EAGLE | Asset Management

Small Cap Growth commentary

Second Quarter 2011

Market Overview

The Russell 2000 Growth Index was down 0.59 percent during the second quarter, and is now up 8.59 percent for the year. Growth finished ahead of value for the fifth quarter in a row (the Russell 2000 Value was down 2.65 percent). With financials comprising more than one-third of the value benchmark, we believe it will be tough for value to beat growth until the outlook for financials improves. Within the Russell 2000 Growth Index, consumer staples, healthcare and consumer discretionary finished the quarter in positive territory; meanwhile, energy, information technology, materials, industrials and financials traded down.

Portfolio Review[1,2]

Our portfolios finished significantly ahead of the Russell 2000 Growth Index for the quarter. On a relative basis, we outperformed in information technology and consumer discretionary through strong stock selection. Our top performers were Genesco, BJ's Restaurants, EMS Technologies and Varian Semiconductor Equipment. Genesco is a retailer of headwear, footwear and clothing accessories. The stock has benefitted from strong earnings growth and the recent acquisition of Schuh Group. BJ's Restaurants has benefitted from strong earnings and comparable store growth, pricing power and a long growth runway ahead. EMS Technologies and Varian were both acquired during the quarter at sizeable premiums.

We lagged slightly in energy due to our overweight posture in the space. Our worst performers were Sotheby's, Lufkin Industries and SuccessFactors. Sotheby's operates auction houses dealing fine art, antiques and other collectibles. The dip in the stock reflected a soft auction. However, a recent auction showed improved results and the stock has recovered much of the loss. Lufkin gave back a small portion of its solid gains during the first quarter but continues to be our top contributing stock this year. SuccessFactors provides performance-management software for employers. The company's first-quarter billing came in a bit lighter than expected.

Outlook

We view the selloff for the bulk of the second quarter as a normal correction in what we see as a positive environment for equities. We believe lower gasoline prices and a rebound in auto production following the earthquake in Japan should enable reasonable economic growth for the balance of the year. Continued government stimulus focused on reducing unemployment – sure to be a theme of the 2012 presidential election – also will be a plus. Small-cap stocks may appear expensive relative to large caps but their price/earnings ratio is approximately in line with historical averages and they continue to be boosted by high levels of mergers and acquisitions as well as continued strong earnings growth projected into 2012.

We remain positive on the energy sector with our longstanding preference toward companies leveraged to oil over natural gas. Ironically, we believe the International Energy Administration's (IEA) decision to release 60 million barrels of oil from the strategic reserve actually benefited the energy industry by lowering prices enough to help shore up demand. The industry's rush toward emerging oil-producing areas, such as the Permian Basin and Bakken Shale, continues to accelerate as evidenced by the stunning 18 percent sequential increase (more than double its year-ago level) in the oil-rig count in the second quarter. We continue to favor companies (e.g,. Brigham Exploration) that have large acreage positions in those areas.

Within the materials and industrials industries, we continue to favor companies with exposure to the aerospace industry. Both Boeing and Airbus reported sizable orders at the Paris Air Show. With backlogs at record levels, both companies are increasing their production rates, which should have positive implications for suppliers such as Triumph Group. Additionally, we expect Boeing to deliver the long-awaited 787 plane during the third quarter, which should serve as a meaningful catalyst for titanium suppliers (e.g., Titanium Metals). From a macroeconomic perspective, we believe U.S. industrial activity should benefit from an expected uptick in auto production as supply-chain constraints stemming from the devastating earthquake in Japan begin to ease. Encouragingly, recent manufacturing surveys have shown modest improvements following a modest pullback in the spring.

The yield curve flattened in the second quarter as weaker economic data helped to quell concerns over inflationary pressures and demand for U.S. Treasury securities seemed to increase, driven by fears over sovereign-debt problems in Europe. A flatter yield curve is not usually good news for bank stocks, as it likely will put pressure on net-interest margins. We currently own shares of one bank, UMB Financial, largely because it derives nearly half of its revenues from fees rather than interest, and also because of the significant insider ownership, which we believe helps to ensure good loan quality. Looking ahead, financial stocks continue to be challenged by the slow pace of the economic recovery, and it remains hard to find names that have good underlying fundamentals that will support quality earnings growth.

While healthcare certainly had strong relative performance during the second quarter of 2011, this was largely the result of a rotation into defensive stocks at this stage of the market cycle. Changes in the space include health care reform, a reluctance to approve new drugs and devices by the FDA, sluggish utilization of healthcare resources by patients due to the economy, and constant pressure on profit margins.

In the technology sector, we continue to focus on companies that have a secular, rather than cyclical, growth story as well as those with the potential for accelerating earnings growth. Recently, we have favored software companies that offer strong competitive positions, high margins and operating leverage, recurring revenue streams, high barriers to entry and switching costs, and have the potential to be acquired. For example, we are excited about Qlik Technologies, a vendor of easy-to-use business-intelligence software. As we move closer to the end of the year, we likely will increase our weighting in semiconductor stocks, which now offer attractive valuations and may begin to anticipate the next up-cycle in spending.

Following the recently rally in consumer stocks, we believe they will likely perform in line with the broader market. We finished the quarter with a modest overweight in consumer discretionary due to both very strong stock selection and the recent lowering of the benchmark sector weight following Russell's annual reconstitution. We are comfortable with the names we currently own but we may reduce our weighting to be more in line with the benchmark.

1. References to specific securities are intended to illustrate the types of securities Eagle may hold in this portfolio. They are not intended as representations of specific investment recommendations that would have been profitable to an investor. Past performance is not a guarantee of future results.
2. Source: FactSet, Frank Russell Co. Statistics represent an aggregate of all Small Cap Growth portfolios.