

# ECONOMIC RECOVERY: WHERE THE MARKET MAY GO

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

## EXECUTIVE SUMMARY

- Eagle Asset Management's equity and fixed-income portfolio managers gathered recently to discuss current events in the stock market, where they believe things are heading and potential opportunities for investors.
- The federal government – in conjunction with central bankers around the world – has exercised many different programs to try to stimulate the economy. The question now is, How does the government back itself out of those programs while ensuring the economy is stable?
- The stock market historically has been able to see past the trough to better times ...even before those better times make headlines. Our managers highlight the positive and challenging factors they see over the next year.
- Eagle managers continue to believe independent, diligent research is paramount in selecting stocks right now and that this likely will prove to be an excellent opportunity for long-term investors.

Eagle's portfolio managers gather semiannually to discuss the current market situation, what they are doing in their portfolios and what they see going forward. Last fall's talk centered on the factors that got the world's economies and financial markets into the mess from which we are trying to recover. The spring talk came close on the heels of the equity markets breaking through what probably everyone had hoped would be lows set in November 2008.

There has been a recovery in markets since March. Meanwhile, broad economic data has been mixed. Eagle's managers discussed the various opportunities and challenges they see as global economies – ever more intertwined – try to maintain their recovery.

Present for the most recent roundtable were Richard Skeppstrom (Large Cap Core); Todd McCallister and Stacey Serafini Thomas (Small/Mid Cap Core); Bert L. Boksen and Eric Mintz (Small Cap Growth); Dave Adams and Jack McPherson (Small Cap Core Value); David Blount, Ed Cowart and John Pandtle (Equity Income and Value); as well as James Camp and Pete Wallace (Fixed Income).

**Head of Investments:** Over the past 18 to 24 months, everyone has learned a great deal about mortgages, subprime, models, greed, risk premiums, agent theory, retribution, regulation and globalization. What observations do you have looking back across this period, now that we've had some time to digest it?

**Todd McCallister:** The Federal Reserve (the Fed) basically has taken over the financial system by instituting both qualitative (buying different types of assets) and quantitative (adjusting interest rates and taking debt on to its balance sheet) measures in an incredibly aggressive monetary policy.

We have a zero percent interest rate and commodities are going through the roof. The concern in the back of my mind is if we are going to wake up one day and have hyperinflation because of what the Fed is doing. The question remains: How is the Fed going to back out of this?

**Jack McPherson:** The past year has been a blur but it's become clear that the complete failure of enforcing the regulations that were in place led to a lot of this. Yes, some of it was the financial

innovation that was ahead of the curve but, as I said, it has become abundantly clear that the existing regulations were not properly applied. The challenge going forward will be to develop regulations that are effective but don't go too far to stifle opportunities for growth.

**James Camp:** One concern I've had over the last six months is the ongoing degree of severity in residential-mortgage foreclosures and liquidations. It is staggering to look at the downgrades on non-agency-backed mortgages: 71 percent of the loans originated between 2005 and 2007 that had been triple-A-rated have been downgraded.

Many people presume a strengthening in the mortgage market is based on companies recovering 70 percent or 80 percent of their loan values. Pete and I have looked into some of these and the recovery rates are zero.

**Pete Wallace:** And some of those are greater than a 100 percent loss, which means all the principal's gone along with such things as closing costs and fees.

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**Camp:** That tells me the private-mortgage market remains in dire straits. Further, those agencies that already have raised additional capital may need to raise more.

**Wallace:** There has been no real production on jumbo mortgages. Nor has there been any securitization of non-conventional mortgages. I predict that segment of the market will look a lot different when it rebounds, which speaks to some growth limitations Jack mentioned.

**Ed Cowart:** This massive stimulus did save the system but it may be hard to understand later that it went to invisible infrastructure rather than to tangible infrastructure. We're not going to have WPA-type projects – roads and bridges and power plants – to look at and say, “Well, we really got something with that money.”

Globally, the money is gone. It shored up personal and business incomes but we're not going to have much to show for it on the other side.

**Head of Investments:** What about the theory vs. practice of risk management and the limits of quantitatively modeling human behavior?

**Wallace:** I think people are starting to question the whole topic of risk management and how it is applied. Standard risk-management tactics traditionally have been based on various assumptions that we may have to question and adapt going forward.

**Head of Investments:** What structural challenges does this environment present to Wall Street, to capitalism?

**Bert Boksen:** What really gets called into question is the definition of capitalism. There is a problem with the structure of large corporations: The guys on top are not entrepreneurs, they don't have a vested interest in managing long-term risk. They just want

to look out about six months to a year and maximize their profits. It's not investing; it's trading and people generally ignore risk when they are making money.

We saw that in the internet bubble. We saw that with the housing situation. We saw that with the banks for which securitization was incredibly profitable. And unfortunately, we'll probably see it again someday in something we're not yet aware of.

The government now is assuming that risk from the consumer and putting it on its balance sheet. Eventually, someone is going to have to pay for that.

**Cowart:** The structural changes in Wall Street companies have had a big impact. They used to be all private partnerships. The managers' own money was at risk; now, they take risk with other people's money.

