Eagle Insight

EAGLE | Asset Management
AN AFFILIATE OF CARILLON TOWER ADVISERS

Small Cap Growth

First Quarter | 2018

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Market Overview

Small-cap stocks posted varied results in the midst of substantial volatility during the first quarter as the Russell 2000® Growth Index[1] (up 2.3 percent) outperformed the Russell 2000 Value Index (down 2.7 percent). Sector-level returns within the Russell 2000 Growth were primarily led by strong results within information technology (up 9.9 percent) while healthcare (up 6.4 percent) also meaningfully contributed to returns. Results within the energy sector (down 15.5 percent) most notably weighed on index returns while real estate (down 7.3 percent), consumer staples (down 4.3 percent) and consumer discretionary (down 3.1 percent) also declined.

Portfolio Review[2,3]

Eagle Small Cap Growth portfolios trailed the benchmark Russell 2000 Growth Index during the first quarter. The portfolios' information technology sector detracted most notably because, despite positive absolute returns, our holdings there failed to keep up with those of the benchmark. To a lesser extent, the portfolios' consumer discretionary and financials holdings also slightly weighed on relative returns. Solid results within energy somewhat tempered the broader portfolios' relative underperformance while positive relative returns within industrials also helped to provide some offset.

Atara Biotherapeutics develops drug therapies focused on treating degenerative muscular conditions as well as cancer. The firm's lead program, which is focused on the treatment of Espstein-Barre virus-related cancers, is progressing well through clinical trials. Further, there was increased optimism about Atara's prospects for the treatment of multiple sclerosis.

Nektar Therapeutics is a clinical-stage biopharmaceutical firm. Shares rose when Nektar provided a favorable update via clinical-trial data from one of its immuno-oncology drug candidates.

PTC develops and markets product-development software. PTC has done well in transitioning its business to a recurring-subscription model; further, its new products targeting the industrial "internet of things" market have sold well.

Proofpoint is a security-software company that continues to perform well as customers move their email security "to the cloud." Proofpoint has also made small acquisitions that support longer-term growth prospects.

RSP Permian is an energy exploration-and-production (E&P) operator in the Permian Basin of West Texas. Shares rose at the end of the quarter as the firm was announced to be acquired by Concho Resources.

Coherent makes systems used in the fabrication of organic light-emitting diode (OLED) displays. Shares fell in the wake of an underwhelming launch of Apple's iPhone X. Despite the near-term setback, we believe Coherent is oversold at current levels given the potential for applications of its Smartbeam system (e.g., in tablets, autos and television), which we believe provides compelling upside over the longer term.

Nutrisystem sells prepared meals primarily to individuals looking to manage their weight. Following a strong performance in 2017, shares declined as difficult year-over-year comparisons led the firm to miss earnings estimates during the quarter. That's a near-term disappointment but we maintain a cautiously optimistic outlook given what we view as the firm's solid fundamentals.

Cognex sells "machine vision" systems used to monitor various aspects of manufacturing and distribution processes. Its year-over-year growth-rate comparisons will be more difficult after a very strong 2017 and the stock consequently pulled back. We continue to like the company's competitive position in the factory-automation market.

Penn National Gaming owns several casino properties under different brand names. Shares declined modestly after the firm reported mixed quarterly results; further, investors looked for additional clarity regarding the acquisition of Pinnacle Entertainment (announced toward the end of 2017).

Exact Sciences manufactures cancer-screening tests. Perceived competitive pressures, coupled with investor concerns over potential moderation of the firm's growth prospects, weighed on the stock. We believe Exact has solid positioning because its products generally are more cost-effective and less invasive than those of its peers.

Outlook[2]

Fears of a trade war, compounded by relatively high valuations, led to extreme volatility at the end of the first quarter that has continued into the current quarter. Ultimately, we believe there is a high probability that the trade situation will ultimately resolve itself without significant consequences. After all, President Trump cares very much about the economy and the stock market; similarly, the Chinese government has incentive be rational. This is not Republicans vs. Democrats.

The recent volatility appears to us to be a normal correction and not the beginnings of a bear market. Gross domestic product (GDP) growth is strong, the benefits of the tax cuts are just beginning, unemployment is approaching all-time lows and both consumer and business confidence are positive. With the recent retrenchment, some excesses were quickly corrected and valuations appear reasonable to us with the 2018 broad S&P 500 Index price currently projected at about 16 times earnings. The U.S. Federal Reserve's tightening has caused a slight uptick in interest rates but we don't believe 10-year Treasuries at 2.85 percent are anywhere near high enough to derail the economy. We also believe the Federal Reserve is very sensitive about overshooting on its rate increases. We expect strong first-quarter earnings from the majority of our companies with mostly positive guidance. We believe we are still in a secular bull market and view the recent weakness as a normal correction and, as such, remain bullish.

