

UPDATE: WHERE WE ARE AND WHERE WE'RE GOING

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 recent events in the stock market, where they believe things are heading and potential opportunities for investors.
- The federal government is exercising many different programs to try to stimulate the economy. It's likely only a matter of time before the liquidity injected into the system since last fall finds traction and the economy picks back up.
- Economic news may get worse over the next year but the stock market historically has been able to see past the trough to better times ... even before those better times make headlines.
- 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.

Last fall, Eagle's portfolio managers gathered to discuss the current market situation, how things got there and where they believed the market was heading.

A combination of factors got us into the current mess: financial engineering (e.g., collateralized-debt obligations); credit-rating agencies that were vested in the deals they were supposed to be monitoring; a monumental increase in the use of leverage by financial institutions; a Federal Reserve policy in the early 2000s that kept interest rates artificially low; lax lending standards in large part led to a real-estate bubble; and record commodity prices.

The markets have continued to roil since October. The federal government has spent billions and billions of dollars casting lifelines to well-known, well-established financial firms, and sometimes more than once. The Federal Reserve has cut interest rates to near zero percent. The Obama administration continues to tweak its economic-stimulus plan. And the equity markets broke through what probably everyone had hoped would be lows set in November.

We brought back together several of our managers to discuss their thoughts on where we are now, what they're doing in their portfolios and what they see going forward. Present were Richard Skeppstrom (Large Cap Core), Todd McCallister (Small/Mid Cap Core), Bert L. Boksen (Small Cap Growth), Jack McPherson (Small Cap Core Value) as well as James Camp and Pete Wallace (Fixed Income).

Moderator: *Let's quickly touch on a few of the things that got us to where we are and that may be still overhanging the economy and the markets.*

Todd McCallister: I still think that some of the nervousness we have with our big financial institutions is due to the fact we still have these huge credit default swaps out there. We need to clear out the bad assets from banks before the market can really move on.

James Camp: The bond market remains generally illiquid. Wall Street firms are unwinding their own leverage so they are holding on to their cash. There's no money for bonds so prices – due primarily to mark-to-market rules, which become

out of whack in extraordinary markets like we're enduring now – have become ridiculous. Just because something had to sell recently at 20 cents on the dollar doesn't mean that's what it would be worth in more normal times.

We will return to those so-called normal times but we must expose all the underlying loans that make up what are now singular products and put them in a "bad bank," or something akin to that, or the problem stays with us.

The capital markets need to unpeel the layers of these engineered products to see what's really there. There so far has been a simplistic approach to split the difference between a note's perceived cash-flow

value and its marked-to-market value. That is folly; things are much more complicated than that.

We still need to monitor real estate and I'm not just talking about declining prices, either. The issue for financial institutions is that mortgages are one of a few loans from which a consumer can just walk away. It's unlikely, of course, but if everyone left their keys in the door and walked away from their mortgage, that would leave lenders still wildly exposed to the real-estate market.

Finally, I say this delicately because recessions are never really good for those affected by them. However, I believe the United States was very lucky that the "decoupling" scenario – the idea that we might fall into a recession but the rest of the world would continue to see double-digit growth – never happened. Much of the rest of the world is in recession. I believe we have a chance to use this to help ourselves, particularly since the U.S. dollar remains the global standard. Foreign countries, such as China, probably are going to continue to fund our debt.

Moderator: *You have tagged real estate as part of why the market is here. How much further do you see real estate going down as a percent from where it is today?*

McCallister: My guess is that generally prices need to drop another 10 percent to 15 percent and that will move sales. I do believe we're closer to the bottom than the top.

Pete Wallace: I agree. We overshot the top for prices in 2003 and 2004 and so we're probably going to go too low on the downside. This has been a very region-specific issue. Data from some areas already

suggest housing has reached pre-bubble affordability levels.

Real estate ties to the stress tests the federal government has conducted on the largest banks. But one of their assumptions is, "What happens if real-estate prices fall another 25 percent in 2009 and then another 7 percent in 2010?" That's pretty outlandish because it would have many places down 60 percent or 70 percent, which is way out of the ballpark.

A 10 percent to 15 percent reduction from here is probably the right number.

