.

RMT has a policy of paying 7% of net asset value to shareholders per year in the form of quarterly distributions.

> "The Fund pays quarterly distributions on the Fund's Common Stock at the annual rate of 7% of the rolling average of the prior four calendar quarter-end NAVs of the Fund's Common Stock, with the fourth quarter distribution being the greater of 1.75% of the rolling average or the distribution required by IRS regulations"

Source: Annual Report

Valued on a quarterly basis, the result is a lumpy distribution which is directly connected to the current performance and health of the fund. While many investors may fund it unattractive as a result of unpredictability, we find it appealing from a sustainability perspective. While funds with a managed distribution policy offer the benefit of straight-line income, it can jeopardize the long-term health of the investment during down markets. RMT's flexible approach provides a systematic, protective layering to the distribution.

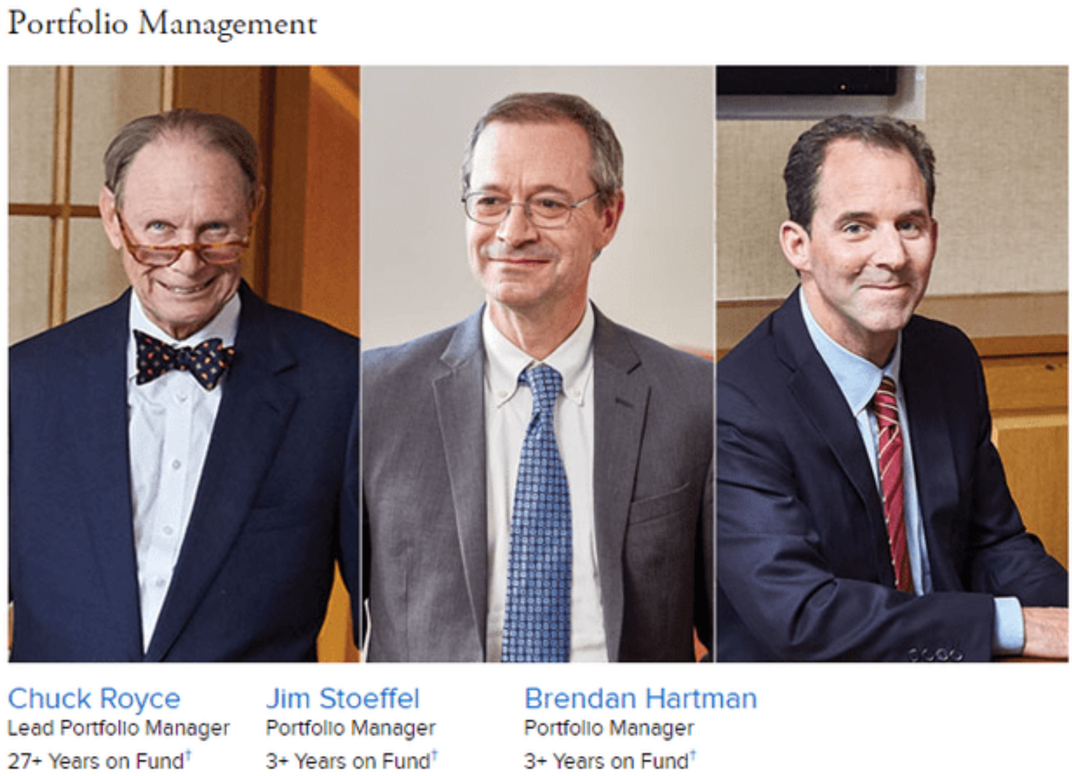


Shareholders who are willing to stomach the variability have been handsomely rewarded. Strong market fundamentals have translated to growth in the distribution, especially over the past twelve months.

As we mentioned, one of the major advantages of RMT as a closed end fund is the distribution of capital gains. Microcaps generally do not pay strong dividends due to less predictable cash flows and earnings histories. As a result, the income produced by holdings in the portfolio is limited, at best. Accordingly, income accounts for a small portion of RMT's distribution, relying more heavily on reaping long-term gains. The result is a tax efficient dividend for shareholders, derived from opportunistic growth. The heavy reliance on capital gain creates pressure for RMT's managers. With low dividend income, the manager must perform well each year in order to cover the distribution. Should the market turn around, RMT's distribution could struggle as it lacks the foundation often provided by reliable dividends.

Management

One of the strongest aspects of the Royce Micro-Cap Trust is the fund's experienced management team. Royce Investment Partners is managed by Charles Royce, a veteran with over two decades managing the fund. Sub-managers are well tenured as well, each spending years dedicated to management of RMT. The fund's continuous management results in strong, consistent performance from internal continuity.



Source: RMT

As with the other closed end funds offered by Royce, RMT has a degree of internal ownership from the fund's management. While it's small even relative to other Royce funds, management currently owns over 1.5 million shares, equating to roughly 5% of the fund's total value.