2015

Slow but steady: Markets likely to slog along

Eagle's senior portfolio managers offer informed perspectives on the current market situation and potential investment opportunities.

Executive Summary

- Eagle Asset Management's equity and fixed-income portfolio managers regularly meet to discuss ideas, events in the financial markets and potential opportunities for investors.
- The market has managed to continue its long bull run despite some dramatic headlines. Bond and equity markets likely will be focused this year on global interest rates and monetary policy.
- There always are risks – those that are anticipated and some that are not – to the markets but Eagle's managers believe that, short of a global financial collapse, further growth is ahead.
- Eagle continues to believe independent, diligent research and active management are paramount in constructing portfolios for long-term investors.

EAGLE Asset Management

Eagle's portfolio managers gather regularly to discuss market trends and how they are positioning their portfolios.

The U.S. equity markets continued their bullish ways in 2014 but it wasn't an entirely smooth ride. Biotech stocks soared while energy stocks tanked. Predicting the U.S. Federal Reserve would raise interest rates, particularly since it ended the quantitative-easing (QE) program, seemed smart but short-term rates haven't budged. Our managers' discussion included the ongoing effects of U.S. Federal Reserve policy on markets and the economy; an increase in volatility and a decrease in correlation; and – perhaps most interesting to readers – how they have positioned the investment portfolios they run.

Included in the most recent roundtable were Betsy Pecor, Chuck Schwartz, Matthew McGeary and Matthew Spitznagle (Eagle Smaller Company Strategy); Stacey Nutt (Eagle Large Cap Core, Eagle Large Cap Growth and Eagle International ADR); James Camp (Eagle Fixed Income and Eagle Strategic Income Portfolio); Ed Cowart and Harald Hvideberg (Eagle Equity Income, Eagle All Cap Equity, Eagle Value and Eagle Strategic Income Portfolio); Todd McCallister and Scott Renner (Eagle Small Cap Core); Bert L. Boksen, Eric Mintz and Chris Sassouni (Eagle Small Cap Growth and Mid Cap Growth); and Richard Skeppstrom (Eagle Strategic Return Portfolio). The moderator was Cooper Abbott, Eagle's co-chief operating officer and executive vice president of investments.

WHERE WE WERE: A LOOK BACK AT 2014

Cooper Abbott, Moderator: Let's discuss what worked or didn't – and why – for your portfolios in 2014.

Harald Hvideberg: Technology was an area that really worked for us across all our strategies. Apple, which is one of our biggest holdings, had an unbelievable year in terms of product rollouts, refreshed iPads and the iPhone 6. It also introduced new products, including the Apple watch and Apple Pay.

Outside of technology, Kroger and Home Depot in the consumer space performed well as did Actavis in healthcare. On the other hand, our underweight position in utilities hurt us.

Ed Cowart: Meanwhile, our overweight position in energy – where we did OK in terms of stock-picking – ended up hurting us, particularly in All Cap Equity.

Bert Boksen: We also did well in the consumer space. Cars were sold on horsepower when I was a teen but today cars are sold on electronics. And we did well with names like Harman (which makes stereos and speakers) and SiriusXM, the satellite-radio company. We also did well with takeovers of portfolio holdings Bally Technologies and Multimedia Games. In consumer staples, Hanesbrands and WhiteWave Foods had a good year. The popular energy-drink company Monster, partially taken over by Coca-Cola, was a horse for us. Another holding, convenience-store chain The Pantry, also was bought out.

Some of our best performers last year were in biotech and that change certainly helped a lot. That was quite a turnaround because we had a terrible 2013 in the biotechnology industry. We were underweighted and we owned non-benchmark-centric names. We tried to target the names that had earnings, but in '13 and then going into '14, those types of names underperformed. So we made a conscious approach to be more benchmark-centric in biotech. All the names won't work but when they do, they are so big.

Eric Mintz: Two other areas that were great for us in 2014 were software security and airlines. There were two high-profile security breaches – one at Target and another at Sony – that really brought this topic to the attention of consumers and companies. IT security suddenly became a very high priority for chief executives who likely are going to have an open-checkbook policy to ensure their companies – and possibly their own livelihoods – aren't the next victims.

One of the really attractive components to the business model is these companies essentially add incremental modules to the products they are selling to their existing customer base. It is an extremely high-margin business. And we see only accelerating demand for software/internet security.

The airlines industry is a group we have owned for several years. They obviously have the benefit now of incredibly low fuel prices but I believe the real story here is the industry finally seems to have found religion in terms of controlling capacity.

Airlines have a general rule that capacity growth shouldn't exceed gross domestic product (GDP) growth. They now have lower costs and there was some concern that, in response, management teams would blow it by adding capacity. But what we've heard is that they are holding steady on capacity and not acting as if fuel prices will remain in the $50-per-barrel range. Airfares haven't gone down, capacity growth has stayed steady and fuel costs are lower. These management teams are extremely focused on making sure the return on invested capital now exceeds their weighted average cost of capital. The poster child for that is JetBlue, which has been underperforming on that key metric for quite some time. The airline will start charging a baggage fee, which is highly profitable, and also adding in a few rows of seats. That's not great for the passenger but there is enormous margin upside on that.

> *"What was odd to us is that two industries seemingly on the opposite ends of the spectrum – utilities and biotech – were both working."*
>
> *– Chuck Schwartz*

Chris Sassouni: Finally, I would say there were two areas – hospitals and Medicaid managed-care companies – that really worked well for us last year in healthcare.

Hospitals have been natural beneficiaries of Obamacare. Obamacare has clearly reduced the number of the uninsured by almost 20 million: 11.7 million on exchanges and at least 8 million were moved into Medicaid. This, in turn, has reduced the number of uninsured patients that hospitals are treating. The net result of this has been lower bad-debt expense and higher profit margins. In fact, profit margins should continue to improve as more and more Americans enroll for Obamacare. Consequently, it did not take much of an increase in coverage of the previously uninsured to get those stocks to really start moving.