Brown Brothers Harriman is essentially the last big private investment bank. It didn't get into trouble over the last couple of years. Why not? These guys had the same opportunities as Lehman Brothers and Bear Stearns to make money via increased leverage but this is their own money so they took less risk.

There have been financial crises in the past but there wasn't the leverage we saw going into this last crisis. And there also wasn't the risk culture that the structure of Wall Street really encouraged this time around.

**Head of Investments:** We know when markets burst, correlations increase but this time, correlations across practically all asset classes approximated 1.0. Why was it such a punctuated global phenomenon instead of being more regionally sequential?

**McCallister:** We have a more intricately connected global market.

**Cowart:** The hunt for yield was global in nature. The motivating factor is that interest rates were very

low, volatility had been quite low, savings were very high and there was a great hunt for yield. And if you could stamp a triple-A rating on a 6 percent or 7 percent mortgage, that was a very attractive piece of paper. People were hungry for yield and mortgage salesmen and the rating agencies were glad to accommodate them.

The German banks are in much worse trouble than U.S. banks because they had higher leverage and less transparency. There were bad mortgages spread around the world.

**Wallace:** The only way in that environment to get excess returns was to leverage up.

**Camp:** I'm not so sure the search-for-yield game isn't going on now. It takes 655 years for money to double at 11 basis points and yet people will move money to pick up an additional four basis points of yield.

**John Pandt:** I think the proliferation of derivatives markets from the late '90s until now didn't disperse risk but, in some respects, concentrated risk. Later, some investors woke up and realized the same asset had been re-levered many times.

**Eric Mintz:** Maybe a silver lining to this downturn – and the coordinated response to it – is that we are now witnessing an unprecedented global recovery. There is unprecedented monetary and fiscal stimulus in the system but it is crucial to recognize the maximum benefits of those actions likely won't occur until mid-2010.

**Head of Investments:** The Federal Reserve has been very proactive over the past 18 months: lowering interest rates, opening emergency lending windows,

creating various loan programs and working with other central bankers around the planet. What else do you expect from the Fed in the near term and what are some of the effects we already see from its policies?

**McCallister:** The Federal Reserve is operating in uncharted territory in trying to save the system. They have pushed rates to zero, or near-zero, but that's only because they can't go lower: It's not a great idea to put a dollar in the bank and get 94 cents back.

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There is still a lot of bad debt to work through. Someone asked me: Why not just do a Resolution Trust Co.-type bank like the government used in the 1990s for the savings-and-loan crisis? The RTC, if I remember, was \$300 million. This one would be \$5 trillion. So, given that, Congress won't do a good bank/bad bank even

though that may be the best way to do it.

**Wallace:** Among the things the Fed is doing now that it hasn't done before is financing commercial paper. The balance sheet is into the trillions of dollars now in those private assets. How it will go about liquidating those assets and how much independence the Fed will have are real issues.

**McCallister:** Ironically, the government is encouraging risk-seeking behavior when it holds interest rates at zero percent. You go short U.S. dollars because the funding is cheap and go long in anything else.

**Camp:** Central-bank leaders around the globe have said they will continue their coordinated efforts to get their countries' economies back on their feet. It's possible that what we're seeing now could continue for a while.

**Head of Investments:** Let's touch on the threat of inflation, which many people are presuming is a natural reaction to the low interest rates the Fed has set.

**Boksen:** There are only a few ways to pay for government spending: raise taxes, print or borrow the money. It would be impossible to raise taxes enough to make up for the amount of money Washington is spending. And if they borrow the money, there eventually will be inflation. The United States isn't the only country facing this challenge, by the way.

**McCallister:** The Internal Revenue Service collected \$1 trillion in tax revenue in 2006 at the peak of the cycle. The current projected deficit is \$9 trillion. It wouldn't be fun to go to everyone who paid taxes in 2006 and say, "We need you to kick in twice what you paid then to help pay down the deficit," to say nothing of nine times that amount. That's a lot of money.

**Camp:** We're interested to see how the Fed will end up addressing whatever inflation may come. I don't believe the Fed can move on interest rates, probably through 2010, because so many regional banks remain virtually insolvent. Further, tremendous slack remains in the economy; there is high unemployment; companies have posted record productivity gains; and certain real assets, notably real estate, continue to drop in value. Credit is still very tight despite policy measures, and the securitization market, requisite for meaningful credit expansion, is moribund.

In the meantime, the sponsorship at the U.S. debt auctions remains extraordinary. Japan actually out-purchased China in the last auction. I read an article that suggested Japan is used to deflation; they like just getting their money back!

**Head of Investments:** What things are you expecting from the White House and/or Congress? Does anybody believe Congress will enact anything in the next few

years that's going to change capital requirements or to separate investment banking from traditional banking or any of these things that have been knocked around? How about employer or healthcare mandates?

**Boksen:** I don't recall a time when I've kept my eyes on Washington as much as I am today because actions in Washington really are dictating a lot of what's going on in the stock market. The government is out of control with its spending. I believe any increase in interest rates may not even happen next summer. There may be political pressure to keep rates low until after next fall's elections.

