

A Broad Selection of Small Caps

At the end of the day, we're striving to provide investors in this Fund with a broad representation of the small-cap universe. Sometimes people will define core investing as GARP but for us it's really end-to-end investing, providing investors with the broadest spectrum of small-cap investments. Small-cap companies are under-followed and under-owned. Francis X. Morris and his team have an organized approach to select companies that are in the early part of the product cycle and have a catalyst to generate growth.

What is the history of the Fund? How is your investment strategy different from its peers?

The retail mutual fund was launched in 1998 and was managed by another manager. The strategy [that we manage today] was developed in June 2000 as an institutional strategy. In November 2004 I became CIO of both the mutual fund and institutional separate account.

The differentiating factor from our peers is in the way we construct the portfolio and my team's experience. At the end of the day, we're striving to provide investors in this Fund with a broad spectrum of small-cap investments. My five-person team has an average of 22 years of investment experience, 15 years of experience with the firm, and 10 years of experience covering small-cap stocks.

Sometimes when you talk about small- or large-cap core, people ask, "What's core?" or "How do you define core?" For us, it simply means we go end-to-end in terms of investing. In our portfolio you'll see deep-value names and you'll see high-growth names. It's just by virtue of the diligence of how we construct the portfolio that we make sure that the end portfolio is within that Core box.

Sometimes people will define core as GARP — Growth at a Reasonable Price — but for us it's really end-to-end investing, providing investors with the best stocks we can find up and down the cap spectrum.

Broadest in what sense?

Broadest in the sense that, as you look at the holdings in our portfolio, there are deep-value stocks, there are high-growth stocks. Along the market cap spectrum you are going to see stocks in our portfolio that are at the upper end of the Russell 2000® Index, which is around \$3.5 billion and stocks at the lower end of the Russell 2000 Index, which is around \$200 million, and everything in between.

So when I talk about broad investing in small caps, we are striving to make sure that what we're providing investors with in our particular Fund is this broad experience of investing in small caps. So you'll see growth and value dynamics at play in the portfolio and you will see market cap up and down the market cap spectrum as well.



Francis X. Morris joined Delaware Investments in 1997 as a vice president and portfolio manager, and is currently the chief investment officer for Core Equity investments. He is a member of the firm's asset allocation committee in addition to being a Trustee for the Delaware Management Holdings, Inc. (Delaware Investments) 401(k) and Retirement Plan. Prior to joining the firm, Morris was vice president and director of equity research at PNC Asset Management. He received a bachelor's degree from Providence College and holds an MBA from Widener University. He is currently a member of the Business Advisory Council of the Providence College School of Business. Morris is a past president of the CFA Society of Philadelphia and is a member of the CFA Institute.

How is investing in small cap stocks different from investing in large or mid cap stocks?

We find no shortage of opportunities in small caps that are under-followed, under-owned, and are in the beginning phases of their growth cycle from a product point of view — if we're doing our jobs correctly we can grow with the company.

The sweet spot is to find companies with market cap between \$200 million to \$300 million. We're interested in understanding the management, understanding their philosophies, understanding how they're going to expand their businesses so that, if we're successful in finding a good under-followed company, we can grow with it until it becomes a large-cap company and then we're happy to let that pass to our large-cap brethren. Then we'll start the process all over again.

In our investment philosophy we believe in the inefficiency of the markets. That is particularly true within small cap. As I mentioned, we find no shortage of opportunities, companies that are under-followed, under-owned that we can discover early in their life-cycles and grow with for long periods of time. What we strive to do and what we have been able to do over the life of our portfolio is generate a superior risk-adjusted return, so when you look at our portfolio you will see good alpha or excess return to market and a lot lower standard deviation than our peers.

Our investment philosophy is based on combining fundamental research, conducted by our five-member team including me, along with quantitative modeling on the front-end. This means screening the Russell 2000 so that it breaks down to a more manageable list and then performing bottom up analysis on the stocks that we would want to own.