Moderator: *One of the things you all talked about in the fall was the idea that we need to see the credit markets thaw – even solid companies need to be able to issue short-term commercial paper to run their businesses – before the economy really gets back on track. Are you seeing things get easier in that arena?*

Wallace: In terms of what's going on in the commercial-paper market, the government has really stepped up. The commercial-paper funding facility has helped tremendously to free up credit in the short markets. That program allowed issuers of 90-day commercial paper to go to the Fed and – this is a first in my 42-year career – the Fed will be an end buyer of assets. The Fed will buy top-rated paper to help pay maturing notes coming due.

The program started in October and grew significantly. The Fed currently owns about \$246 billion of commercial paper, or about 16 percent of the approximately \$1.5 trillion market. So things are freeing up and starting to trade but I believe we're still a long way from being back to normal.

Moderator: *The government has gotten more involved in the economy in the last few months than it has in the last 70 years. What are your thoughts on how it's doing?*

Richard Skeppstrom: I believe the government is going to try to stimulate consumer spending to counterbalance an increase in the savings rate. People are trying to pay down debt, as they should, and saving is a perfectly logical response to what's happened and it's going to go on for quite a while.

The market likely will react well to any increased spending because comparisons to sales from last year would be favorable.

One thought many of us have is: How will we pay for all this over the long term? But I have come to believe we can't worry about that too much because it seems like "the long term" always plays out differently than we expect.

McCallister: The argument for current government spending, and it's a temporary spending burst, is that no one wants to loan to each other and there's no confidence. So there is a role – and we're going back to the Great Depression days – for the government to step in and kick-start spending to renew confidence.

The issue, as Richard suggested, is the long term. We all know that if you tax people more, all you're

doing is shifting the chairs around. We need the government to boost confidence even if it involves running up a deficit. I was concerned at the beginning of the year that maybe we'd see some inflationary pressures. But I've kind of put that on the back burner given the events we've seen.

Camp: The concern that I have about what's going on, at least with the rhetoric in Washington, is framing issues as Wall Street vs. Main Street. This is the most uniquely complete crisis we've ever created and it affects everyone. Washington needs to tamp down the rhetoric and lock in on exactly

what the stimulus is going to be and how it's going to work.

Obviously, when we spend the kind of money Washington is proposing, I worry about inflation in the long term. But right now, the entire world is in recession, which may be the best thing that could have happened.

China is still buying 10-year Treasuries.

Wallace: Government funding is necessary at this point in time. We need capital injected into the banks. We do need to have the government stand up and take out some of these assets, at least until we can value them correctly.

We do need to be careful because once this economy starts to improve, we need to pull that liquidity out as quickly as it went in. Otherwise, we may end up in a hyper-inflationary environment. Consider that industrial production numbers are nearly shut down. If there becomes any demand,

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there won't be any supply; meanwhile, the system is flush with cash: a perfect recipe for rampant inflation.

Jack McPherson: I believe the markets would respond very positively to getting some details on the stimulus plan, including what the new rules of engagement are going to be for those who participate.* The same holds true for the president's budget.

(*Editor's note: Broad equity indices leaped more than 5 percent March 23, the day Treasury Secretary Timothy Geithner outlined details of the president's financial-rescue plan.)

The market hates uncertainty. Healthcare stocks are a great example. They had held up relatively well. Many people perceived the healthcare component of the president's proposed budget as perhaps a move toward socialized medicine and healthcare stocks got crushed. That was just a proposal; there's no telling when, or even if, any of those things will come to pass.

This gets back to understanding our short-term downside risk. Look at some areas – broadband, engineering and construction – that may benefit from the president's proposal. We own some companies that do those things. The government can say "spend money" on a Monday but that money won't be spent that week; sometimes, it can take years. So we have to pay close attention to current fundamentals to ensure a company can hold on if it takes longer than expected for capital projects to get under way.

Moderator: *How confident are you that what the government is doing is going to help?*

McCallister: Federal Reserve Chairman Ben Bernanke is doing his job. The Fed has inflated its balance sheet dramatically over the past year to try to help get the credit markets moving again. But, as Jack said earlier, I believe we have to clear out these bad banks or the bad assets before we can move on. And we need some clarity.

The United States had about \$1.5 trillion of bank capital before this started. Some have suggested that if we marked all losses at current market prices, we could have as much as \$4 trillion in losses. But those market prices are very distressed. I suspect if we mark-to-market, the actual losses may be close to \$2.5 trillion to maybe \$3 trillion.