After the election, I believe they're going to have to push rates because the dollar is going to be so weak. In the meantime, everybody is putting their blinders on to the federal deficit.

**McCallister:** I don't think anything that is going to be done with healthcare is going to be substantial.

**Richard Skeppstrom:** I agree, but Congress spent an entire year trying to add a trillion dollars in spending when everybody who knows anything knows we should have spent that year trying to figure out how NOT to spend a trillion dollars.

**Cowart:** In every cycle since World War II, private-sector debt has gone up more than in the previous cycle, but that is not going to happen this time. What has happened now is that the government is substituting its balance sheet for the private sector's in an attempt to keep the bicycle upright and moving forward.

**Head of Investments:** Are "boom-and-bust" cycles an increasing component of "efficient markets"?

**McPherson:** I think bubbles have always been there and they'll continue to be. The information flow now and a move toward globalization both lend themselves to continue that.

**Camp:** I believe information is available so quickly that people are making shorter-term decisions and are just chasing whatever the latest yield is. Layer that with leverage and financial innovation and you will continue to see irrational behavior unless governments here and elsewhere step in to limit it.

**McCallister:** We have had four great bear markets in modern times and two of them have been in the past decade. And both of those were caused by asset frenzy. More information may just have made market participants better gamblers and not necessarily more efficient.

**Head of Investments:**

How do we balance the strength of our dollar with continuing a positive relationship with China? Is the real issue an artificially low Yuan? What impact does that have on our trade – and budget – deficits?

**Skeppstrom:** I doubt you can find a portfolio manager or even an individual who watches a little bit of TV who isn't deeply concerned about the dollar, which is already down 40 percent vs. the Euro.

**McCallister:** Our relationship is a challenge because the Chinese over-save and work very hard to keep their currency pegged to the dollar. We have a problem with that and you see it now with the dollar going down. One might normally say, "Good, the dollar is going down, so our exports will naturally go up."

The rub is that with the Chinese currency pegged to the dollar, they are also selling our currency and buying dollars. That doesn't help the rest of the world's currencies that are consequently overvalued

because the Chinese currency moves in step with the dollar.

It could be that we end up with the hyperinflation so many people have talked about when we get to the point where countries all are trying to deflate their currencies at the same time.

This is why I think commodities have done well. Currency previously wasn't an asset class. And with the Fed pushing near-zero interest rates, you're not going to want to own any paper currency. You'll want to own copper.

**Cowart:** One thing that might be helpful over the long term – for ALL countries – would be for China and the United States

to begin to trade places, for China to become more of a consumer. It's easy for an academic economist to look at China and the United States and say, "Well, it's simple, here's how we do it." But that would be a huge cultural flip-flop on both sides and I'm not sure anyone is ready to do that.

**Mintz:** Chinese-government policies appear focused on shifting its economic growth engine away from fixed-asset investment toward consumption. For example, this year may be an inflection point in the global automobile market as the Chinese market will eclipse the U.S. market for the first time: Chinese consumers are expected to purchase approximately 13 million vehicles vs. the estimated 10 million sold here. We should keep in mind that as China increases consumption, it will increase its demand for such things as oil and that, in turn, likely will drive energy and commodity prices higher.

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**Head of Investments:** It's become nearly axiomatic that things won't get better until the fixed-income world gets better. Is it improving?

**Wallace:** Over the last six months or so, we've seen a gradual improvement in terms of financing. There has been an increase in the issue of commercial paper and consumer spending; however, those levels are less than half what they were in 2006. So, the market still has considerable room for improvement.

There is no risk premium in the short end of the market. Generally, everything that is a Treasury or rated A1 or A1-plus has virtually the same yield. But we are starting to see some increases in yield. The Commercial Paper Funding Facility (CPFF) was a fabulous move by the Fed. It kept approximately 100 money market funds whole during the past year or so. It helped a lot but will be going away in early 2010. The CPFF currently is less than 5 percent of commercial paper, which is down from about 21 percent in the depths of the crisis, and it continues to get smaller.

The Fed has made a huge improvement in the short end of the market. Funding spreads have gone back to what they were just after the Lehman Brothers collapse. So we're starting to see less worry about risk and we're getting back toward normal range on the financing side.

**Camp:** The interesting thing about the risk premium is that agency-backed mortgages are at an all-time tight vs. Treasuries. I don't believe residential real estate is at an all-time low in terms of risk, even with the value or implied value of the government guarantee. Corporate-bond spreads have come in to

10-year averages and high-yield spreads are close as well. Consequently, the bond market is going to have the first negative total return for Treasuries in a decade while non-Treasury assets will see double-digit returns. That is well ahead of fundamentals, especially on the mortgage side. The wild card for us now is the commercial mortgage-backed securities (CMBS) market. It has traded into higher levels but

not based on fundamentals. No one is issuing new CMBS notes. Our concern is for the regional banks where the default rates could increase over the next couple of years and there isn't currently funding to refinance those notes.

**Head of Investments:** Two inter-related, broadly discussed issues are consumer spending, which comprised more than 60 percent of gross domestic

product before the most recent recession, and consumer saving. How is the consumer impacting how you're positioning portfolios?