The second area that has been a phenomenal growth story over many years has been Medicaid managed-care companies. Medicaid managed-care companies save states huge amounts of money by moving state Medicaid programs from fee-for-service to a managed-care model. Given that Medicaid is usually the largest line item in the budgets of most states, any savings generated from Medicaid managed care companies are very welcome. These Medicaid managed-care companies have benefited from three distinct tailwinds. First, the ongoing conversion of state fee-for-service Medicaid programs to managed-care programs. Second, Medicaid expansion as a result of Obamacare and third, pushing high-acuity dual-eligible patients into Medicaid managed-care programs where reimbursement for the care of these patients is generally multiples of typical Medicaid lives. The potential growth of these companies isn't necessarily unabated but they have at least a year or two of extraordinary growth and extraordinary profitability ahead of them.

Betsy Pecor: We saw some positive performance from our materials holdings and also our one holding in telecommunications services was bought out.

One of the things that hurt us last year was our average market-cap size. We found that being on the smaller end of the capitalization ranges for our portfolio was a significant headwind. We were underweight in some of the sectors and industries (e.g., real-estate investment trusts, or REITs, and utilities) that did well but that didn't hurt as much as our market-cap positioning.

The other thing that hurt was the drop in oil prices, which hurt our energy-sector holdings but also affected our industrial holdings. Two of our big holdings there are heavily tied to the energy industry.

Chuck Schwartz: What was odd to us is that two industries seemingly on the opposite ends of the spectrum – utilities and biotech – were both working. That made it tough on a lot of managers who typically avoid both ends simply because the cost-vs.-benefits metrics don't make sense.

Stacey Nutt: We found success last year through diversification. Specifically, we had winners among airlines, grocery stores and healthcare. And we were able to find those kinds of companies around the globe.

I think it is not a time to be a hero but, rather, to eke out gains on individual stocks slowly but surely. It's not to be too overly concerned about biotech in one month or oil another month or whatever the headline volatility is of the day. Headlines will only get you in trouble if you pay too much attention to them.

> *"Headlines will only get you in trouble if you pay too much attention to them."*
>
> *– Stacey Nutt*

Our focus isn't on emphasizing just whether a company is good or bad but how people are reacting to it. How the sentiment changes. Fundamentals matter but how they interact with human behavior is what creates investing opportunities.

Our view is: Stay in the middle of the boat, ignore the headlines and do well in some companies that people may not expect: healthcare in emerging markets or U.S. grocery stores, for example.

James Camp: The story of 2014 for us was municipal bonds. Our tax-advantaged team did a great job estimating the confluence of supply and demand. Municipals' credit quality improved and these bonds remain tax havens, which is a very attractive feature.

Longer durations worked. And staying invested in fixed income worked. High-yield notes generally lagged high-grade bonds. This is an area where falling energy prices also affected the bond market. Overall, high-yield bonds essentially treaded water for 2014, which is pretty remarkable since energy-related bonds – which now make up more than 20 percent of the high-yield market – were down in the 5 percent-5.5 percent range.

What did not work out for many fixed-income investors were unconstrained portfolios that were promoted as relatively safer ways to boost current income. Most of the unconstrained funds launched at the end of 2013 fared very poorly; meanwhile, traditional, research-driven fixed income did well.

Our income-agnostic portfolios – the Strategic Income Portfolios that the Equity Income team and my team co-manage – generated what we would describe as expected returns for clients. We believe this notion of having really good equity and really good bond managers essentially moving up and down the capital structure – we're indifferent if an equity provides a better income stream via dividends than a bond, or vice versa – is a better way to generate income than overly clever quasi-bond portfolios.

Richard Skeppstrom: I run a tactical-allocation portfolio and at the beginning of last year I couldn't see appreciable valuation differences among the various sectors. Consequently, I mostly kept the portfolio equity weightings targeted toward the S&P 500. It's good that I can't short anything because I may have done so in REITs and utilities, which would have been a disaster. I wasn't thrilled about maintaining a 15 percent cash position but I could not see adding to equities and I could not see adding to bonds when everything seemed to be pretty full valued.

Todd McCallister: We operated on the theme that the strongest economy has been that of the United States. Sometimes the obvious works! Consequently, we generally stayed away from foreign exposure. Dull and domestic – companies such as an air-conditioning distributor and a staffing firm – worked very well.

We outperformed in energy, which simply means we bled less than other people. U.S. energy now, particularly as it relates to shale drilling, is much more of a production process and less of an exploration process. You used to want to own cheap but now it's important to own quality – and try not to pay through the nose for it – because it works on the way up and good companies can weather downturns.

Scott Renner: Like Todd said, energy worked for us probably because we tend to have a high focus on quality and balance sheets. Having a conservative approach there certainly helped when oil prices imploded.

The consumer sectors also worked well for us. We were probably underweight retail for most of 2014 but I would say we have a little bit more positive view than we did a year ago with respect to what is happening there.

WHERE WE ARE

Moderator: Discuss the current environment and what macroeconomic or global events are shaping the market.

Cowart: I don't believe we've ever seen a confluence of issues at one time like we have now. We've had low energy prices before, and we've studied those periods pretty exhaustively. We've had periods when currencies have gone up and down against one another. And we've seen low interest rates before but we've never seen negative interest rates as we now have around the world, and particularly in Europe. The result has been a lot of volatility, at least with respect to the equity market.

Clients have asked, "What's going on with the equity market? It seems like it's going down, down, down." Well, yes and no. It's gone up and down and up again. The market moved hundreds of points cumulatively over six weeks but not really gone too far away from where it started. The volatility has a lot of people kind of uneasy about the market.

Camp: I would note that it is the exit of the Fed's quantitative-easing (QE) program that has spiked volatility. Otherwise, volatility indices have been low for the last couple of years. I believe that's lulled people into a good bit of complacency when it comes to really assessing risk in bonds and "bond-like" asset classes.