A creative government will go in there and provide capital to replace the \$1.5 trillion that was lost, add a little bit more, buy these bad assets, wait it out, and make some money. I don't believe those losses are worth \$4 trillion and so the government could "make" the difference.

That is exactly what the government did with the Resolution Trust Corp. and that's what needs to be done now. By the way, banks right now are marking assets down 90 cents on the dollar. It's probably really 75 cents and the market is 50 cents. The point is, the government can make it work if it buys at 50 cents and holds to 75 cents, the hold-to-maturity prices. They'll make some money on the back end, just like the RTC did.

Skeppstrom: The really big banks – like JPMorgan Chase, for instance – will tell you they're lending. If you look at their balance sheet, the toxic assets that we're going to take away from them are, by and large, credit-card loans, home-equity loans and prime mortgages. They're not all going to go bad

today or tomorrow or maybe even this year and, in many of these cases, these banks are going to earn tens of billions of dollars before credit costs. Some of them will earn their way out of this.

The problem the government seems to have is figuring out which ones it simply needs to take over so it can get at these assets. That's because it's very difficult to assess what the bad assets are. It's not easy to predict who is not going to pay or, when somebody is not paying, whether an amount due is collectable at all. This is a very complicated situation.

Let me make one more point: The capitalization of banks has gone to almost a fractional percent of the S&P 500. I had believed for many, many months over the last couple of years that we needed banks to get healthy for the market to start to improve.

I'm not convinced now that it makes any difference, and I'm not being negative. Consider your local Bank of America branches: The tellers and loan officers are going to be there whether it's private or nationalized. At some point – and probably sooner rather than later – it won't make any difference to the S&P whether the banks see their shareholders wiped out because the capitalizations will be too small to matter.

Camp: You've got to get credit to private capital and private enterprise to start buying these assets. Money will find a way into this marketplace but

until the mark-to-market issue, which I still view as a big problem, goes away or gets some sort of temporary relief,* there's little incentive to buy financial assets in the debt markets today.

(*Editor's note: The Financial Accounting Standards Board voted April 2 to ease mark-to-market rules. The board ruled banks can use more judgment in what price an asset might fetch in "normal" market conditions.)

The government is doing its part to help banks get back on their feet. Money is free. Yield curves are positive. Spreads are at historically wide margins. Net of toxic assets, this looks to us like a potentially good environment for the financial

companies that survive.

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We're in a foot race to get banks solvent. The Fed indicated at its last meeting – and for the first time in my career – that interest rates will be accommodated for the foreseeable future.

Wallace: Under these conditions, and with re-found religion as it relates to checking borrowers' creditworthiness, it may not take very long to build banks' capital bases back again.

Jack's right about the need to amend the mark-to-market rules. I believe there is some concern among lawmakers and regulators about changing the rules now after Bear Stearns and Lehman Brothers failed under mark-to-market. But we need to change the rules because there's no real market right now. So, making banks mark assets to what amounts to a non-market is going to keep the system distressed.

Moderator: How do these policy moves affect the bond market?

Wallace: Let's start at the front end of the curve and move out. We're going to see a lot of Treasuries coming out because the government has an approximately \$1.8 trillion deficit to finance.

It creates an interesting paradox for the Federal Reserve, which is trying to keep its rates low to help keep mortgage rates down. Now, we have a tremendous amount of supply.

We expect short rates will continue to benefit from the notion of "flight to quality." We're still seeing a lot of money come out of other assets and go into the Treasury market.

Camp: If tax rates go up, as many people expect they will over the next eight years, municipal bonds are going to make more sense for many investors. Long-term Treasuries are, in my estimation, risky.

Skeppstrom: I believe there's a ceiling on long-term rates – at least the 10-year – for the foreseeable future because the Fed wants to keep them in check. If our problems begin and end with the mortgage market, my belief is that the Fed isn't going to allow the 10-year note to get above 3 percent or 3¼ percent at least in the next year. I believe the Fed has the means to keep a lid on long-term rates, at least for a while, despite the unbelievable liquidity injected in the system.

Wallace: The 10-year Treasury also could stay low if the Fed follows through on some talk it may be buying as much as \$500 billion in the long-term Treasury market. That would help with supply as well.

Moderator: How are you determining what to buy? Have you adapted the measures you use to value companies in light of what's happened in the last 18 months?

