Eagle Insight

EAGLE | Asset Management
AN AFFILIATE OF CARILLON TOWER ADVISERS

Equity Income

Fourth Quarter | 2017

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The risks associated with Equity Income investing are based upon the identification of companies that possess both moderate growth rates as well as higher-than-average and consistent dividend distributions. There are risks associated with dividend investing, including that dividend-issuing companies may choose not to pay a dividend, may not have the ability to pay or the dividend may be less than what is anticipated. Dividend-issuing companies are subject to interest-rate risk and high dividends can sometimes signal that a company is in distress. Historically, dividend yields have been relatively constant and therefore have created a cushion for investors when stock prices have declined. However, as with all equity investing, there is the risk that a company will not achieve its expected earnings results, or that an unexpected change in the market or within the company will occur, both of which may adversely affect investment results. The biggest risk of equity investing is that returns can fluctuate and investors can lose money.

Market Overview

The U.S. equity market (as measured by the S&P 500 Index) capped off a monumental year, gaining 6.6 percent in the fourth quarter. That brought the index's total gain to 21.8 percent for 2017: the only year on record in which the market posted a gain in all 12 months. The macroeconomic backdrop was mostly favorable for equities, with a generally improving economic environment; rising business and consumer confidence; and very low market volatility. Crude oil continued creeping higher (up 19.5 percent) with help from declining inventory and uncertainty about additional supply. The U.S. dollar continued to weaken while inflation remains below historical levels.

Portfolio Review[1,2]

Eagle Equity Income portfolios outperformed (on a gross basis) the benchmark S&P 500 Index during the fourth quarter. Positive stock selection within the consumer discretionary, industrials and energy sectors contributed to performance. Meanwhile, stock selection within utilities, materials and telecommunication services proved weak. Cash was also a detractor during the quarter. The outperformance was impressive given the narrow spread between returns of above-median dividend-paying stocks (those we strive to own in this portfolio) and their non-dividend-paying counterparts.

Regal Entertainment traded much higher after the company confirmed it was in discussions with Cineworld for a potential acquisition of Regal. The deal is expected to be all cash at a price of $23 per share.

Microsoft announced strong earnings as every business unit reported higher-than-expected results. The cloud business, Azure, again grew almost 100 percent. The accelerating-growth thesis continues to play out for Microsoft.

Home Depot reported better-than-expected earnings-per-share on higher same-store sales growth. The company benefited from a number of natural disasters in the quarter; further, the company raised guidance for the year.

JPMorgan Chase announced stronger-than-expected earnings. Strong loan growth was a bright spot while higher fee income (particularly in mortgage and card income) and lower expenses also benefited earnings.

Apple continued to trade higher as demand for the iPhone X appears to be strong. It was reported that Apple asked some of its suppliers to double capacity since pre-orders for the initial stock sold out within minutes.

Merck's underperformance was due primarily to its decision to delay the results from an important clinical trial for a lung-cancer treatment, which was viewed as an important catalyst for the stock. The delay also resulted in modestly lower financial expectations for 2018.

We sold PG&E due to reports that linked downed power lines to massive wildfires in California. Management confirmed that it had experienced "equipment failures" and there were news reports of downed power lines in the area. The stock was down meaningfully on these news reports. Large California utilities, including PG&E, have a long history of being found responsible for wildfires, sometimes due to inadequate maintenance of their power lines.

We sold Nielsen because of weakening growth trends in one of its major business segments and didn't see a reason to believe that trend would reverse.

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Wildfires in Ventura County, Calif., affected the share price of Sempra Energy. That fire was in an area where Sempra distributes natural gas (via pipes) but not electricity (via wires that can fall and spark fires). We believe that lowers the probability Sempra will be blamed for the fire and that the stock's sell-off is overdone.

Great Plains Energy traded lower with its utility-sector peers. Utilities will receive little benefit from tax reform primarily due to their regulatory structure and exclusions from certain provisions of the bill. Consequently, the sector – which lagged the overall market by 6.4 percentage points – was the worst performer for the quarter.

Outlook[2]

Looking forward to 2018, we believe the outlook for the U.S. economy is similar to the view we had one year ago. That is, we expect continued moderate economic growth, growing corporate profits and further normalization of monetary policy. As the current economic expansion approaches its ninth anniversary, some investors have expressed concern that a recession is likely sometime soon since the current expansion already has lasted more than twice as long as historical averages. We do not share this concern. There is a natural tendency toward growth in the U.S. economy. Expansions do not die of old age but, rather, because of policy actions or major exogenous events. We believe that current policies are supportive of continued growth. In particular, on the fiscal and regulatory fronts, policies are becoming even more conducive to growth. A major tax-reform bill recently passed Congress with a key feature being a major reduction in the corporate tax rate. By some estimates, that could add about 10 percent to S&P 500 earnings next year. In addition, favorable terms for repatriation of the $2 trillion – $3 trillion in U.S. companies' cash stranded overseas is likely. That, in turn, could unleash a number of favorable actions for the U.S. economy and for shareholders. On the regulatory front, great progress in rolling back many growth-inhibiting policies of the previous administration already has been made. But further regulatory relief, particularly in the area of financial institutions, is in prospect.