What's also disconcerting is what I call "mission creep." The debt markets have morphed. They've become hybrid and unconstrained as many bond managers – in response to a cry for income in what is essentially a 0-percent-interest world – are now doing things they've never done before.

If you look at what have been some of the best-performing instruments, they're duration equities such as utilities and REITs. For the first time in my career, there was a 100 percent consensus among the 70 economists Bloomberg polls monthly that rates were going up. Lo and behold, the 30-year Treasury had one of its best performances ever. I think the bond proxies benefited from that and duration assets – debt or equities – rallied significantly.

Cowart: I believe that this is what the central banks had in mind when they embarked on quantitative easing. The original idea was to create reserves for the banks, which would then turn around and lend money to get the whole credit process going again. But the credit-creation process was broken and it's still not completely healed. So the objective then turned to the so-called portfolio channel: trying to force people into riskier assets, raise the price of risk assets and therefore create a kind of wealth effect that will maybe get the economy going.

This idea that there's no place else to go, from the standpoint of central banks, is a feature and not a bug. They're trying to get people to go out on the yield curve and I don't think any of us like that. Those folks who worked all their lives to accumulate $1 million – thinking they could have a $40,000 to $60,000 annual income from that – shouldn't have to be forced into riskier assets but now they believe they have to.

Renner: This reminds me of the late '90s: We had a stronger dollar and lower commodity prices and pretty good markets but with the prospect for some crisis to crop up. And there was the Asian currency crisis and a Russian meltdown. More currently, we had nine central banks lower interest rates in January.

Commodity prices have come down very, very abruptly. There are economies across the world built on those commodities and so I believe there's a prospect for some dislocation.

Hvideberg: I agree. Some research has shown that there has been some sort of financial crisis when the global purchasing managers' indices (PMI) readings fall below 50 and there have been falling energy prices. Energy prices clearly are down and we currently are looking at global PMI readings of about 50 and they are trending down. So, I agree that this is probably something we should keep in the back of our minds.

Nutt: Is this like any other time in history? No. There are different players. There are different events. There may be different backgrounds but don't TV shows and movies today often discuss the same things Shakespearean plays did?

What is common over time is how human beings behave, how we react to things. And we typically overreact. We are stubborn; we anchor on things. Greece and Europe are fighting right now; we've seen that before. This is what we try to keep in mind when we're investing.

Boksen: The big difference now is that global markets have never been as intertwined as they are today. Domestically, everything looks wonderful: Gas prices are down and interest rates are low. Europe seems to be recovering with its QE program but there's worry about China. That interconnectedness, when things aren't globally perfect, should be a little bit of a yellow light out there.

"If you look at where bull markets have ended in the past, the P/Es have been a little bit higher than they are right now and with interest rates much higher than they are now."

– Ed Cowart

I'm not saying the sky is falling but something is happening with rates where they are and with energy prices where they are. I think it's wise to respect those very important signals.

Camp: The whole commodity space – not just oil – is down significantly. We mostly talk about oil because it is the headline commodity but the entire commodities space is rolling over, which has generated fears of deflation in the Eurozone.

Cowart: I wonder, with the global markets as interconnected as they are now, to what extent is quantitative easing fungible? We've mostly stopped in the United States but Japan has embarked on a QE program that, in terms of the size of the economy and the central bank's balance sheet, is much bigger than anything that we've done. And Europe is just beginning its program. So, does it really matter that we have stopped when two of the world's other big central banks have started? Is there going to be a global kind of response to quantitative easing?

Camp: The Treasury market would tell you that it is fungible and that it is supportive. The 30-year Treasury now is flatter and lower than it was this time last year despite an end to the domestic QE program. I would agree that global rates matter. They do and that's why we have been pretty bullish on Treasuries throughout this cycle.

Nutt: It is interesting to me that in my travels to Europe over the last few years there was all kinds of angst or cynicism around the United States and its QE program: "You cannot spend your way out! You cannot print your way out!"

But that tune has changed over the last 18 months or so as U.S. markets have continued to go up. Now the angst seems more to come from a feeling of having missed out. They didn't get invited to a party and now they want to have one of their own. One of the differences there is the number of countries involved in a Eurozone QE program. Countries such as Germany likely aren't really opposed to QE but they want QE to come with reforms to southern Europe's economic policies.

Boksen: The stronger dollar that has resulted allows me to make a very strong case for small caps over large caps this year since small caps are more domestically focused. Healthcare should perform well, as it is domestically focused. A lot of domestic consumer companies – convenience stores, restaurants, recreational-vehicle manufacturers – are in the sweet spot when it comes to benefitting from lower gas prices.

Moderator: Why does there seem to be such a dichotomy between how Main Street views the economy and markets vs. how Wall Street views them?

Cowart: I think it is pretty clear what the disconnect is: As a percentage of GDP, we currently have wages at an all-time low and profits at an all-time high. I think it could be just as simple as that.

> *"You never make money if you are always bearish, if the sky is always falling."*
>
> *– Bert Boksen*

Now what do you do about that? A big cause is globalization. Twenty-five years ago, many jobs would have been done by U.S. blue-collar workers – and some well-paid ones at that – and now many of the same jobs are being done at one-third or half that wage in China, India or Mexico. That has had a direct negative impact on wages. And, at the same time, a direct positive impact on profits.

The solution is to get wages higher but how do you do that? I do not think it is a $30-per-hour minimum wage. Maybe it's about de-emphasizing college and teaching kids skills that are applicable for employers. **(See "QE and Real Economic Growth" sidebar.)**

Moderator: Let's change the focus a little bit and talk about valuations in your respective styles and capitalization ranges. Do you consider them high, low? And how does that impact your portfolio construction?