Skeppstrom: We continue to view things on a relative-valuation basis. So, while Wal-Mart and McDonald's – companies that have done

relatively well through the downturn and which we have owned – aren't expensive by historical standards, they are expensive relative to some other things. Consequently, we have been selling Wal-Mart, Procter & Gamble, ExxonMobil and, believe it or not, McDonald's and we've been mostly buying technology.

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— Richard Skeppstrom

Many of the tech companies have what we view as pristine balance sheets and extreme amounts of cash that can distort the valuation. We own companies such as Adobe, Applied Materials, eBay, Electronic Arts and Texas Instruments. We now have the largest overweight in technology we've ever had. As a group, the stocks are selling on a normalized basis somewhere between 11 and 12 times earnings with dividend yields somewhere between 8 percent and 9 percent. That's a huge upside to Treasuries. It's pretty extreme to have very high free-cash-flow

businesses – and that have withstood the market’s recent stress – to have those kinds of balance sheets and valuation measures.

It’s critical to be careful, of course, but I believe the potential returns from buying select companies today may be monumental. We have as low a cash position as we’ve had in a very long time and we’re going to continue to buy.

McCallister: I believe there are always things to buy. Small companies don’t often have dividend yields but the good ones have cash-flow yield, free-cash flow. So pay attention to cash. And pay attention to how companies are managing their cash during this downturn. We’re currently finding free-cash-flow yields between 10 percent and 20 percent without taking an inordinate amount of risk.

Pay attention to fundamentals. Debt hasn’t always been a bad thing but it is now. Funeral homes are a solid business. Maybe a funeral home with debt sold at 10 times earnings last year; the same company, because it has the dreaded D-word, is selling for three times earnings this year.

I own Plum Creek Timber. If you love your kids, give them a forest; it takes 20 years for the trees to grow but it’s an easy business to run.

In January – of this year, not January 2007 or January of 2008 – Plum Creek sold about 45,000 acres of underdeveloped timberland for \$1,700 an

acre. If you figured this company’s value on a per-acre basis, it’s selling for \$1,000 per acre. The math on how you make money in a company like this under these conditions is pretty simple. You don’t need an advanced degree to figure out how that might be an opportunity.

We remain careful with consumer stocks. People can’t use their homes like ATMs anymore so we’ll likely see a savings rate that’s higher than we’ve experienced in some time. But we’re not avoiding the sector entirely.

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We own DirecTV, which is now a stable mid-cap stock with low debt and doing quite well. We also own discount retailer TJ Maxx. We own Washington Post. Many people recognize the eponymous newspaper part of the company but it’s 80 percent an education company by way of Kaplan, which is the least expensive

of its peers. Kaplan is doing very well because many people return to school, especially these vocational-type places, during recessions to try to increase their employment potential.

We remain very careful with cyclical finance stocks. I believe there is still a huge opportunity in insurance stocks, provided they’re not doing life insurance. The AIG fiasco has helped smaller companies because there’s now an opportunity for them to do business. Rates are firm and, in some cases, are going up. And, the really good news is that I’m not paying more than book value for the property-casualty companies I like.

Bert L. Boksen: We've been dividing our companies into two categories.

Typically, we buy companies that are doing well, that show accelerating earnings growth rates. Obviously, that's a challenge right now but we do have some names like that: Netflix and GameStop are examples as consumers stay home. Another example is FTI Consulting, which benefits from corporate restructuring and bankruptcies. And we have some companies with lots of cash and, in some cases, dividend yield.

We also have some special situations that we try to exploit. One example is Huntsman Chemical, which will survive this cycle because it got a billion-dollar settlement from Apollo Group. Insiders are buying millions of shares, the stock's selling at a reasonable valuation and the market hasn't seemed to notice. We own First Solar because we believe the president will emphasize alternative energy.

McPherson: We sometimes tend to be contrarian and try to have a two- or three-year time horizon. So, for example, we have bought some coal companies despite the fact they have been crushed since last summer. Coal, not oil, fuels most of the power plants in this country. Coal demand may be going down a bit but we don't believe it's going to go down dramatically.

One specialty retailer with a unique situation is Jo-Ann Stores, which sells fabric and crafts. Wal-Mart is getting out of the fabric business and one of Jo-Ann's other competitors has gone bankrupt, so they have a nice opportunity to pick up market share. Further, in this economic environment, people are not going out as much for entertainment and may turn to craft situations.

The key is digging into individual companies to try to understand what your downside risk is. Unfortunately, we may think we have that understanding but the market has been particularly fickle lately and that's a frustration right now.