**Boksen:** The consumer actually is spending a little more than you might have thought. The shoe business, for example, has been great this fall. But current stock prices reflect a complete recovery of the consumer, which I don't see. I still see excess capacity. Large, established retailers, which generate a lot of cash, are muddling along.

I went to a consumer conference recently and nobody was overly optimistic about holiday-shopping trends but the stock prices would tell you that we're going to have a great holiday-shopping season. Again, I just don't see it yet while consumers are repairing their own balance sheets and unemployment remains high. This is true not just at retail stores but we're also underweight in retail restaurants.

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**Wallace:** I believe we will see the U.S. savings rate continue to rise and that comes right out of consumption.

**David Blount:** Some might question whether the American consumer has changed. I would say no. Many people have looked for value over the years, which explains the growth of Wal-Mart, Costco and online retailers. But so many of us still want the bigger house, the bigger car, the big-screen TV and so on. What's changed is that nobody is giving us money anymore to buy those things.

**Stacey Serafini Thomas:**

There are opportunities to make money in the consumer space but caution is paramount. There are some retailers who are beneficiaries of a tough market environment. I believe the consumer "trade-down," or bargain mentality, is going to be here for a while.

**Skeppstrom:** It bears recalling that the consumer isn't monolithic. There are really wealthy consumers who have been among those hit the hardest because they had more stocks and real estate in their portfolios. But, they've never had a real debt issue. Their spending may increase when they realize their job is safe and they have savings in the bank and they think, "After all that, I still do have some money to spend."

American Express's monthly data indicates people whose income is more than \$200,000 have cut back by about 20 percent. And those whose income is less than \$50,000 had cut back about 5 percent. That could make the case that if the consumer is going to pick up, it's going to first pick up in the higher economic brackets.

**McPherson:** The run-up in retail and the restaurant stocks doesn't make any sense given the backdrop for the consumer we've just discussed. I have no doubt a higher savings rate is the right thing in the long term but it doesn't help in the near term.

Those retailers that survive this likely will come out stronger because some of their competitors (Circuit City and Linens 'n' Things, for example) will have gone out of business. It is our job to figure out for individual companies the kind of recovery being reflected in its stock price and what we should pay for its potential growth opportunity. We're not macroeconomic forecasters; it's at the company level where we believe we can make prudent decisions.

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**Mintz:** The key factor governing the sustainability of the economic recovery will be the employment picture, which clearly impacts consumer spending. Nearly eight million jobs have been lost in this country since the downturn began. Manufacturing activity has begun to recover, which bodes well not only for many small-cap companies that bore the brunt of the destocking process. More active plants, in turn, mean additional hires.

**Cowart:** What makes sense for one person to do may be bad when everybody does it. It's very good for me if I save but it's bad for the economy, at least in the short term, if everyone saves. The same holds true for businesses: It's good for one business if it cuts costs but it's bad for the broad economy if all businesses cut costs.

**Head of Investments:** Are banks restructuring their balance sheets as well? Do they still have bad assets washing around?

**McCallister:** Big banks are rebuilding their balance sheets as we speak but I don't believe small banks are. I believe some banks really are too big to fail now, and the government is going to keep this going. Big banks are going to do very well and you've seen that with the S&P bank index doing fairly well over the last couple of months while the regional-bank index has lagged.

Large banks may have an advantage over medium and small banks because their cost of capital will be lower.

**Pandle:** The banks have moved away from the chasm but they still face some challenges. Residential and consumer delinquencies are starting to slow, which is good news. On the other hand, there has been an increase in the number of delinquencies and defaults in the commercial-mortgage space.

Regulators are helping banks through this problem. They have changed some guidelines that will allow them to restructure loans without having to increase collateral in cases where the collateral value has decreased. This has a facetious name – “extend and pretend” – but it could help banks through this next phase of working out of the real-estate bubble.

**Head of Investments:** The broad stock market touched a bottom in March but equities have had a strong run since then. Can you discuss your thoughts on the surge, its strength, breadth and speed?

**Cowart:** Think back to March and what the dominant fears were:

- I We're going to have a financial meltdown where the best-case scenario is that the government nationalizes all the banks.
- I We're going to have the Second Great Depression in which gross domestic product (GDP) drops 25 percent and unemployment hits 40 percent.
- I Corporate profits collapse.

*None of those things happened.* The government helped heal the banking system; nobody is too concerned about a financial collapse anymore. We're not going to have another Great Depression. Corporate-bond defaults never hit the levels some projections had called for.

Those first two items admittedly were low-odds events. But what did seem plausible then was that corporate profit margins would collapse, taking cumulative S&P 500 earnings to \$35 to \$40, but that didn't happen either. In fact, we didn't even go back to 2001 margins but, rather, we held corporate profit margins way above that. Annualized earnings for the S&P 500 in the quarter that just ended were about \$75 per share.

One might say the S&P's move from 660 to 800 was because the financial system didn't collapse. The move to 900 was because we're not having another Great Depression and, in fact, we might have a little V-shaped recovery. And finally, the move to nearly 1100 was because corporate profit margins were remarkably high.