Cowart: If you look at the large-cap sector's absolute price-to-earnings (P/E) ratio, we are probably around 16 times forward earnings, which is a little bit on the high side of average. But it's well worth pointing out that averages are made up of highs and lows. We have spent five years kind of on the low side of that and now we are a little bit on the high side.

If you look at where bull markets have ended in the past, the P/Es have been a little bit higher than they are right now and with interest rates much higher than they are now. I still believe there is something to the concept of looking at the return you would get as the owner of a whole company vs. alternatives on the fixed-income side. And there remains a high discrepancy on that count.

The other thing about the absolute P/E level is that the defensive sectors of the market – the utilities, REITs, telephone companies and such where people have been searching for bond substitutes – are where the valuations are really getting stretched. Many of the more-cyclical sectors are at a below-average P/E. In all, the valuation does not really scare me right here.

Boksen: On the small-cap side, the P/E is about 18 times forward earnings. But there are faster growth rates and less cyclical exposure in these stocks. And like Ed said, you have to take into account what the alternatives are. There remains almost no real return in fixed income unless you go out on the risk curve.

I still believe equity markets are attractive and are not overextended. I do not see any financial crisis on the horizon but I do worry about interest rates and oil prices coming down. Maybe there is something out there. We don't ever really know what's going on with China but there is no way to monitor it because the numbers are just whatever the government decides they want to put out there. Overall valuations do not concern me.

People tend too often to cry wolf and be bearish because they believe it expresses concern. I am concerned about what's going on but it seems like there's always something going on: There's always a (Vladimir) Putin saber-rattling and tension in the Middle East is as old as time. But you never make money if you are always bearish, if the sky is always falling.

Matt McGeary: Small-cap valuations are not on their low end historically but I think there are still good prospects for the space. Small caps have less international exposure, which helps in a strong-dollar environment. People often tend to grasp for growth when a bull market has continued this long so I wouldn't be surprised to see more mergers-and-acquisitions (M&A) activity. And finally, the small-cap space may bounce back coming off a year when it underperformed.

Nutt: It seems dangerous to me to talk about valuations without talking about earnings expectations and what direction earnings are moving. Are they expensive or are they cheap? Do we know?

I get back to what I talked about earlier: What do people believe about what's going on in a space? I look at what direction people are moving. I look at Europe and I don't know how much more negative it could be there. But then I look at their QE program and what is going on with that and I actually think things are getting better there. I like that combination of cynicism and improving trends.

The U.S. story is certainly further along than most of the rest of the world. But that doesn't mean I see any immediate causes of alarm. There may be some headwinds this year for the large-cap multinationals because of the strong dollar. Emerging markets and international may be a good way to diversify. Now, I would not sell the farm and go buy Europe! But from a diversification standpoint, the best thing to do while we figure out what the next big trends are is to be diversified.

Camp: The bond market has been a complete converse of the equity markets. The bond market is telling us one thing and the equity markets are hanging in there. They are as divergent as I have ever seen them. High-yield bonds started cracking last year and a big part of that was the fall in energy prices. However, it is historically inconsistent for high-yield bonds to struggle while equities rally. And that is what we have.

McCallister: The old adage is that the bond market predicts and the stock market reacts. I saw something last year that I hadn't previously seen: The five-year Treasury was above the 10-year Treasury. If you believe in the term structure of interest rates, that means years one through five are going to have some decent growth but years five through 10 are going to tamp down. I thought it was kind of strange. I believe it may mean the world's growth is going to continue to be slow.

The Continuing Saga of Obamacare

Moderator: The Affordable Care Act, more often called Obamacare, continues to get a lot of attention as a political football and possibly as a social experiment but perhaps you would comment on what impact it has had on actual businesses? And also the latest U.S. Supreme Court case and what people ought to know about that.

Sassouni: In a sense, Obamacare is the single largest economic experiment that we've probably ever seen in the sense that no other piece of legislation has touched 18 percent of the GDP. It certainly has shaken the healthcare industry to its core.

I believe that just about everybody sensed we had a broken healthcare system that, if left unchecked, would bankrupt the country as it was crowding out the capital available for the government to invest in other parts of the economy. But it's tough to balance the three-legged stool of expanding access, maintaining quality and lowering costs. And whether Obamacare has the right incentives to optimally manage those three legs is open to debate. The law was poorly written. I believe there were members of Congress who said, "We have to pass this bill into law to learn what is in it." I believe there are some elements that have worked well and other elements that have created some unintended consequences.

Those who run large managed-care organizations, hospital systems or other large healthcare service providers are still trying to understand how to position their companies to generate profits optimally in this new environment. They were just finding their footing when the Supreme Court threw a monkey wrench into it by questioning whether the federal government had the right to use taxpayer dollars to pay for federally funded exchanges.

When I listen to the legal pundits, it seems – at best – a coin toss as to which way the Supreme Court will rule in late June or early July with this case (King vs. Burwell). The oral arguments may reveal what the various justices are thinking. I would argue that it is leaning toward the government losing the case and that subsidies for federally funded exchanges may go away. Would it all happen in one fell swoop if that were the decision? I believe they would set things up for a transition plan.

It is really hard to evaluate which side is going to prevail in this. I believe that if the justices were to say, "OK, you can no longer take taxpayer dollars to pay for the subsidies," you would just see a bunch of people basically cancel their policies because they couldn't afford to keep them. Let me put it into perspective: An estimated 2 million to 3 million people are currently getting subsidies on the federal exchanges.

Right now, the subsidies are artificially keeping insurance costs low. If you remove those subsidies, many of the up to 3 million people I just mentioned would say, "I can't afford to pay this anymore." The ones who absolutely need the coverage – the sickest of the sick, those with chronic issues – are the ones who will figure out a way to pay for healthcare insurance. The managed-care companies, in response to this lopsided risk pool, would then be forced to raise premiums. This, then, would create a "death spiral" where premiums would rise as healthier individuals would opt out of the risk pool, unraveling the very foundations of Obamacare.

