Eagle Insight

EAGLE | Asset Management
AN AFFILIATE OF CARILLON TOWER ADVISERS

Small Cap Growth

Fourth Quarter | 2017

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Market Overview

Small-cap stocks continued their rise in the fourth quarter, with the Russell 2000 Growth Index1 (up 4.6 percent) outperforming the Russell 2000 Value Index (up 2.1 percent). Sector-level returns within the Russell 2000 Growth were broadly positive, driven by solid results within energy (up 8.9 percent), consumer staples (up 8.5 percent), consumer discretionary (up 8.4 percent) and industrials (up 7.6 percent). The nominally weighted telecommunication services sector (down 1.6 percent) was the only negatively performing sector while information technology (up 1.3 percent) and real estate (up 1.8 percent) were relative laggards despite positive returns.

For the full year, small-cap stocks posted strong results with the Russell 2000 Growth (up 22.2 percent) substantially leading the Russell 2000 Value (up 7.8 percent). Within the growth index, healthcare (up 36.9 percent), nominally weighted telecommunication services (up 35.4 percent), materials (up 22.2 percent) and industrials (up 20.3 percent) led sector results. Energy (down 23.2 percent) was the only sector to finish with negative results for 2017, largely due to weak oil prices

Portfolio Review[2,3]

Eagle Small Cap Growth portfolios Eagle Small Cap Growth portfolios led (on a gross basis) the benchmark Russell 2000 Growth Index during the fourth quarter. Outperformance primarily came from the portfolios' information technology holdings while energy holdings also contributed to positive relative returns. Soft relative results within the financials sector slightly tempered the portfolios' outperformance.

For the full year, the Eagle Small Cap Growth portfolios outperformed (on a gross basis) the benchmark Russell 2000 Growth Index. Information technology was the standout sector as the portfolios' holdings there posted strong returns. Solid absolute and relative results within the industrials sector also contributed. The portfolios' healthcare sector holdings posted strong absolutely performance over the course of 2017 but were ultimately outpaced by their benchmark counterparts. Soft relative returns within the financials sector also weighed on the portfolios' relative returns.

SAGE Therapeutics, which develops therapies used to treat rare central-nervous system disorders, saw shares jump twice in the quarter after announcing positive trial results for drugs aimed at treating postpartum depression and major depressive disorder.

Coherent continues to benefit from strong orders for its Smartbeam product used in the fabrication of organic light-emitting diode (OLED) displays increasingly used in smartphones. The product is sold out through 2018 with incremental capacity coming on in 2019. Further, we believe the potential for applications of Coherent's equipment (e.g., in tablets, autos and television) provide upside over the longer term.

Penn National Gaming owns and manages several U.S. gaming and casino properties under different brand names. Shares continued their upward trajectory after the company agreed to purchase Ameristar Casinos, which analysts believe will be a beneficial acquisition.

Cavium, which makes semiconductors used in network equipment (e.g., security appliances), was announced to be acquired by Marvell Technology Group during the quarter.

Laser-maker IPG Photonics continues to benefit from the solid competitive positioning of its high-power lasers as well as cost advantages vs. its peers.

Universal Electronics, a manufacturer of remote controls for television sets, said it was having manufacturing issues due to an abundance of new-product orders for its advanced remote-control product and related startup expenses. We would expect solid revenue growth and gradually improving margins as the company works through those issues and we continue to believe its longer-term prospects are intact.

Biohaven Pharmaceutical develops drug treatments for rare neurological conditions. The firm reported clinical trial results for a drug to treat a neurodegenerative disorder that did not meet the primary endpoint. That was disappointing but the company is expected to report trial results for an acute migraine-therapy candidate early in 2018 that could boost its pipeline.

Veeco Instruments sells equipment used to make light-emitting diode (LED) products and tools for semiconductor chips. Competitive pressures and an unfavorable patent ruling in China weighed on the company's stock. We maintain a cautiously optimistic perspective on the firm's long-term prospects.

Biotech firm Akebia Therapeutics saw investor enthusiasm wane in the absence of recent clinical trial data. Akebia is testing a treatment for chronic kidney disease, which could have a large market. We remain optimistic that favorable results could result in this treatment becoming a new standard of care for affected patients.

Software provider Pegasystems is shifting rapidly from a license-based to a recurring subscription model. Its near-term performance has come under pressure but the business-model transition is encouraging. We believe shifting to the subscription model should translate to better performance.

