Smaller Company Strategy

First Quarter | 2018

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Investments in small-cap companies generally involve greater risks than investing in larger-capitalization companies. Small-cap 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.

Market Overview

The first quarter of 2018 ended up being a good one for small-cap stocks despite some turmoil. The Russell 2500™ Index was essentially flat in the quarter, down just 0.60 percentage points. The leading sectors from last year – information technology and healthcare – continued to outperform, while energy and yield-oriented sectors – real estate investment trusts (REITs) and utilities – underperformed. Investors continued to prefer stocks with lower volatility and companies with less financial leverage. Momentum continued to be a hot theme although there are some signs the heat may be fading. Yields on the 10-year Treasury advanced strongly out of the gate before normalizing back to 2.74 percent, reflecting increased expectations for Federal Reserve rate increases. The much-discussed spike in volatility in February, while violent, seems to represent a return to normalcy from record-low levels of volatility in January 2018 and throughout 2017.

One noteworthy change was the improving relative performance of small-cap stocks vs. large-caps that emerged since the Jan. 26 market peak.

Portfolio Review[2,3]

Eagle Smaller Company Strategies outperformed (on a gross basis) the benchmark Russell 2500™ Index. Our portfolio continued to benefit from style preferences toward companies with higher profitability, lower leverage and lower volatility. We achieved strong stock selection in consumer discretionary and real estate sectors. Conversely, selection among information technology and healthcare stocks hurt performance.

Qualys offers computer security and compliance solutions. The company reported good growth for its newest product lines as well as its legacy offerings. Qualys also expanded operating margins, cash flow and bookings. The accelerated pace of major security breaches (e.g., Equifax) has kept demand for the company's products high.

HEICO provides parts and electronics for aerospace, defense and other industries. The company reported strong quarterly and full-year 2017 results, and provided encouraging 2018 guidance.

POOLCORP is the world's largest wholesale distributor of swimming pool supplies and equipment. The shares outperformed as the company continues to benefit from a high recurring revenue stream and a growing installed base of swimming pools.

Ultimate Software develops web-based payroll and human resource management software solutions. After reducing guidance last summer, which the company claimed was a timing issue and not a reflection of the general health of the business, the company reported quarterly results that supported its view and gave an outlook that was modestly above current expectations. Investors seemed satisfied and the stock trended up in the period.

ICU Medical is a provider of infusion therapy (IV) equipment and supplies. The company had another strong quarter after acquiring the IV pump system from Pfizer. The company's oncology business was up and it expected to continue its strong growth.

Cimarex Energy is an oil and gas exploration and production company with assets located primarily in Texas and Oklahoma. The company's shares underperformed due to investor concerns about natural-gas prices and some lackluster results from several competitors. We continue to believe the company has outstanding assets and management.

Snap-On makes tools, diagnostics and related equipment for the automotive service industry. The company's shares underperformed due to ongoing concerns about growth in its core tools business. We share these concerns but we believe management is appropriately addressing the issue via new-product development and enhancement of the sales network.

Prestige Brands supplies over-the-counter healthcare products including brands such as Monistat, Clear Eyes, and Luden's. The company missed quarterly expectations. Prestige described the elevated costs as temporary. Management has executed poorly of late but we continue maintain our current position (not adding to it) as the valuation is attractive and some of the headwinds appear industry-wide.

Cognex makes machine vision systems. The company reported very good quarterly results but gave an outlook that was slightly below expectations. That fueled fears of the potential impact of a slowdown at Apple, the company's largest customer. We believe the long-term demand backdrop remains strong enough to more than offset a slowdown at Apple.

CoreSite Realty is a REIT that focuses on data centers. The shares underperformed as higher interest rates reignited fears of asset re-pricing and higher capital costs. CoreSite also experienced its slowest leasing quarter in about four years. We remain shareholders because we like the company's sector-leading internal growth and return on invested capital.

Outlook[2]

In our fourth-quarter letter we opined that the healthy global economic backdrop that drove a strong 2017 equity market would likely persist into 2018. That statement seemed prescient for the first few weeks of 2018 as stocks rallied to new highs through January. Volatility ensued, resulting in essentially flat returns.

We still believe fundamentals remain in place to support positive equity market returns, despite the reemergence of volatility and uncertainty created by global trade dynamics. Our investment team welcomes volatility back into the equity market. We believe our focus on fundamental analysis, differentiated franchises and effective management teams will be rewarded.

Global gross domestic product (GDP) growth is healthy, manufacturing activity is robust and the job market is strong. Tax cuts should stimulate both consumer and corporate spending and liquidity is plentiful. Interest rates remain low despite Fed tightening and improved infrastructure spending seems likely. These issues together create a healthy environment for earnings growth and potential equity returns.

As we enter the second quarter our portfolios remain overweight the healthcare sector. We continue to find opportunities in the equipment and diagnostic industries. Those companies improve outcomes, control costs and benefit from the demographic tailwind inherent in the sector.

Tech companies should – in our view – benefit from improved capital spending and focus on operating efficiency. Emerging trends such as the "internet of things," automation, artificial intelligence and machine learning will be tailwinds for the foreseeable future.

Top 10 Holdings

NICE
HEICO
STERIS
Berry Global Group
LabCorp
Reinsurance
Ultimate Software
Catalent
Diamondback Energy
South State

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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Top Securities	Average Weight (%)	Security Contribution to Portfolio Return	Bottom Securities	Average Weight (%)	Security Contribution to Portfolio Return
Qualys	1.43	0.30	Cimerex Energy	1.22	-0.36
HEICO	2.15	0.29	Snap-On	1.51	-0.26
POOL	1.71	0.22	Prestige Brands	0.63	-0.20
Ultimate Software Group	1.90	0.22	Cognex	1.13	-0.19
ICU Medical	1.17	0.18	CoreSite Realty	0.85	-0.18

* 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.

We also remain constructive on both the industrial and materials sectors. These companies generally have leverage to improved economic conditions both here and abroad. Our companies should benefit not only from lower corporate taxes but also pricing power driven by higher levels of inflation.

Financials remain an area of focus. Modest reflationary trends, higher long-term interest rates and lower corporate taxes should be positive for this group. Better economic activity could drive stronger loan growth and earnings.

We remain cautious on the consumer sectors. Tax cuts should put more money in consumers' pockets and we may see some improvement in wage gains. However, the traditional consumer landscape remains challenging and fraught with revenue and margin pressures.

We remain confident in our ability to find attractive investment options and build portfolios with what we view as well-managed, differentiated businesses. As always, we thank you for your trust and confidence.

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[3] Source: FactSet