As I mentioned before, we really believe that we're differentiated from our peers in how we construct the portfolio. The benefits that we see for people who are invested with us are that we are disciplined in how we manage money and we've been able to generate consistent returns in both up and down markets.

The hallmark of what we do is to generate a solid risk-adjusted return. We have a very stable investment team and we've been together for 10 years. We've got a very cohesive team in terms of finding and generating alpha for our clients and also maintaining consistency in strategy. We recognize that when we're hired as a core manager that's what people expect from us, not to wander into small-cap value space when that's popular or wander into small-cap growth space when that's popular. We are a core manager and that's what people can expect from us every day.

What is your investment process?

We have a four-step process. It's a dynamic process so, whereas I'm running through it in a chronological fashion, it can really begin at any point in the cycle and work its way around. But let's take it in numerical order.

We start every morning with the screen of the Russell 2000 Index. What we are screening for are characteristics of valuation, expectations of the company's growth potential, and statistical quality of how its management is investing the firm's capital.

This initial screening cuts the list of 2,000 names to a more manageable list of 650 to 700 names. I refer to that as the priority list. We decile rank every name within the Russell 2000 Index, with 10 being the most attractive, 1 being the least attractive, and our area of focus should be at the upper end of that ranking.

So step one is screening the names down from a quantitative point of view to a priority list. Step two is about fundamental research where we are reviewing and assessing the financial statements and understanding the company's competitive position. We're valuing these companies based on sector specific metrics, so what works in healthcare doesn't necessarily work in energy. It's incumbent upon each member of the team to come up with the one or two valuation metrics from a fundamental point of view that best identifies value within that particular industry group.

Finally, we're constantly asking ourselves where the catalyst is that will lift the company's valuation higher, to drive the shares of this company to reach their intrinsic value. So step two takes that priority list and gets it down to a focused list. The focused list is roughly 300 names, and that's the universe that we're looking at on an ongoing basis from which to pick stocks for our portfolio.

We're using strengths of both steps one and two to offset the weaknesses of each other. Quantitative is all about the numbers but it looks backward, it doesn't pick up the inflection points. Fundamental is where we apply the human capital of talking to the management teams, visiting them, understanding their strategies, and assessing near-term and future plans.

Step three for us is about portfolio construction and here is the bottom line: We're all about letting stock selection drive returns.

We're not about sector over weights or under weights, in fact we're relatively tight around the sector (plus or minus 200 basis points). We're interested in making sure we have adequate small-cap exposures and not allowing a bad sector call or a bad factor call to dilute what we do best — selecting securities. Again, portfolio construction is all about stock selection for the Delaware Small Cap Core team.

Our final step is our sell discipline. There we sell stocks if we've had success, we've achieved our price target, and can't extend our price target any further. We'll also sell a stock if there's been a breakdown in the fundamental or quantitative data. We're always fully invested; cash is less than 5% of the portfolio at all times.

When we're looking to add a new name, generally it will replace a stock that is currently in the portfolio. Lastly what we believe to be a differentiating characteristic of our team is that when a name graduates from the Russell 2000 Index into the Russell 1000 Index when Russell rebalances, if that name is in our portfolio, we go about the business of an orderly exit of that particular position to start the process all over again.

What I like to say is that in our portfolio, you won't find a large-cap name that started as small and now has a \$30 billion market cap. What we provide is a true representation of small cap investing. We'll move on from that large cap name or that mid cap name and start the process all over again. That is one of the beauties of small-cap investing: We find no shortage of opportunities to start the process again with a lower market cap name.

I would say that, from the research point of view, we put a strong emphasis on going out and visiting the managements, having them come see us. They're interested in talking to us because we are long-term holders and, while we're interested in the latest data point, it is not necessarily the data point we're going to trade the stock on. We're interested in understanding the company strategy, how they are going to grow over time and how we can participate in their growth.

Our turnover over the past several years has run less than 40%, so we're owners not renters.

Can we discuss two names that highlight your investment and research process?