If this were to happen, I believe that there would eventually be some sort of détente among Congress, the president and the Supreme Court to try to ease the transition if the Supreme Court rules against the subsidies. It may require some rewriting of the law because without the subsidies, Obamacare would collapse and millions would lose their coverage.

Some people would say, "Well, some states will just create their own exchanges." That's true, but some do not want to. There will be people who no longer have subsidies in states without exchanges. Where do they go?

Skeppstrom: I believe there are too many vested political interests now involved for a ruling from the Supreme Court just to stop it completely. I don't think anybody could just stand up and say, "Well sorry, it failed." Do you believe that could happen?

Sassouni: This is big. The Supreme Court is charged with evaluating the constitutionality of taking taxpayer dollars that were not authorized by Congress to pay for subsidies on federally run exchanges. The heart of the whole issue revolves around the role of executive power vs. the way the legislative branch is supposed to provide checks and balances for the executive branch.

From a rational point of view, I would like to believe the justices – if they were to issue an adverse ruling – would say, "Let's work this all out."

Right now we have a situation that, at best, can be described as chaotic. Again, it is very hard to figure out how this thing is going to get to a point of equilibrium until after the Supreme Court's official ruling, which isn't expected until June. This period of uncertainty will continue at least until then.

WHERE WE'RE GOING: A LOOK AHEAD

Moderator: How have you synthesized all the issues we have discussed in positioning your portfolios for the balance of 2015?

Pecor: We haven't really changed our positioning except for tweaking certain sectors. We are overweight in healthcare just because we have such a huge underweight position in biotech. Healthcare has been very tricky for the past five years as biotech has seen such outperformance and we generally don't invest in that industry. We try to find companies that serve biotech companies; also, we see interesting diagnostics and medical-device companies. Finally, healthcare-services companies, especially ones that help hospitals reduce costs, are a solid area for us. We remain underweight in utilities because we do not find a lot of growth opportunities in that sector.

McGeary: We are about equal weight in energy and industrials. We have tried, in the aftermath of the oil-price decline, to upgrade the quality of our holdings in the space. There will be a time to go back to an overweight position but we are not there yet. In industrials, we still see a lot of opportunities, particularly in transports.

Matt Spitznagle: The consumer absolutely has benefited from lower energy prices – it costs less to fill the car and to heat the house – but there haven't been real wage increases, which are a much more permanent income boost. Retail is tough because there are so many venues where consumers can spend their money and all that competition, especially from the internet, has driven down profits. So, we remain underweight in consumer stocks. We are positive on some restaurants because cooking at the end of a long day at work is unattractive to busy people. We would look to add to consumer-services companies if we see real wage growth for the same reason: time-constrained people start saying, "I'm busy and now I'm in a position to pay somebody to do this for me."

In financials, we are focused primarily on banks. The headwinds there are interest margins, a competitive pricing environment and the fact that energy-related lending clearly will slow. That said, positive results from upcoming stress tests could prompt banks to deploy capital.

McCallister: We have our financial holdings – some regional banks, life-insurance companies and capital-market companies – tilted a little bit toward the possibility of higher interest rates and the companies that should benefit from them. There simply aren't great deals in that space with interest rates this low. That's tough because there is a good chance that rates could stay low, as we discussed, but our portfolio likely would benefit if interest rates go up.

Renner: On balance, we are cautious. We continue to look for quality and strong balance sheets because we believe companies with those characteristics will do well going forward. I believe we are in a favorable equity environment with the usual caveats of unexpected crises. Our caution leads us to be a little more focused on consumer staples, consumer discretionary and healthcare names. In technology, we are more focused on the services side than on communication equipment or semiconductor equipment. Overall, we are shying away from sectors driven more by capital expenditures (e.g., industrials) or commodities (e.g., materials and energy).

McCallister: We are a little bit overweight healthcare for the first time in a long time. It's been tough but we have found some interesting names, such as nursing homes. We own six or seven biotech-type names and have tried to avoid binary-outcome names, which is difficult to do. We own some life-sciences tools companies, which gives us some exposure to the sector without as much risk as pure biotechs. The problem is that clients generally aren't so happy when they read about biotechs being up a really big number and a tool company is up just a bit. But we believe the tradeoff makes sense. The other thing going on in healthcare is continued M&A activity. I believe the low interest rates have encouraged biotech management teams to say, "Money's almost free so there is not much cost of a mistake. Let's go ahead and do this."

Mintz: The heart of the issue with biotechs is, "What is in the benchmark?" If you do not own the stocks that are in the benchmark, you are effectively shorting them. So you have to own several just to keep up.

Sassouni: There are a couple of eye-opening things about biotech. It is the single largest industry group within the Russell 2000 Growth Index and it is 44 percent of the index's healthcare sector. So what is really driving the growth in biotech stocks? Some of it undoubtedly is money chasing beta (risk) and there's some notion, as Eric mentioned, that you have to own it because it is such a large chunk of the benchmark. But there are fundamental things that have changed. The U.S. Food and Drug Administration (FDA) has become more accommodative in terms of allowing drugs to get through the FDA approval process. Between 2005 and 2010, an average of about 22 drugs was approved annually. This has increased 55 percent to 34 FDA drug approvals per year over the last four years. This is a very significant increase in FDA drug approvals and appears to be indicative of a more accommodative FDA. Since FDA approval is usually one of the most significant value-creating events for biotech companies, the stocks tend to perform exceedingly well once these companies successfully navigate through FDA approval. The reduction in the risk profile for these companies as the result of FDA approval – combined with a license to sell a product into what is normally a multi-billion-dollar market – creates tremendous returns for those willing to invest in the volatile but recently rewarding world of biotech stocks.