**Boksen:** The speed of the bounce surprised everybody, including me. We went from a depression mentality, a global meltdown mentality to, “Hey, we're out of the woods!” in virtually no time. That may be a function of the speed of information, the globalization of the marketplace. The market consequently reacts very, very quickly.

So, we no longer fear another Great Depression but I don't view this as a bull market. We're just getting back close to the pre-Lehman days.

**McCallister:** I was surprised by the comeback, but I shouldn't have been since the four great bear markets had 50 to 60 percent recoveries after hitting their bottoms. But the way things are, I was surprised.

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People went rapidly from not wanting to touch anything to now seeking risk. There has been a suggestion, and I tend to agree, that people are seeking risk too aggressively now; however, the Fed essentially has forced people to seek risk with zero percent interest rates.

Junk has done well and our portfolios are about even, which is pretty good considering we have such a bias toward high quality. And I believe the market will rotate back to those high-quality companies we prefer to own.

**Pandtle:** I look at the recovery and where we are in the market now and maybe the momentum money – the easy money – has been made. But that’s good news for managers who have proven to be excellent stock-pickers over the long term.

There has been talk about the so-called “dash for trash.” In financials, from July until the end of September, the best-performing bank stocks were the ones that lost money. And the more money a bank lost, the better its stock did! The higher-quality banks that were still profitable and paying dividends underperformed.

I believe we have hit a turning point. We’ve seen the higher-quality names starting to outperform recently.

**Cowart:** John talked about the banks that lost money doing better than those that didn’t. That reminded me of 1999, when losing money – for companies across the capitalization range – pushed a stock’s price up. I told people then that if someone changed the rules of finance, nobody was nice enough to tell me about it.

These kinds of phenomena occur from time to time but they don’t last very long. The rules of finance don’t change. Owning high-quality, strong franchises is the key to long-term success. And looking for those kinds of companies is what we have done for a long time and will continue to do.

**Pandtle:** I’m noticing this earnings season, for the first time in about a year, that analysts are really parsing companies’ reports trying to differentiate fundamental outlooks. I think we’re going to see more of that closer inspection – maybe even skepticism – going forward.

**Head of Investments:** Is the market getting ahead of itself, or is there still a long way to go as the market approaches the Lehman-bankruptcy levels from below?

**Cowart:** It has moved very quickly. Credit spreads have returned. We’re approaching the market levels we saw before Lehman collapsed. But let’s not forget we’d been in a 14-month bear market when that happened. I believe you can make the case that as we get back to pre-Lehman levels, the S&P moves to nearly 1200.

I believe S&P 500 companies may be in better shape than some smaller names since they have export opportunities and earnings from global operations. Some countries’ recoveries are moving more quickly than ours.

**Blount:** I believe what the latest move – especially the latest quarter – reflects is that earnings revisions were up and maybe so, too, is the level of optimism. We’re just a little below the S&P 500 selling at 15 times earnings, which is about what the long-term average is.

The broad downturn, particularly in March and April, provided us an opportunity to pick up some high-quality companies that we know and love but have never been able to look at before because the valuations were too high, which also usually meant that the dividend yield was too low. I’m talking about names like Coca-Cola, Johnson & Johnson and Abbott Laboratories. Those are companies that have increased their dividend over the last 10 years at very stable rates, their valuations have come down and we were able to buy them.

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We stuck to our discipline. 2008 was very good for us. Others have talked about how those things that have done really well in 2009 are low-quality stocks while high-quality, large-cap, dividend-paying stocks have lagged. In fact, dividend-paying stocks in the S&P 500 are up basically 15 percent while non-dividend payers are up 47 percent.

**Head of Investments:** What are your thoughts on how much longer this recovery will last? Is it sustainable?

**Thomas:** I think there is a real chance that we could be facing a jobless economic recovery. A company's management team said at a recent industrials conference that every one of its employees had taken an involuntary week off during each quarter of 2009: a total of four weeks! Therefore, the company suggested it has a month's worth of excess production capacity when business returns even at its current staffing level.

Companies have been very aggressive at cutting costs over the last year and most appear not to plan to add to their labor force until demand comes back. The general sense seems to be that business has stabilized but that it might bounce along the bottom for a while. This does not bode well for robust job creation in the near future.

**Skeppstrom:** I want to see how vigorous the earnings recovery is. People I respect have suggested companies' margins, excluding financials, bottomed at 50 percent above where they historically hit a bottom in recessions.

So perhaps there are two views: One, the economic recovery will be extremely sluggish and that won't result in enormous earnings growth. Two, there eventually will be actual revenue growth, in which case earnings will be beyond anyone's reasonable expectation.

I believe the stock market could easily decouple from the economy and the job market for some time and so I don't see any reason not to be pretty bullish on stocks at the moment. I'd say we're still in the early stages of an earnings recovery and there are companies that historically have done well in times such as these.

Businesses are consolidating and their top-line growth rates are lower. Therefore, managements have concentrated quite naturally on margins. And what are they doing? They're not hiring and particularly not when the federal government continues to talk about various programs that will cost employers more money. Business owners take that stuff seriously.