Let me give you a name that's in the energy area. We've been invested in Kodiak Oil & Gas. We discovered Kodiak while visiting another portfolio holding. We were attracted to Kodiak because it had good acreage within its core basin and as the company developed this acreage it would lead to higher production. As it continued to exploit its relative position, this would lead to lower well operating costs, ultimately leading to the company turning free cash flow positive.

In the year and a half since we first came across Kodiak, we've seen them several times. What we thought would happen has actually played out. The company has successfully delineated its acreage and lowered its well cost. Now we're seeing more consistent production. We believe that will lead to a consistent earnings and cash flow stream, and hopefully that will reduce the financial leverage.

So after seeing them several times and discussing this idea with my team we add the name to the portfolio.

A company may be doing everything right but the oil price, which is a commodity cycle, could change and that could change the entire revenue picture. How much do you worry about macro forces?

That's a fair point. This is something that if you're invested in the energy space you always need to be cognizant of and we are. Really though I'm looking to find a good company that's undervalued, that's doing the right things in terms of being able to keep its cost structure low or reduce its cost structure. In any type of commodity business it is imperative to drive your cost as low as possible to help navigate the vagaries of the commodity cycle.

Another example in the portfolio that we own is a company called Air Methods. The company provides medical emergency transportation via helicopter transport in cases where ambulance transport would not be effective.

The company has done an excellent job of growing its earnings and cash flow; the company has also done a nice job of consolidating the business and expanding its share. When we added it to our portfolio, we believed it was undervalued based on what we believed would be a more favorable earnings and cash flow outlook.

What is your price discipline at the time of purchase?

We're disciplined in how we look at the multiples and that gets to our point about sector-specific valuations. What you'll find as you look from group to group is that companies will be valued differently from a multiple point of view but there is a price or a multiple valuation where things are just too rich and you have to walk away from them.

Our ability to walk away is what's enabled us to be successful over time, to be able to capitalize on our sell discipline, and to make sure that as multiples move to higher levels, we know when it's the right time to walk away.

The other thing I would point out is the beauty of our quantitative data. If we purchase a name when it's very highly rated quantitatively and it does well, then it begins to move down that spectrum to where it's now at the bottom end of that range; it's a check and balance for us. I'll look at that and say we've had success, it's now moved down our quantitative ranking system because of that success, so maybe it's time for us to move on from that holding.

The beauty of us looking at both of these disciplines is it helps us with respect to high multiple stocks and when it's time to exit a particular position.

What is your portfolio construction strategy?

From a portfolio construction point of view, we're relatively tight around sectors; we're plus or minus 2% of the benchmark weightings. I should point out that the benchmark we're looking at is the Russell 2000 Index. The second thing is that we begin a position with no greater than a 50 basis point active weight and we'll let those positions grow over time as we've had success.

Also from the standpoint of constructing the portfolio, we will be broadly diversified. If you were, for example, to quintile the portfolio, and look at relative position size measured by market cap, you would see that we have representation in all five quintiles.

We have representation in the lowest market cap names all the way up the spectrum to the highest market cap names. We believe that is a strength of our process, since it allows us to uncover good names in the lower market cap spectrum and benefit from their growth cycle if they get to the upper end of the range. From a risk point of view, it's how we construct the portfolio to make sure that we have broad representation in terms of small cap investing.

We're very diligent in looking at how the portfolio is positioned to ensure we're providing a good, true, small cap portfolio. We make sure that, as we monitor the risk, the portfolio has the appropriate risk metrics.

The number of names in the portfolio ranges from 135 to 175.

Most small-cap companies operate in niches and they do quite well, but those niches are governed by what happens in the broader industry dynamic. That means keeping up with trade publications and prowling trade shows becomes something of an important issue. Do you agree?

We would totally agree with that and we believe that it is critical when investing in small caps to keep on top of what's happening in each sector or industry. My team is structured such that each one of the five members of my team focuses on a particular sector or two within the Russell 2000 Index.

Team members are responsible for conducting research and recommending names from their particular sectors. Yes, we read industry publications; yes, we go to conferences; and, yes, we meet with company management teams to ensure we have a full understanding of the particular industry and the company's position within that industry.