Outlook[2]

Macroeconomic data improved steadily through 2017 and now seems to be further accelerating.

Gross domestic product (GDP) growth is projected to be about 3 percent for the back half of 2017 after years of sub-2 percent numbers. That's not all: Consumer confidence numbers and manufacturing data have been strong, unemployment numbers are at new lows and federal regulations continue to be rolled back. Global growth in Asia and Europe also has been good. Commodity prices have been rising and sector rotation has been good with even beleaguered retailers showing signs of "life after Amazon." The recent tax cut can – in our view – only further accelerate the economy. We believe GDP growth could potentially approach 4 percent by the back half of 2018. Some industries will have labor shortages and wages may finally push higher. We believe the administration's pro-business agenda has been instrumental in driving an improved economy but higher wages are critical to the success of the program. Interest rates have remained – and will continue to be low on an historical basis – through all this. The U.S. Federal Reserve appears poised to raise rates three to four times this year by increments of 0.25 percentage basis points. We believe the Fed has done a good job of modest tightening and broadcasting its intent. Valuations may appear expensive by historical measures – small-cap stocks currently trade at 21.5 times earnings – but that ratio declines to about 18 times earnings after adjusting for tax revisions. It seems the moon, sun and stars are aligned for at least a positive start to the year for equities. However, our concern is that markets tend to go against the consensus, which clearly is bullish.

The outlook for the energy sector appears to us to be positive due to improved supply/demand

Top 10 Holdings

- Waste Connections
- Coherent
- Cognex
- IPG Photonics
- Penn National Gaming
- RSP Permian
- Nutrisystem
- Ultimate Software Group
- Cavium
- PTC

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.

Small Cap **Growth**

Fourth Quarter | 2017

	Best Securities	Average Weight (%)	Security Contribution to Return
Small Cap Growth	SAGE Therapeutics	0.69	0.77
	Coherent	3.08	0.58
	Penn National Gaming	1.69	0.51
	Cavium	1.52	0.36
	IPG Photonics	2.14	0.33

Worst Securities	Average Weight (%)	Security Contribution to Portfolio Return
Universal Electronics	1.67	-0.50
Biohaven Pharmaceutical	0.53	-0.22
Veeco Instruments	0.54	-0.21
Akebia Therapeutics	0.67	-0.20
Pegasystems	0.89	-0.18

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Investments in small-cap companies generally involve greater risks than investing in larger capitalization companies. These companies often have narrower commercial markets and more limited managerial and financial resources than larger, more established companies. As a result, their performance can be more volatile and they face greater risk of business failure, which could increase the volatility of a fund's portfolio. Additionally, small-cap companies may have less market liquidity than larger companies.

Growth companies are expected to increase their earnings at a certain rate. When these expectations are not met, investors may punish the stocks excessively, even if earnings showed an absolute increase. Growth company stocks also typically lack the dividend yield that can cushion stock prices in market downturns. The companies engaged in the technology industry are subject to fierce competition and their products and services may be subject to rapid obsolescence. The values of these companies tend to fluctuate sharply.

fundamentals for oil. Global oil inventories gradually tightened through the second half of 2017 and appear poised to return to normalized levels in 2018. Oil production from North American shale has continued its upward climb but management teams across the industry are now acutely aware that investors are demanding satisfactory returns on invested capital. Importantly, we believe the equity markets will no longer offer a financing mechanism to bridge the funding gap between operations and drilling budgets: the hallmark of the energy boom. With this fiscal constraint in place, we believe that higher oil prices are necessary in 2018 to fund drilling activities to meet strong global demand for oil. In an environment where investors are more closely scrutinizing drilling returns and disproportionately rewarding the companies that need minimal external funding to grow production, we continue to favor companies that control leasehold positions in the Permian Basin.

On the heels of a strong performance in 2017, the materials and industrials sectors appear to us to be poised for further gains in 2018. The prospects for continued earnings growth in both sectors are good due to strengthening economic activity bolstered by a recovery in the energy sector and sustained momentum in the supply-constrained housing market. Encouragingly, the Institute for Supply Management (ISM) Manufacturing Index rose 1.5 points in December to 59.7: its second-highest reading since February 2011 and near its best level since mid-2004. Additionally, new-home sales surged 17.5 percent, the biggest gain since January 1992, in November to a 733,000 unit annual rate: the highest level since July 2007. Given this backdrop, we will continue to favor building products and materials industries. Finally, it is important to note that the industrials and materials sectors are projected to benefit greatly by the lower corporate-tax rate, which represents a catalyst for significant earnings growth in 2018.