We will be in a great position profits-wise if we get any kind of economic improvement. It's not as easy as I made it sound because there are still going to be some challenges, but the opportunity is there.

**Cowart:** Companies have to start truly growing. If they continue to raise margins by laying off employees, who are consumers in their off time, it creates problems for demand. Macroeconomic growth happens when there is employment growth, which feeds into income growth, which feeds into sales, which feeds into production and so on: a virtuous cycle.

Some statistical models are suggesting job losses may peak at the beginning of 2010 and perhaps we would then see a recovery in employment. Small businesses have been the engine for employment growth over the last two decades and they appear to face some challenges: possibly higher tax rates, maybe healthcare mandates. It's a very uncertain environment right now and so maybe business owners continue to squeeze a few extra hours out of their existing employees rather than hire anyone new.

**McCallister:** I believe we may start to see some mergers-and-acquisitions activity and some high-quality companies might get taken over. I believe it's

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important to be prepared if interest rates do go up. Companies like State Street, Ameritrade, Schwab all are likely under-earning now because their short-term-interest-rate earnings are all gone.

The short-term party may be over when rates go up but it may be well into 2010 before that happens so the party could keep swinging in the meantime.

**Boksen:** The market also looks to me like it could go higher – perhaps 8 percent to 10 percent – at least for the short term. That could happen until we start seeing interest rates pick up.

**Head of Investments:** Let's look forward: how you have your portfolio positioned, the sectors or companies you're looking at.

**McCallister:** One thing I'm thinking about is ensuring there are companies in our portfolio that we believe will perform well when interest rates go up. Brokers and exchanges should do well. And, since junk had a nice run off the March lows, I believe the market will turn its attention increasingly to quality. Earnings are probably going to be scarce while the economy recovers so it makes sense to buy stable companies.

**Thomas:** We continue to be cautious on consumer discretionary stocks, tilting our portfolio toward stable, cash-rich media companies and away from retailers and restaurants. We talked earlier about retailers that may be the beneficiaries of a tough market environment. For instance, TJ Maxx has greatly benefited from the consumer trade-down activity. Another example would be auto-parts retailer O'Reilly, which is benefiting from a trend toward people fixing their own cars.

Technology stocks offer some very compelling values, primarily because many technology companies' balance sheets are exceptionally strong and they are producing large amounts of free cash flow. Part of the reason that technology companies are producing so much cash is that they responded to the downturn by dramatically reducing their inventories, causing

working capital to become a source of – rather than a use of – cash. The free-cash-flow yields of many of the technology companies in our portfolio are between 8 percent and 10 percent. The real reason to own these stocks is to benefit from a dramatic reset in the valuations investors pay for these stocks. The stocks become even more appealing if we get earnings growth on top of these high cash-flow yields.

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“(W)e’re geared toward an earnings recovery. Our focus is on things like technology, finance and consumer discretionary, all of which we believe will continue to work in a recovery.”

— Richard Skeppstrom

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**Skeppstrom:** I believe margins are going to be higher than people originally thought and so we're geared toward an earnings recovery. Our focus is on things like technology, finance and consumer discretionary, all of which we believe will continue to work in a recovery.

The third quarter was pretty much as I expected: there wouldn't be revenue growth but margins would be better than expected. If there is a pickup in revenues sometime in the first few quarters of 2010, I believe we'll have a pretty decent earnings environment for a while and that would help continue this rally.

It is harder to delineate quality companies in the large-cap space. Bank of America believes it is nearing a peak in its provisioning for bad loans. Maybe it is not a high-quality name right now but my suspicion is that as soon as it turns the corner on its

bad loans, investors will likely view it as a quality company again.

I believe it's entirely possible we may see cumulative annualized earnings for the S&P at \$80 around the middle of next year. And if interest rates don't go up, which would throw a wrench in the works, we may see it go higher from there. We're trying to keep cash out of the portfolio and avoid hand grenades.

**Boksen:** I believe fear, not greed, is currently dominating the market. Look at fund flows into the fixed-income market. But, we have some momentum going so we may see a nice year-end rally particularly since this fourth-quarter's earnings comparisons are so easy.

I believe things will be fine over the next six to nine months. We're positioning ourselves for what we believe could be an era of a weak dollar so we have slightly overweight positions in energy and materials, which benefit from a weaker dollar. In the consumer space, business remains weak and I believe we'll be stuck with double-digit unemployment for some time. We have maintained our historic overweight in slot-machine companies because we believe so many more states are going to look to gaming to increase their revenue streams.

In financials, I'm trying to buy for the long haul with companies we believe will benefit from an increase in short-term interest rates. In technology, we have a small overweight position in semiconductors but we'll probably be reducing that going into next year. Healthcare? It's so unclear on what Washington might do that we have a market weight there.

**Mintz:** We are focused on finding companies that have aggressively cut overhead costs. Corporate-profit margins held up better than some people feared they would in 2009 due to cost-cutting. Looking into 2010, we believe most companies will show modest revenue growth against a backdrop of moderate economic growth. Consequently, operating leverage will be the key driver of corporate profit growth.