One of the things I love about our team is that we average 22 years of experience in the business. We are seasoned investors, we've witnessed many business cycles, and we know the right questions to ask to really understand any given company and how they're positioned relative to their peers. So we would concur, we think that's very important to get to know the managements when you are investing in small caps.

Could you discuss more about your research organization, how many people, what kind of responsibilities they have. Are they organized on the sector level or investment style and what their focus is?

At Delaware, the way we're structured is that each particular investment discipline has its own research staff. We consider ourselves a multi-boutique investment firm. Each team is its own business, like a boutique.

We are the Delaware Small Cap Core team of which I am in charge. We manage our own business, we run our own profit & loss and we're responsible for doing the research and investing within the small cap universe. Our five-member team is responsible for going out and visiting the companies and doing all the research necessary to uncover good names to put in the portfolio. We don't have centralized research at Delaware.

Each member of the team has responsibility for one or two sectors within the Russell 2000 Index, as I mentioned before. For example, my sectors tend to be more on the heavy industries side, capital goods, and energy. I also follow media. Chris Adams, who has been in the business for 25 years, follows healthcare, credit cyclicals, communication services.

Mike Morris (who is of no relation by the way) follows finance and business services. Don Padilla follows everything consumer for us (he's been in the business for 27 years) and Mac Burke follows basic materials, transport, and utilities, and he's been in the business eight years.

Each one of us has spent a great deal of time focusing on these sectors and so for each one of us we've got a number of years looking at these particular areas and have become industry experts within these particular areas. The one sector that I did not mention is technology — in the technology space we each follow a particular area within technology. That's by design.

Technology is a very big weight within the Russell 2000 Index. It's broad and it's very complex. It's subject to high obsolescence rates. So we felt, as a team, that to put our best foot forward, each one of us would follow a particular area within the technology sector. So we're structured along traditional lines, each one of us follows an area and each is responsible for coming up with the valuation metrics that best uncover value within that area.

In this business there are so many forms of risks, some we can quantify and some we cannot, and some we cannot even understand. How do you view risk, how do you define risk and then how do you measure, if you do, and how do you manage it?

We do measure risk. We're interested in making sure that we have the appropriate risk measures so that the portfolio's return is driven by stock selection.

We're looking at risk from the standpoint of how we minimize it so we can maximize our stock selection. I'm looking at the portfolio's overall position relative to a variety of risk factors or how the portfolio is positioned with respect to growth versus value, how it's positioned from a beta point of view, how it's positioned from a market cap point of view, what's its earnings yield?

We're looking broadly and at many different risk measures to make sure that that the portfolio is in a good position relative to the Russell 2000 Index. We manage risk by making sure that the portfolio has adequate exposures and, by making sure that we have positions across the risk spectrum. This has enabled us to drive our returns from stock selection.

What have you learned from the recent financial crisis?

We know that our returns are predominantly driven by stock selection. One of the things we learned coming out of the financial crisis is that in times of stress within the system, you do need to let the macro in a little bit more.

That gets me back to your earlier point where you mentioned that you could have a company that is doing everything right but the macro totally overwhelms it. That was certainly the case during the great recession and one of the lessons that we learned is that we can be the best stock pickers in the world but, if we don't allow the macro to be a portion of our discussion, that could overwhelm what's going on. So that's one of the lessons that we've learned.

What drives your sell discipline?

We will sell if we've reached our target price and we constantly set target prices on every stock in the portfolio. We continue to evaluate those target prices to make sure that we are maximizing the value out of a particular investment.

We're very patient investors. We're long-term holders so we will give the thesis time to work and as long as the reason(s) we purchased the stock remain(s) in place, we are not likely to sell on a change in a single data point. As long as our original reason(s) for owning the company is still there, we'll be patient and let the management realize their goals.

You do, at times, have to admit that you've made a mistake and for us, that generally takes the form of some sort of breakdown in the quantitative data or some sort of a breakdown in our fundamental thesis that forces us to change our mind and to move on.

