BARRON'S
THE DOW JONES BUSINESS AND FINANCIAL WEEKLY www.barrons.com SEPTEMBER 21, 2015

Fund of Information

A New Way to Think Small

By Lewis Braham

When it comes to small-caps, cheap and high-quality aren't mutually exclusive terms.

Small-cap value funds are like those lovable losers you've seen in almost every high school comedy. They get bullied by players on the aggressive-growth team and by the blue-chip cliques. But, invariably, they triumph over adversity and get the girl.

Or so a less wonky version might go of the story that financial academics have told since 1993. That's when Nobel Prize–winning economist Eugene Fama and Kenneth French identified beaten-up small-caps as the most likely to generate excess returns in their famous three-factor model. No other major stock investment style has come close to small value's 16.2% annualized return from 1935 through 2014, according to Dimensional Fund Advisors, of which French and Fama are board members.

The only problem is that we're now in the loser phase. The small-cap Russell 2000 Value Index has lagged the Russell 2000 Growth by 4.4 percentage points a year over the past five years, delivering a respectable 12% annualized return, but piddling beside growth's 16.4%. Meanwhile, the Russell 1000's large-caps are up 14.7% annually. Funds are just as bad. The average small-cap value fund has trailed every other domestic equity category during the same period.

And even this disappointment conceals some giant slumps by deep-value managers. Seven of the 10 funds with the lowest average price/book values below one in the small value fund category all are down by double-digits in the past year, compared with just a 2.75% average loss for the category. Five of those, including former stars Aegis Value (ticker: AVALX) and Schneider Small Cap Value (SCMVX), have dived about 25%.

"Our fund's portfolio trades at 66% of book value, as opposed to the Standard & Poor's 500, which is at 279% of book value," says Scott Barbee, manager of the Aegis Value fund. "The spread on that gap is at more than a 10-year high." Widening valuation spreads are a larger trend. The price/earnings ratio difference between the average small-cap value and growth stock is currently 7.5; it has averaged 5.7 since 1986, according to FSTE Russell.

The two sectors that have hurt Aegis are energy and mining, which account for more than 40% of its portfolio. "Mining stocks are trading at 20-year lows," says Barbee. "On the energy side, many stocks are now at or below their March 2009 lows."

The problem, with oil prices more than cut in half from their recent $100 peak and metals down almost as much, is that Barbee has to find investments that will survive the lean times. "We are really focused on the companies that have very strong balance sheets and low costs of production," he says.

He points to Nevsun Resources (NSU), a copper miner that pays a 5% dividend and has $452 million in cash on its balance sheet. "It has one of the lowest costs of production for a copper miner," he says. It's still down 20% this year. He also likes WPX Energy (WPX), a natural-gas exploration company that recently nose-dived for taking on debt to make an acquisition, but also has low production costs and plans to divest other assets to pay down the debt. It's off 30% in 2015.

Some deep-value managers have already profited in the energy space by playing a different part of the sector's food chain. Co-manager Chris Towle of the Towle Deep Value fund (TDVFX) favors oil refiners like Valero Energy (VLO) and PBF Energy (PBF), which he says are still "supercheap" despite being up double digits in the past year. As these companies process instead of drill for oil, the petrol slide actually benefits them, providing them a cheaper feedstock and fatter profit margins.

But the best-performing small-cap value funds in recent months are not the deep-value players. It's those buying cheap, high-quality stocks that can withstand a downturn. "Our whole portfolio has a higher return on equity and lower leverage, and is more profitable than our [Russell 2000 Value] benchmark," says Tom Reynolds, co-manager of the Perkins Small Cap Value fund (JSCVX), which, with a 3.2% one-year return, has outperformed 92% of its peers. Reynolds has largely ignored the energy space in favor of more conservatively financed industrial companies and banks.

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There's now academic evidence that Reynolds' high-quality strategy may be superior to deep value. This January, fund firm AQR Capital Management added another twist to Fama and French by publishing the amusingly titled report, "Size Matters, if You Control Your Junk." The study's co-author, Ronen Israel, argues that cheap and high-quality are not mutually exclusive terms. From 1957 through 2012, the study found, quality small-cap stocks outperformed the market by 5.9% a year, Israel says. "Even in the best measures of the small-cap effect prior to our study, you would see maybe half that advantage," Israel says. "Controlling for quality really bumps up the return."

Playing defense could make more sense right now. That's because even though small-cap value stocks are inexpensive, relative to other companies, they aren't cheap relative to their own history. According to FTSE Russell, stocks in the Russell 2000 Value Index currently have a P/E ratio of 18.2 compared with their 15.4 average since 1986.

With stretched valuations all around, you may want some downside protection, in case everything starts to slide. That's because, in real life, losers don't always triumph in the end. ■

As of 9/30/15, average annual total returns for Perkins Small Cap Value Fund – T Shares were 1.19%, 10.49%, 8.80%, and 7.41% respectively for the 1-year, 3-year, 5-year, and 10-year periods.

The gross and net annual expense ratios for Perkins Small Cap Value Fund – T Shares as of the Fund's fiscal year-end were 0.83%.

Returns quoted are past performance and do not guarantee future results; current performance may be lower or higher. Investment returns and principal value will vary; there may be a gain or loss when shares are sold. For the most recent month-end performance call 877.33JANUS (52687) or visit janus.com/advisor/mutual-funds.

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A Fund's portfolio may differ significantly from the securities in an index. An investment cannot be made directly in an index.

Russell 2000® Value Index measures performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.

Investing involves market risk and it is possible to lose money by investing. Investment return and value will fluctuate in response to issuer, political, market and economic developments, which can affect a single issuer, issuers within an industry, economic sector or geographic region, or the market as a whole. Funds that emphasize investments in smaller companies may experience greater price volatility

As of 9/30/15, the top ten portfolio holdings of the Perkins Small Cap Value Fund were Casey's General Stores, Inc. (3.45%), Jack Henry & Associates, Inc. (2.72%), UniFirst Corp/MA (2.68%), Sovran Self Storage, Inc. (2.64%), Sonoco Products Co., (2.23%), Standard Motor Products, Inc. (2.14%), Sterling Bancorp/CE (2.06%), Cedar Fair LP (2.01%), Owens & Minor, Inc. (2.00%), and Premier, Inc. (1.98%) respectively. There is no assurance that any Janus portfolio currently holds these securities or other securities mentioned in this article.

The Morningstar percentile ranking is based on the fund's total-return percentile rank relative to all funds that have the same category for the same time period. The highest (or most favorable) percentile rank is 1%, and the lowest (or least favorable) percentile rank is 100%. Morningstar total-return includes both income and capital gains or losses and is not adjusted for sales charges. The top-performing funds in a category will always receive a rank of 1.

As of 9/30/15, Perkins Small Cap Value Fund Class T Shares Morningstar Rankings: 90/437, 299/367 and 40/311, for the 1-, 5-, and 10-year periods, respectively in the Small Value category.

Rankings based on total returns.

When an expense waiver is in effect, it may have a material effect on the total return or yield, and therefore the ranking and/or rating for the period.

Differences between compared investments may include objectives, sales and management fees, liquidity, volatility, tax features and other features, which may result in differences in performance.

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