We try to discern among our companies how much cost-cutting was permanent reductions to their fixed costs, such as shifting of production to low-cost regions. We believe companies that did that will produce earnings growth rates above their peers and should see stronger share-price performance.

Broadly, our focus is identifying companies that will experience accelerating earnings growth. We believe we are entering a sweet spot of the economic cycle for our investment strategy given the current depressed levels of corporate earnings.

**Cowart:** We believe high-quality, strong-franchise companies will be the way to go and those are right in our wheelhouse for both Equity Income and Value.

I believe the market can grind higher into early next year. And, if we get a hint that the economic recovery is sustainable – and not just based on inventory-rebuilding and good exports – then the market could go a lot higher.

There continues to be tremendous skepticism – to a degree I've not seen – about the market. I'll ask – somewhat kiddingly – if the market has gone high enough for clients to want to get back in. In March, it was too low to buy; now, it's too high to buy. People are just kind of frozen probably because the market has come so far, so fast against this backdrop of still-mostly bad news.

We are not particularly overweight in any sector in Value portfolios for the first time in a number of years. We were definitely tilted in favor of energy and against financials a couple of years ago and that worked out very well. We have evened those up over the last year or so. There may be individual financial stocks where investors can make money but there aren't any sectors jumping out at us as being undervalued right now.

Consumers have been hit hard over the last couple of years but many corporations are in as good of financial shape as they've ever been. When we look

below the surface – not just at earnings and yields but also the cash flows that truly underpin the health of the corporate sector – we feel pretty comfortable owning a lot of different things right now. There are pretty strong fundamental underpinnings for where the market is right now.

Over the next year, we will keep our eye on the issues we've discussed. We do believe we're in a nice spot now where earnings estimates are going up, valuations are reasonable, there's still a lot of cash on the sidelines and perhaps even more skepticism.

Markets climb walls of worry and there's a big wall of worry out there right now.

**Blount:** I'd like to focus on dividends and to put some things in perspective. Positive dividend actions outnumbered negative dividend actions over the last 10 years by nearly 20:1. Even in 2001, a really bad year, the positive outweighed negatives 8:1. This year, the number has fallen to 1.1:1.

In 2005-2007, there were about 40 dividend decreases per year and about the same number of companies didn't pay their dividends. In the last 12 months, 586 companies have lowered their dividends and 370 have omitted them.

We believe August was a turning point. Decreases have not gotten bigger since then; they've held steady. We believe companies are moving closer to making positive moves. Some energy companies (e.g., Chevron, ConocoPhillips) that hadn't raised dividends for a year now have done so. We believe some of our other holdings that haven't raised their dividends for some time may begin to do so, even if it means ones that historically raised dividends by 10 percent may only do so now by 1 percent to 2 percent. Easing the credit situation is really going to help because many companies – including banks – are sitting on piles of cash and we believe they will be willing to raise their dividend rates when they can refinance their debt.

**Pandtle:** Some of the big banks that have repaid their federal Troubled Asset Relief Program (TARP) money are sending positive signals that they intend to reinstate more normalized dividends, perhaps as soon as the first quarter. JPMorgan Chase has gone as far as to indicate it's looking for a dividend of 75 cents to \$1 (vs. a 20-cent dividend now).

**Dave Adams:** We talked a lot earlier this year about what we should do. In the end, the reality was that we felt like we knew our companies well and that, with them, it wasn't a question of whether they'd go out of business but, rather, when things would come around.

We've actually had less turnover in the past year. We stuck to our guns. We didn't change our overall strategy but continued to focus on individual companies and their opportunities going forward, particularly over the next two years. That's been our real challenge, particularly in small-cap stocks: separating the here-and-now from potential opportunities in two years.

**McPherson:** We didn't buy anything in the first quarter because we felt comfortable with the companies we owned and that has paid off so far this year. We haven't added to the companies we purchased since then because we believe interest rates are going up or oil is going to cost a certain amount per barrel. We bought them because we believe in their individual long-term potential.

The question now is, "Where do we go now, given the run off the bottom?" I didn't believe it would come this far, this fast. We believe the equity-risk premium has come back into a normal range, whatever that means. It's hard to believe that, going forward, it's going to shrink to below-normal levels since it is an uncertain world, economically and geopolitically. It's clichéd but true: We believe it's going to be a stock-picker's market.

As we look out over the next couple of years, we

believe there are going to be companies that will come out stronger on the other side of this. The weaker competitors will go by the wayside, so there will be opportunities even in a weak economic environment.

The short-term upside from here may not be tremendous but if nothing comes along to reignite investors' fear, we'll keep working toward long-term recovery. It may be slow, it may be fast; the pace doesn't matter to us. Our adding value is going to come down to picking good individual stocks. And we believe that, with all the names we have to choose from in the small-cap universe, we will be able to find companies that outperform even in underperforming sectors.

**Adams:** We are overweight in the technology and energy sectors and, to a lesser degree, consumer staples. Conversely, we are somewhat underweight in the consumer discretionary sector. We also continue to be underweight in financials as well as industrials, though that is a sector where we may begin to add names in the next couple of quarters. Again, we are looking for high-quality companies in all the sectors.