There are a couple of ways to mitigate risk in biotech. One is to be very careful of investing based on "launch buzz." People can get excited that a company has FDA approval for a drug only to watch its launch fall flat. The companies (for obvious reasons) and analysts often overestimate what a launch is going to look like. The other thing is what Eric mentioned: Make sure you understand why you do or don't own the most heavily weighted stocks in the biotech space because those are the ones most likely to hurt you.

Boksen: We are overweight healthcare and consumer discretionary. In general, we want to stay more with domestic stocks to avoid the strong dollar and possible global slowdown. We are underweight financials because we believe this low-interest-rate environment will persist a little longer than most people believe. Financials – I think of banks in Texas – could struggle with some of the oil-related debt so we are underweight there.

(continued on page 16)

QE and Real Economic Growth

Moderator: The current round of domestic quantitative easing (QE) has ended and interest rates remain low. The Fed talks as if it wants to raise rates but hasn't. Are we looking at inflation? Deflation?

Cowart: Historically, if the Fed has raised rates because it believes the economy is doing better, that has not been negative for equities. I think the Fed wants to raise rates mainly because board members believe 0 percent interest rates are such an unnatural state of affairs. Also, the Fed has no more ammunition if it ever needed to lower rates again. I think we may see an increase of 0.25 percentage points or 0.50 percentage points simply to show the world it remembers how to do it.

On one end of the spectrum, we had former Fed Chair Paul Volcker keep rates higher and longer – in an effort to kill inflation – than most people expected. And now we have the (former Chair Ben) Bernanke/(current Chair Janet) Yellen Fed keeping rates lower and longer than anyone might have believed because of global deflationary influences. Deflation would be a disaster to them and so I believe they're very sensitive about raising rates. That doesn't mean zero forever but I believe it is going to be a long time before we see the federal funds rate at 2.0 percent.

Skeppstrom: Incredibly stimulative oil prices and low interest rates just don't seem to be getting the economy going much faster than it is now, with projected growth at 2 percent-3 percent annually.

Cowart: I believe that's where we are: still in payback mode from the grand party we had in the 1990s and early 2000s.

Camp: Those who study debt super-cycles likely would suggest it takes about a decade to shake off the effects of a collapse and we are about six years into a 10-year phenomenon. So that 2 percent-3 percent growth should be expected. At the very least, it's not surprising.

I agree with Ed about the Fed. I believe they should "shake the tree" by raising rates just a bit. Financial markets have responded to QE with increased leverage and risk-taking. A bump up in rates likely would reveal who is off-sides, if you will.

Even when the Fed decides to move, the challenge, though, may be in pushing short-term rates off the current baseline. The banking system has $2 trillion-plus in excess reserves, loan demand remains tepid and tighter lending standards are tempering banks' willingness to lend. Thus, trying to raise short-term rates in a market with low demand for funds might prove problematic.

Nutt: I don't see how we get to inflation without growth. There were fears in the United States three years ago about stoking inflation without growth but, of course, it never happened.

Camp: It's amazing to me when I hear people say QE hasn't been consequential. I believe that's dead wrong and we've seen it play out in real time. Each round of quantitative easing has been at least a partial result of U.S. equity markets stumbling. The Fed knew that was the one lever it had – juxtaposed against the real economic levers it had been unable to move – to push people into risk-taking.

I believe inflation is menacingly low. QE didn't stoke it in the United States and I believe it will be difficult to do in Europe as well.

Nutt: We may be planting the seeds of our destruction by printing all this money. It certainly doesn't feel kosher. But this ties back to what I discussed earlier about human behavior: People would much rather deal with an unknown pain later than a known pain now.

Moderator: We have seen a lot of emphasis in terms of stimulus, in terms of fiscal policy. But when does that translate into the real, or Main Street, economy?

Camp: That is a question we've wrestled with for the last five years. This Fed experiment has been a little bewildering. I never anticipated it having a $4 trillion balance sheet but we have had two – in 2000 and 2008 – very consequential hits to the financial system.

Hvideberg: One encouraging thing is that after a period of outsourcing so many jobs, we are starting to see a reversal of that. Manufacturing GDP in the United States now is growing faster than non-manufacturing GDP. That may mean people will be able to get good-paying jobs without college degrees, something we haven't talked about here in the United States for some time. I hope that trend has some legs to it.

QE and Real Economic Growth

Mintz: Millennials living at home is a huge headwind. Mortgage rates remain at 3 percent but first-time buyers do not have the income to get their first houses. One study I read suggested that the number of millennials living with their parents represents demand for 3 million homes. Wage gains will be a tipping point.

Camp: QE did not create a robust wage environment for the labor markets. We have had no wage acceleration to speak of. Nominal wage growth for the last 36 months has been lower than any period over the last 14 years except for one. The Fed probably gets back in the game when it sees labor markets tighten and, subsequently, wages increase.

Nutt: I wonder if there are a significant number of people older than 40 who simply won't come back to the labor market because – for lack of education or proper training – are basically unemployable now. So maybe we have to recalibrate what is realistic for full U.S. employment.

Sassouni: There is another element of economic growth that is tied to the availability of talent. If we look back to the 1990s and early 2000s, venture capitalists and banks were willing to lend money to the fastest growth engine of the U.S. economy: talented entrepreneurs with unique ideas for products and services. There was a virtuous cycle of wealth creation in which venture capitalists put up seed money, companies blossomed from those investments and then those companies went public. Venture capitalists would cash in on these IPOs which would create liquidity for new investments in start-ups. The question is: Can we return to those days? We need the capital – as well as the right talent and skills – to create successful growth companies, the real engines of the economy.

After a long dry spell in IPOs from 2008 until 2013, venture capitalists were able to once again monetize their investments through the public markets. This led to an unprecedented number of biotech IPOs. In 2014, there were 82 IPOs that raised $5.5 billion. This was an all-time record, exceeding the biotech boom of the early 2000s.