Moderator: *Give some reasons why investors – still hearing bad economic news on TV – should keep their money in equities when many are scared, or tired, and simply want to move to bonds or cash.*

Skeppstrom: We're actually moving away from cash; we have been buying. We have the lowest cash level since the start of 2003 and we're pressing on. It seems to me that this is an excellent time to be positioning for an inevitable rebound; the numbers will get less bad and things will get better.

McCallister: We can talk about how banks need to get fixed or we need to get the nation's housing supply down to a certain number of months but here's what I'm hanging my hat on: Things are getting darn cheap. I can't tell you WHEN things are going to turn but valuations are cheap.

McPherson: We still need to see more general confidence in the markets. We need to get to the point where people are clear on what the rules of the game are going to be going forward. Because the fact is there are some tremendous values out there.

Weaker competitors are going to go by the wayside. The market leaders are going to be even stronger coming out of this and I believe you will look back three or four years from now and say this was a time of tremendous opportunity.

McCallister: The immutable laws of supply and demand will help us, too. A Bank of America

economist recently predicted positive gross domestic product (GDP) numbers for the second half of 2009. He has projected the nation's inventory withdrawals are going to be so great that eventually they're going to have to be replenished.

Cars are a good example. Recent sales numbers intimate we all plan to hold on to our cars for 27 years. I have yet to make a car last even close to 27 years. We're going to see some natural reversion to the mean. People will have to buy.

Boksen: It may seem hard to be too optimistic when the market has totally fallen apart and hit 12-year lows. But consider that the market had two downturns last year: The first was a financial crisis early in the year that sparked panic and the second was in October when China fell apart and global commodity prices collapsed.

We will probably see positive economic news in October. The economy may not be completely out of the woods but, in all likelihood, results then will exceed what happened 12 months earlier. Historically, the market has bottomed when the news was the bleakest, and usually six to nine months before an economic bottom.

Maybe we should start looking for signs of good news now. Credit markets are getting better slowly and there were even a couple of equity deals this quarter. That said, economic news may continue to get worse; for instance, we may approach double-digit unemployment before it's over.

The market has been a very rapid discounting mechanism. One of the things I've watched change during my 30 years in the industry is how the market acts faster, and faster, and faster. The information flow is so quick and you saw how the

market reacted to this downturn in the economy: It fell off a cliff.

I will also tell you that I have never seen the market this cheap since I got into industry in the 1970s. There are stocks now trading at prices equal to their cash per share, that are generating cash and have positive earnings. Some are selling for three times earnings with 7 percent to 8 percent dividend yields even if you take out the cash.

There are tremendous valuations out there but you must focus on balance sheets because many companies won't survive; however, those that do are going to come out of this a lot stronger. I would suggest that a couple of years from now, this will have looked like a rare buying opportunity.

Past performance does not guarantee future results. Opinions and estimates offered constitute Eagle's judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. The meeting of Eagle's portfolio managers occurred March 3. Under no circumstances does the information contained within represent a recommendation to buy, hold or sell any security and it should not be assumed that the securities transactions or holdings discussed were or will prove to be profitable. Any Index is referred to for information purposes only; the composition of each Index is different from the composition of the accounts managed by the investment manager. An index is unmanaged and has no expenses, and it is not possible to invest directly in an index.

EAGLE'S PORTFOLIO MANAGERS

SMALL CAP CORE VALUE

Jack McPherson, CFA

- 18 years of investment experience
- Joined Eagle Boston in 2006
- 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

- 31 years of investment experience
- Joined Eagle in 1995
- B.A., City College of New York (1970)
- M.B.A., St. John's University (1977)
- Earned his Chartered Financial Analyst designation in 1981

SMALL AND MID CAP CORE

Todd McCallister, PhD, CFA

- 21 years of investment experience
- Joined Eagle in 1997
- 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

LARGE CAP CORE

Richard Skeppstrom

- 17 years of investment experience
- Joined Eagle in 2001
- B.A. in mathematics (1985) and M.B.A. (1990), University of Virginia

FIXED INCOME

James C. Camp, CFA

- 19 years of investment experience
- Joined Eagle in 1997
- 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

- 41 years of investment experience
- Joined Eagle/Heritage in 1993
- Northeastern University (1968-1972)
- Earned his Chartered Financial Analyst designation in 1978