Another way to think about the current environment is that we are just a couple of years into a "normal" economic environment. By this, we mean that the once-in-a-generation financial crisis that occurred nearly a decade ago left consumers and businesses in an extended period of fear and caution that, historically, only time can heal. The period from 2008 until just recently was depression-like in many ways: very slow growth, stagnant incomes, deflationary tendencies and a reluctance of businesses and consumers to spend and invest. Monetary policy came to the rescue with the most aggressive interest-rate and quantitative-easing programs ever seen. Monetary policy kept the real economy growing, if only slowly, but the major impact of monetary policy was on financial markets where a global bull market in equities and bonds ensued.

Time has passed. Balance sheets have improved. Consumer incomes are growing again. Business and consumer confidence are near record highs. And the United States is fortunate to have a business-friendly government eager to promote economic growth. The next recession and bear market are well over the investment horizon, in our view.

The recent appointment of Federal Reserve Governor Jerome Powell as chair of the board indicates to us that President Donald Trump wants a continuation of the gradual normalization of policy rather than radical change. As with this year, we believe three Fed interest-rate

Top 10 Holdings

Microsoft
JPMorgan Chase
PNC Financial Services
Apple
Honeywell International
Regal Entertainment
Home Depot
Carnival
Johnson & Johnson
Lockheed Martin

The information provided above should not be construed as a recommendation to buy, sell or hold any particular security. The data is shown for informational purposes only and is not indicative of future portfolio characteristics or returns. Portfolio holdings are not stagnant and may change over time without prior notice. Past performance does not guarantee future results. Please note that the holdings identified do not represent all of the securities purchased, sold or recommended for the composite. They are provided for informational purposes only. Eagle, its affiliates or their respective employees may have a position in the securities listed. Please contact your financial advisor to obtain the calculation's methodology and/or a list showing every holding's contribution to the overall composite's performance during the measurement period.

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	Best Securities	Average Weight (%)	Security Contribution to Portfolio Return
Equity Income	Regal Entertainment	2.93	1.18
	Microsoft	4.50	0.71
	Home Depot	3.31	0.53
	JPMorgan Chase	4.07	0.50
	Apple	4.44	0.49

Worst Securities	Average Weight (%)	Security Contribution to Portfolio Return
Merck	2.34	-0.32
PG&E	0.31	-0.32
Nielsen Holdings	0.53	-0.13
Sempra Energy	1.93	-0.09
Great Plains Energy	1.29	0.01

* as of Dec. 31. The information provided above should not be construed as a recommendation to buy, sell or hold any particular security. The data are shown for informational purposes only and are not indicative of future portfolio characteristics or returns. Portfolio holdings are not stagnant and may change over time without prior notice. Past performance does not guarantee future results. Please note that the holdings identified do not represent all of the securities purchased, sold or recommended for the composite. They are provided for informational purposes only. Eagle, its affiliates or their respective employees may have a position in the securities listed. Please contact your financial advisor to obtain the calculation's methodology and/or a list showing every holding's contribution to the overall composite's performance during the measurement period.

increases are likely in 2018. As equity investors, we do not fear modest increases in interest rates. Historically, rising rates from a low level – in a low-inflation environment – has not been a negative factor for stocks. Price-to-earnings ratios are a bit above average but, compared to current interest and inflation rates, they are well within historical norms.

Just as was the case in 2017, we believe the broad stock market averages can rise in line with earnings in 2018. However, we believe that a change in the nature of the market is likely. During a period of economic uncertainty, investors tend to flock to a relatively small number of companies with strong revenue growth and good earnings visibility. Valuation takes on a secondary role if it is even considered at all. That is the milieu of growth and momentum investing, which has been dominant recently and especially in 2017. Looking forward, we believe – for a number of reasons – there will be a revival of valuation-focused investing and that our strategy and portfolio are well-positioned to participate. As such, we believe we are likely to continue to see steady and rising dividends for a while since dividend-payout ratios are still well below the long-term average. Consequently, we view our strategy of investing in high-quality, financially strong companies that pay above-market dividends and have cash resources to increase dividends regularly as well-positioned to benefit from this trend.

[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. 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. Investing involves risk, including the possible loss of principle.

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[2] Source: FactSet