In the 1990s and early 2000s, a lot of venture capital had been flowing consistently into early-stage medical technology companies. In part, investments into "med tech" were viewed as less risky with reasonable returns. Venture capital supported biotech companies but there were a large number of high-profile failures and a challenging regulatory environment that made risk capital ebb and flow into biotech. Then, a new class of biotech drugs emerged, known as orphan drugs. These are drugs that have a very limited number of target patients, typically less than 200,000 people. The FDA seemed more than willing to approve these drugs since these patients had few, if any, options and the benefits outweighed the risks. The manufacturers of these orphan drugs had pricing power and began charging upwards of $500,000 per patient per year for treatment. Needless to say, the manufacturers of these orphan drugs created billion-dollar markets very rapidly and, for many, had these markets to themselves. This helped to restart the flow of investment back into biotech from venture capitalists, and institutional as well as retail investors.

That is what eventually helped to fuel the biotech boom of the last several years.

One thing is for sure. The resurgence of the biotech industry has created enormous wealth for investors and management teams alike. This industry has also been a tremendous source of high-paying, high-skill jobs. It has been a model for what can happen when risk capital meets talented entrepreneurs with great ideas.

Camp: It would be helpful if the federal government and regulators were to reconsider some – not all, but some – of the onerous rules that were enacted after the financial collapse of 2007-'08. The regulatory environment is horrible for risk-lending in terms of what bankers can and cannot do. There is so much excess reserve money in the banking system. Banks have $2 trillion-plus and they're just buying 10-year Treasury bonds, 10-year mortgage-backed securities and the like but there's no real velocity to that money.

Nutt: Healthcare and tech are places where we are overweight in all our portfolios. We remind ourselves that, especially in the small-cap growth space, we can do well without owning the most volatile names. We can own some things that look like them from a risk perspective. In the large-cap space, we own healthcare providers and a few biotechs. We have moved into more U.S.-centric consumer discretionary names and are avoiding those we believe will be hurt by the currency challenge, especially those exporting to Europe.

Internationally, we continue to be overweight in Japan and Korea as we have been for some time. We are underweight southern Europe slightly but we are a bit overweight in France and the United Kingdom, though we may be taking that down. We have been underweight materials and energy for a long time, especially in emerging markets.

> *"Less correlation is a much better environment for active management because it allows good managers the opportunity to identify the wheat vs. the chaff when there is that separation."*
>
> *– James Camp*

Cowart: We have not given up on energy. It's hard to say what earnings are going to do in the short term but we believe the valuations are now pretty solid in this sector. Historically, energy stocks have had a nice recovery after getting to the levels where they are now. I am convinced dividends are secure. We are getting 4 percent or 5 percent yields on some of these companies. I believe ExxonMobil would cut its chairman's salary before cutting its dividend.

We have continued to own what we view as very high-quality names, companies with what we believe have very little balance-sheet risk. We want to own the strong operators who are working in the most productive regions.

I would say the most significant change we have made recently is cutting way back on the big banks: the Citigroups and JPMorgan Chases. They were not terrible investments but we had been optimistic about a couple things that haven't come to pass. First, we thought we would get a positive yield curve. Next, we believed the government would finally back off in terms of penalties and regulations and trying to get a proverbial pound of flesh from these companies for what they may or may not have contributed to the financial collapse in 2007. Neither of those things is happening. We have a flat yield curve and the regulatory environment really does not seem to be improving very much. The megabanks are overcapitalized and could, in theory, return that capital via dividends and share buybacks but we aren't sure the government will enable these companies to do that.

Consequently, we are looking more at mid-cap-type banks that don't appear to have those sorts of regulatory issues. Also, we believe those banks may be in a better position to do some higher-priced lending than their larger counterparts.

Hvideberg: We still believe there are a lot of opportunities in information technology, where there definitely has been a change in companies' attitudes towards capital allocation. Tech companies only used to do stock buybacks but they are now issuing dividends as well. And we believe there will be increased M&A activities in the sector.

Camp: We have done a considerable amount of work on liquidity management and rules-based allocations. It is very important for advisors and investors to realize the bond market is not liquid any more. It has changed structurally. Liquidity now in the fixed-income secondary market is very poor since banks cannot trade and make markets as they once did.

I have been in my chair now about 10 years and one of the things we have not done – and will continue not to do – is make duration bets and that has paid off dramatically. Many of my peers make interest-rate-anticipation calls. It's folly to try to do so and those who do have been hurt pretty significantly over the last year.

In Strategic Income Portfolios, we slowly reduced some equity exposure because some of our quantitative indicators suggested it was a good thing to do. We are slightly above neutral in equities because their income-generation power remains stronger than bonds due to equities' multiyear run.

Skeppstrom: Last year's disparate returns in large caps broadly and utilities, healthcare and REITs vs. some other things that did not do nearly as well – energy, for example – likely has created some actionable valuation disparities. I had been overweight in banks but I decided to switch that out and put more money into energy. The yield curve wasn't steepening at all; instead, it was flattening. And, as Ed suggested, the government seems disinclined to quit punishing the megabanks. The shame is that, at this point, they are more punishing shareholders than the bad actors.

I likely will continue to make energy a larger and larger position. I do not believe we are over low prices in the short term but I find it an attractive space for the long term.

> *"Fear, greed and easy access are a potent mix for buying what was just hot (and nearly always being late to the party) vs. adhering to a solid asset-allocation plan."*
>
> *– Todd McCallister*

I believe that, overall, there are more things to be happy about than sad at the moment. I even think there is a possibility that things will turn out really well. A large part of that is due to the fact that so many people have the opposite stance: that everything's going down the tubes.

The third-quarter U.S. GDP growth was 5 percent. It didn't shock me that the fourth-quarter was a little bit less than 2.6 percent but people were acting like it was a bad number. I didn't think it was that bad. I believe earnings continue to power forward as long as the international situation does not get out of hand. The one thing that really concerns me on that front is what may happen to the shaky countries and companies that have ever-more-expensive dollar-denominated loans. There may be some dramatic consequences to the dollar's strength and we may see that sooner rather than later, which could create some volatility.