Despite a tumultuous start to the beginning of the year, we believe the outlook for the energy sector remains positive. The dramatic year-to-date underperformance represents a sharp disconnect with the continued tightening in oil markets. Investor sentiment toward the sector remains very subdued as oil production from North American shale continues to show strong growth. This myopic view overlooks a number of positive factors that more than offset concerns that North American oil production will overwhelm the market. Importantly, demand for oil continues to be extremely robust due to strong growth in the global economy. On the supply side, the Organization of the Petroleum Exporting Countries (OPEC) continues to adhere to its quotas while important oil-producing nations (e.g., Venezuela) are seeing sharp production declines. Against this backdrop, we continue to have a positive bias toward exploration-and-production (E&P) operators with attractive leasehold positions in the Permian Basin. Many of the stocks in the energy sector offer – in our view – the potential for an acceleration in earnings growth along with attractive valuations.

The outlook for the industrials and materials sectors appears positive to us with the global economy showing signs of broad-based strength. Most stocks in both sectors pulled back in the first quarter as investors grappled with rich valuations while further calibrating the

Top 10 Holdings

Cognex
RSP Permian
IPG Photonics
Waste Connections
Coherent
PTC
Ultimate Software
POOLCORP
Penn National Gaming
John Bean Technologies

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

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	Top Securities	Average Weight (%)	Security Contribution to Return	Bottom Securities	Average Weight (%)	Security Contribution to Portfolio Return
Small Cap Growth	Atara Biotherapeutics	0.97	0.57	Coherent	2.55	-0.99
	Nektar Therapeutics	1.05	0.56	Nutrisystem	1.31	-0.80
	PTC	1.75	0.41	Cognex	2.51	-0.39
	Proofpoint	1.38	0.32	Penn National Gaming	1.71	-0.31
	RSP Permian	1.68	0.29	Exact Sciences	1.15	-0.29

*As of March 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.

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.

expected impact of tax reform and considering the possibility of a trade war. Raw materials have risen considerably and will likely pressure profit margins; however, we believe that will be a short-lived concern. In the intermediate term, most companies successfully will pass higher costs to customers and, in many cases, companies will more than offset higher costs through price increases. On an industry level, we remain positive on the building-materials group. The steady recovery in residential housing continues to build momentum and should help support mid- to high-single-digit revenue growth for companies in that industry.

In the current environment, the burgeoning healthcare sector remains the largest in the U.S. economy in the form of a $3.5 trillion industry that continues 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 previous 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), has 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, veterinary products and services as well as dental and orthodontic procedures). 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 – with healthy levels of economic growth coupled with a gently rising interest-rate environment. The backdrop of multiple rate increases projected this year should drive quality earnings growth at those banks with asset-sensitive balance sheets. We believe loan growth across the financials sector will see improvement as we move through 2018; however, it has yet to gain substantial traction thus far. 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 offerings as institutions and consumers alike are evolving in the way they purchase and utilize many financial products. We are also pursuing companies at the forefront of changes in the consumer-payment landscape that we believe will see meaningful market-share gains.

Despite the recent increase in stock-market volatility, we continue to believe that global macroeconomic trends remain generally positive. That, in turn, should help technology spending remain healthy as we move further into 2018. For example, consumer confidence appears steady while improving small-business sentiment and lower corporate-tax rates offer optimism. We would expect M&A activity to continue given fairly palatable interest rates, healthy balance sheets and a seemingly sympathetic political environment in Washington, D.C. We remain focused 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 cloud computing, artificial intelligence, mobility, e-commerce/digital payments, factory/industrial automation, security software, e-gaming and alternative energy.

Consumer stocks trailed the market during the first quarter as several interest-rate-sensitive groups underperformed based on fears of higher interest rates. We believe those fears are overdone and don't view nominal rate increases from current historically low levels as a threat to the economy. Even some long-beleaguered mall-based retailers are seeing signs of recovery. Housing is strong and should continue gradual recovery for at least the balance of this year. Additionally, auto sales have remained resilient. On balance, tax reform was a big positive for consumer companies since they tend to be full taxpayers. Finally, much of the "millennial" generation continues to exhibit its preference for experiential activities such as cruises, fitness and gaming.

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