Leaving 2017 in the rearview and moving into 2018, the $3 trillion healthcare industry retained its position as the largest in the U.S. economy while continuing to grow in the 4 percent-5 percent range. Given its sheer size, one would expect the law of large numbers to begin to impact the industry's growth rate. However, the combined tailwinds of an aging population, longer lifespans and new medical innovations remain poised to support greater-than-GDP growth rates within the healthcare industry. However, as has largely been the case recently, it remains in a state of organized chaos. A great deal of uncertainty remains regarding the status of Obamacare as only a minor adjustment to the legislation has been achieved after two previ-

ous failed attempts for overhaul, leaving major players such as health systems, providers, manufacturers and distributors to wonder what – if any – further industry reform is possible. The adoption of high-deductible health plans, coupled with health savings accounts (HSAs), have forced employees to shoulder a much larger burden of their insurance premiums and other out-of-pocket healthcare expenses, ultimately encouraging patients to curtail their medical utilization.

In light of the sustained uncertainty in the healthcare space, we maintain our favorable disposition toward healthcare companies providing "cash-pay" products and services (e.g., aesthetics, pet care, contact lenses and dental products and services). The products and services that these types of companies provide are targeted directly at the consumer. Those firms generally have little regulatory or reimbursement impact from the federal government but, rather, are largely influenced by consumer confidence and other broad economic factors. Telemedicine has arrived and is gaining traction with managed care and healthcare systems as they realize its benefits, namely access to quality care at a much lower cost. The U.S. healthcare system's transformation from volume- to value-based will – in our view – favor organizations with scale, which likely will be driven by strategic mergers and acquisitions (M&A). Finally, advancements in biotechnology are increasingly yielding therapies that are curing patients of otherwise chronic, expensive or fatal conditions. The ongoing innovation of these firms should continue to draw interest from investors as they develop cost-effective treatments that show meaningful results and serve large markets.

The outlook for the financials sector remains constructive – in our view – as we head into 2018 with healthy levels of economic growth coupled with a rising-interest-rate environment. The possibility of multiple rate increases in 2018 should drive quality earnings growth at those banks with asset-sensitive balance sheets. Loan growth across the financials sector should see improvement as we move through 2018 and gain more certainty on both healthcare and tax policy. Credit quality across consumers and businesses is expected to remain benign but we would not expect to see broad improvements in credit quality from these levels. In addition to the macroeconomic-level drivers within financials, we continue to pursue opportunities in companies that are utilizing technology to improve the performance and value-added proposition of their products. We are also pursuing opportunities in companies at the forefront of changes in the consumer-payment landscape. We believe those types of opportunities should help drive meaningful market-share gains.

We believe continued stability and, in some cases, improvements in global macroeconomic trends should help technology spending remain healthy into 2018. Improving consumer confidence, small-business optimism and lower corporate-tax rates offer optimism for growth in technology spending. Despite the market's healthy performance in 2017, we expect M&A activity to continue into 2018 given fairly palatable interest rates and a seemingly sympathetic political environment in Washington, D.C. We continue to focus on what we view as high-quality companies with strong management teams that are well-positioned to gain market share. Additionally, we are striving to identify names that we believe will benefit from long-term secular growth trends with themes that include security software, cloud computing, artificial intelligence, mobility, e-commerce, digital advertising, factory/industrial automation, security software, e-gaming and alternative energy. We remain positive on semiconductor fundamentals despite the outperformance of the group and are seeing a global increase in demand for factory-/industrial-automation equipment.

We expect consumer stocks to have a strong start to the year given the positive macroeconomic backdrop. Consumer confidence remains at historically high levels and we believe it may improve further reflecting the recent tax-rate reduction. Secular challenges remain but even the beleaguered retail sector showed strong gains in the fourth quarter. The recent cold-weather snap could be a boost for certain retailers. Important housing and auto statistics remain very strong. Consumers continue to favor experiential activities; consequently, we favor beneficiaries such as cruise lines, fitness and gaming. Other attractive areas are stocks tied to autonomous driving. Finally, we believe housing and building-related stocks are also well-positioned in the current environment.

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Small Cap **Growth**

Fourth Quarter | 2017

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[3] Source: FactSet, Frank Russell Co. Statistics represent an aggregate of all portfolios.