Moderator: We have seen increased volatility along with a breakdown in correlation among asset classes, which for the past several years had been moving largely in unison. What does a decrease in correlations and an increase in volatility possibly mean for active managers?

Hvideberg: One percent up and 1 percent down on a day-to-day basis is not good for your blood pressure but that's what happens when volatility goes up. And now, correlations are coming down. Old-fashioned fundamental research and analysis should pay off more than it might have in the past few years. From the point of view of an analyst-portfolio manager, it is exciting that this decreased-correlation/increased-volatility environment may present opportunities to find stand-out stocks.

> *"I think the Fed wants to raise rates because most of the board probably hates 0 percent interest rates just because it is such an unnatural state of affairs."*
>
> *– Ed Cowart*

Camp: It's easier to essentially ride the benchmark when everything is correlated and going up. So I would say less correlation is a much better environment for active management because it allows good managers the opportunity to identify the wheat vs. the chaff when there is that separation.

Investors increasingly have relied on exchange-traded-funds (ETFs) and the like. The ETF world is very large, very powerful and – to many – very alluring. However, its liquidity has not been tested on the exit: when things go down. It is something we have talked about for a couple of years. The test will be when the Fed raises interest rates and long-term Treasuries are up 1 percentage point. It will be very interesting to see what unfolds when that happens.

McCallister: ETFs have created some aggravation for us in the small- and mid-cap space when they sweep companies – regardless of their fundamentals – up or down. But they also bring liquidity to the market.

I would counsel investors to come up with long-term goals with their financial advisors and then stick to them. There's nothing inherently wrong with ETFs but one of their top selling points – their liquidity; the fact investors can get in and out of them easily – is also what prevents many investors from hitting their goals. Fear, greed and easy access are a potent mix for buying what was just hot (and nearly always being late to the party) vs. adhering to a solid asset-allocation plan.

Smaller Company Strategy

Chuck Schwartz, CFA
- 24 years of experience as a portfolio manager and analyst
- BS, University of Colorado (1985)
- MBA, University of Louisville (1989)
- Earned his Chartered Financial Analyst designation in 1999

Betsy Pecor, CFA
- 18 years of investment experience as a portfolio manager and analyst
- BS, University of Vermont (1988)
- MBA, University of South Florida (1999)
- Earned her Chartered Financial Analyst designation in 2002

Matthew McGeary, CFA
- 16 years of investment experience as a portfolio co-manager and analyst
- BA, Kenyon College (1993)
- MBA, Indiana University (1999)
- Earned his Chartered Financial Analyst designation in 2001

Matthew Spitznagle, CFA
- 19 years of investment-related experience
- B.S. in finance, University of Illinois (1991)
- MBA, Northern Illinois University (1995)
- Earned his Chartered Financial Analyst designation in 2000

Equity Income/All Cap Equity/Value/ Strategic Income Porfolio

Ed Cowart, CFA
- 43 years of investment experience
- AB, Dartmouth College (1969)
- Earned his Chartered Financial Analyst designation in 1977

Harald Hvideberg, CFA
- Joined Eagle in 2014
- 18 years of experience as a portfolio manager and analyst
- BA in economics (1992) and B.S. in finance (1993), University of South Florida
- MBA, University of Florida (1997)
- Earned his Chartered Financial Analyst designation in 2000

Large Cape Core/Large Cap Growth/ International ADR

Stacey Nutt, PhD
- 22 years investment experience
- 15 years of experience with current team
- PhD, Georgia Institute of Technology
- MBA, Georgia Institute of Technology
- BS, Oral Roberts University

Fixed Income/Strategic Income Portfolio

James C. Camp, CFA
- 26 years of investment experience
- BS, Vanderbilt University (1986)
- MBA in finance, Emory University (1990)
- Earned his Chartered Financial Analyst designation in 1993

Small and Mid Cap Growth

Bert L. Boksen, CFA
- 38 years of investment experience
- B.A., City College of New York (1970)
- M.B.A., St. John's University (1977)
- Earned his Chartered Financial Analyst designation in 1981

Eric Mintz, CFA
- 20 years of investment experience
- B.A., Washington and Lee University (1995)
- MBA, University of Southern California (2001)
- Earned his Chartered Financial Analyst Designation in 2000

Christopher Sassouni, DMD
- Joined Eagle in 2003
- 26 years of investment experience as an analyst and president of an independent investment research firm focused on healthcare as well as five years of experience with various healthcare companies
- BA (1979) and Doctor of Dental Medicine (1985), University of Pittsburgh
- MBA, University of North Carolina (1989)

Institutional Small Cap Core Team

Todd McCallister, PhD, CFA
- 28 years of investment experience as a portfolio manager and analyst
- BA, with highest honors, University of North Carolina (1982)
- PhD in economics, University of Virginia (1987)
- Earned his Chartered Financial Analyst designation in 1996

Scott Renner
- 23 years of investment experience as a portfolio manager and analyst
- BS, University of Florida (1990)
- MBA, University of South Florida (1993)

Strategic Return Portfolio

Richard Skeppstrom, II
- Joined Eagle in 2001
- 23 years of investment experience, including 19 years as a portfolio manager
- BA in mathematics (1985) and MBA (1990), University of Virginia

J. Cooper Abbott, CFA, Co-Chief Operating Officer and Head of Investments
- 17 years of investment-industry experience
- BA, highest honors, Brown University (1991)
- MBA, University of Pennsylvania (2001)
- Earned his Chartered Financial Analyst designation in 2014

EAGLE | Asset Management

880 Carillon Parkway | St. Petersburg, FL 33716 | 800.235.3903 | 727.573.2453 | eagleasset.com

E7127-3/15 Exp. 4/30/16