And as I mentioned, our ultimate success comes when we buy a stock in the \$200 million to \$400 million market cap range and we participate in its growth through the range of the Russell 2000 Index and then we have to sell is as it becomes a Russell 1000 Index name. That's the ultimate success for us. Then we start our investment process all over again.

We firmly believe we're unique in how we construct our portfolio. We provide our investors with a broad spectrum of small-cap investments from deep-value to high-growth names.

Delaware Small Cap Core Fund

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Source: Company Documents

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Average annual total returns (%) as of March 31, 2014	1Q14 ¹	1 year	3 year	5 year	10 year	Lifetime	Inception date	Gross expense ratio	Net expense ratio
Delaware Small Cap Core Fund									
Class A (NAV)	1.39	28.12	15.84	25.56	9.06	11.26	12/29/98	1.31%	1.31%
Class A (Offer) ²	-4.42	20.77	13.58	24.07	8.41	10.83			

¹Returns for less than one year are not annualized

²Includes maximum 5.75% front-end sales charge

The performance quoted represents past performance and does not guarantee future results. Investment return and principal value of an investment will fluctuate so that shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by calling 800 523-1918 or visiting delawareinvestments.com/performance.

Total returns may reflect waivers and/or expense reimbursements by the manager and/or distributor for some or all periods shown. Performance would have been lower without such waivers or reimbursements.

Performance "at NAV" assumes that no front-end sales charge applied or the investment was not redeemed. Performance "at offer" assumes that a front-end sales charge applied to the extent applicable.

Carefully consider the Fund's investment objectives, risk factors, charges, and expenses before investing. This and other information can be found in the Fund's prospectus and its summary prospectus, which may be obtained by visiting delawareinvestments.com or calling 800 523-1918. Investors should read the prospectus and the summary prospectus carefully before investing.

Investing involves risk, including the possible loss of principal.

Narrowly focused investments may exhibit higher volatility than investments in multiple industry sectors. • Investments in small and/or medium-sized companies typically exhibit greater risk and higher volatility than larger, more established companies. • REIT investments are subject to many of the risks associated with direct real estate ownership, including changes in economic conditions, credit risk, and interest rate fluctuations. • International investments entail risks not ordinarily associated with U.S. investments including fluctuation in currency values, differences in accounting principles, or economic or political instability in other nations. • Investing in emerging markets can be riskier than investing in established foreign markets due to increased volatility and lower trading volume.

Value investing focuses on buying stocks that are trading at bargain prices based on fundamental analysis, then holding them until they become fully valued. Growth investing focuses on buying stocks of companies whose earnings are expected to grow at an above-average rate compared to the industry or overall market.

Growth at a Reasonable Price (GARP) is an equity investment strategy that seeks to combine tenets of both growth investing and value investing to find individual stocks. GARP investors look for companies that show consistent earnings growth above broad market levels (a tenet of growth investing) while excluding companies that have very high valuations (value investing). The overarching goal of GARP is to avoid the extremes of either growth or value investing.

Intrinsic value, which may or may not be the same as the current market value, is the actual value of a company based on an underlying perception of its true value that includes all aspects of the business.

Alpha is a measure of risk-adjusted performance. •Beta is a measure of an asset's risk in relation to the market. • Standard deviation is a measure of volatility, indicating the tendency of the returns to rise or fall drastically in a short period of time.

A bottom up approach to investing primarily considers factors affecting individual companies and secondarily focuses on industries and economic trends.

Diversification may not protect against market risk.



The **Russell 2000 Index** measures the performance of the small-cap segment of the U.S. equity universe. • The **Russell 1000 Index** measures the performance of the large-cap segment of the U.S. equity universe. An index is unmanaged and one cannot invest directly in an index.

Holdings discussed (percentages held: Air Methods 1.2%, and Kodiak Oil & Gas 0.65%) are for informational purposes only and are subject to change at any time. They are not a recommendation to buy, sell, or hold any security.

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Not FDIC Insured • No Bank Guarantee • May Lose Value

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