**Camp:** It's remarkable to me that in less than a year we've gone from a point where a company like General Electric couldn't finance its commercial paper to now, when high-yield spreads are so tight. The disparity in performance between top and bottom managers was pretty extraordinary last year. I'm astounded how far we've come. The stock guys talk about recovering from March numbers, but the low period for fixed income was September 2008. March was when commercial paper actually made a bit of a comeback.

We thought last year that there was an accounting problem in the commercial and residential real-estate sectors. We talked a lot about mark-to-market, we talked about assets pricing at 40 cents on the dollar vs. 80 cents on the dollar. What we realize now is that we don't necessarily have an accounting problem but, rather, an asset problem. It's not just in subprime

loans, either, but across the spectrum where residual values may have fallen below 40 cents to 50 cents on the dollar.

On the portfolio level, we're selling the high-yield bonds we own. We've already sold a lot of the agency-backed mortgages we owned. We're underweight in the Treasury market. We're relying on high-grade industrial and corporate bonds.

On the municipal side, we are paying a lot of attention to individual states. California, for example, remains scary to us because of the depth of the real-estate crash there that, in turn, put a pinch on the state's coffers.

**Wallace:** The banks definitely still have issues. They have written down or taken losses on about \$1.6 trillion and they've raised about \$1.4 trillion in capital. There's still about \$200 billion where the banks are short of capital. The question is, as James suggested, how much will loans' values go down. It's hard to tell right now.

The economy is showing nascent signs of growth. The government reported GDP growth of 3 percent but – after backing out one-time items such as the “cash for clunkers” program and inventory liquidation – real GDP growth is about 1.1 percent. We may have to start to worry about what the Fed might do if

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— James Camp, CFA

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we see stronger growth in the fourth quarter and into the early part of 2010.

The Fed is nervous about balancing growth against inflation. It's a tough spot for them. The good news for us may be that Chairman Ben Bernanke was a scholar of the Great Depression and so we hope he doesn't repeat mistakes that were made then. The Fed in 1935-36 was similarly nervous and its response was to substantially increase rates, which crushed economic growth and sent the country back into a depression-like environment.

We would tread very cautiously here but there may be some opportunities in some mortgage-backed securities, private and agency-backed. Residential

housing appears to have bottomed; it actually went up after being down 15 consecutive quarters. The S&P/Case-Shiller home-price index has risen for four consecutive months, home sales have picked up and inventories have started to slide. There are select investing opportunities now and more may open when the Fed divests itself of the mortgage-backed securities it bought to help keep the system afloat.

**Head of Investments:** It is worth noting that active management, skillfully applied, can identify companies that can grow at rates in excess of the global or U.S. gross domestic product (GDP). There is no substitute for experience, especially in unprecedented times such as these. Thank you for your insights.

Past performance does not guarantee future results.

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# EAGLE'S PORTFOLIO MANAGERS

## Small Cap Core Value

### Dave Adams, CFA

- 19 years of investment experience
- B.S. (1985) and M.S. (1989), Boston College
- Earned his Chartered Financial Analyst designation in 1993

### Jack McPherson, CFA

- 19 years of investment experience
- B.S. in finance, Northeastern University (1990)
- M.B.A., Babson College (2005)
- Earned his Chartered Financial Analyst designation in 1994

## Small and Mid Cap Growth

### Bert L. Boksen, CFA

- 32 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

- 14 years of investment experience
- B.A., Washington and Lee University (1995)
- M.B.A., University of Southern California (2001)
- Earned his Chartered Financial Analyst designation in 2000

## Small/Mid Cap Core

### Todd McCallister, PhD, CFA

- 22 years of investment experience
- B.A., with highest honors, University of North Carolina (1982)
- Ph.D. in economics, University of Virginia (1987)
- Earned his Chartered Financial Analyst designation in 1996

### Stacey Serafini Thomas, CFA

- 12 years of investment experience
- B.A., cum laude, Harvard University (1997)
- Earned her Chartered Financial Analyst designation in 2002

## Large Cap Core

### Richard Skeppstrom

- 18 years of investment experience
- B.A. in mathematics (1985) and M.B.A. (1990), University of Virginia

## Fixed Income

### James C. Camp, CFA

- 20 years of investment experience
- B.S., Vanderbilt University (1986)
- M.B.A. in finance, Emory University (1990)
- Earned his Chartered Financial Analyst designation in 1993

### H. Peter Wallace, CFA

- 42 years of investment experience
- Northeastern University (1968-1972)
- Earned his Chartered Financial Analyst designation in 1978

## Equity Income/Value

### David Blount, CPA, CFA

- 25 years of investment experience
- B.S. in finance, University of Florida (1983)
- Earned his Chartered Financial Analyst designation in 1993

### Ed Cowart, CFA

- 37 years of investment experience
- A.B., Dartmouth College (1969)
- Earned his Chartered Financial Analyst designation in 1977

### John Pandtle, CFA

- 15 years of investment experience
- B.B.A. in finance, University of Georgia (1993)
- Earned his Chartered Financial Analyst designation in 1998

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