Eagle Insight

EAGLE | Asset Management
AN AFFILIATE OF CARILLON TOWER ADVISERS

Smaller Company Strategy

Fourth Quarter | 2017

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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 fourth quarter was another strong quarter for small-/mid-cap equities, with the Russell 2500 Index gaining 5.2 percent in the quarter and 16.8 percent for the full year. Gains were seen across most sectors: The industrials sector saw the largest gains while the higher-yielding real estate, utilities and telecommunications services sectors generally lagged.

The quarter appeared to be a continuation of the trends we saw throughout 2017: Outperforming stocks tended to be larger companies that already have been executing well with better balance sheets and higher profitability. We continue to see the logic and believe it is reflective of a market in the later stages of the economic cycle. We continue to believe that more profitable and less-levered names continue to represent the strongest relative risk/reward for the remainder of this cycle but we acknowledge that if the macroeconomic activity reaccelerates (potentially influenced by fiscal policy), investors may seek relatively cheaper stocks at the expense of momentum names where valuations appear stretched. Our investment process focuses on companies that we believe have strong management teams and superior financial profiles while also seeking those with the best relative value.

Portfolio Review[2,3]

Eagle Smaller Company Strategy portfolios outperformed (on a gross basis) the benchmark Russell 2500 Index. The biggest contributor to outperformance was stock selection among information technology stocks, where we saw double-digit advances across most of our software and electronic equipment holdings. Similarly, we had positive stock selection from most other sectors where our style preferences appear to have aided overall results. Conversely, our industrial and materials holdings modestly underperformed on a relative basis.

Diamondback Energy is an oil and gas exploration-and-production (E&P) company with operations focused in the Permian Basin of West Texas. Diamondback reported continued strong earnings and oil-price strength. We continue to like this company and its prospects for profitable growth.

Discount retailer Burlington Stores reported better-than-expected quarterly results. It's also expected to be a beneficiary of the reformed U.S. corporate-tax code. We continue to like its long-term growth potential.

NICE, which provides software solutions and services, reported good financial results for the quarter. The company said its initiatives continue to deliver consistent revenue growth. Recurring revenue now represents 69 percent of the total, which adds a significant level of predictability to the business model.

FLIR Systems, which sells thermal-imaging products and diagnostic systems, reported solid financial results and strong year-over-year growth. Additionally, the company provided an outlook that met analysts' expectations.

John Wiley & Sons sells academic journals and books; employment assessments and training; test-preparation and other online education products. The company reported stronger-than-expected publishing performance and the announcement of a new chief executive. We like that more than 50 percent of the company's revenue is either subscription-based or recurring under multiyear contracts; further, it has a strong balance sheet that could allow for ongoing dividends, share repurchases, internal expansion or acquisitions.

Smaller Company **Strategy**

Fourth Quarter | 2017

Forum Energy Technologies, a diversified oilfield-services company, underperformed along with many of its oil-services peers. Oil prices improved but excess capacity – combined with capital discipline among the oil producers – restrained pricing and profitability. We became concerned about the degree of Forum Energy's operating leverage and sold our position.

Medidata Solutions, which sells cloud-based services for clinical research, missed quarterly results. We believe the miss was more of a timing issue and that Medidata's business model can generate significant cash flow. We took advantage of the downturn to add to our position.

Black Hills, a South Dakota-based electric and gas utility reported a disappointing earnings outlook. We sold our position given the lack of earnings visibility for the next couple of years.

Prestige Brands sells over-the-counter health-care products under brands such as Monistat, Clear Eyes and Luden's. The company missed quarterly expectations due to order delays attributed to the hurricanes in Florida and Texas. We added slightly to our position when the price dipped because we believe the delays are a temporary issue.

Primoris Services is a U.S. engineering and construction company that operates in the commercial and municipal markets. It reported strong earnings but the market reaction was negative due to concerns about tepid guidance. We sold Primoris and bought one of its peers with a slightly higher market capitalization and what we view as more attractive markets

Outlook[2]

2017 was a year of record highs for all major U.S. equity indices, long streaks of singularly positive markets and consistently muted volatility. Large-cap stocks trounced their smaller brethren and gains were broad-based. In fact, roughly 75 percent of S&P 500 Index stocks were positive in 2017 and nearly 40 percent were up 20 percent or more. Investors ignored political drama and policy uncertainty emanating from Washington and drove stocks steadily higher through the year.

As we survey the 2018 landscape, we see most of the positive market drivers intact … if not improved. The significant reduction in the U.S. corporate tax rate should drive earnings growth on its own. Whether lower taxes for some portion of the population drives improved consumer spending remains open for debate but it should be positive on the margin. The same holds true for corporate capital spending.

Global economic growth remains healthy across major markets (e.g., the United States, Eurozone, China and Japan). Monetary stimulus is nearing its end globally and has reversed here in the United States. But we believe central bankers will continue to err on the side of conservatism given the modest amount of inflation in the economy. We expect U.S. interest rates to increase modestly but not enough to cause meaningful multiple contraction in equities.

Overall, we expect continued healthy equity markets driven by earnings growth in 2018.

As we enter the new year, we are positive on healthcare, technology, industrials, materials and financials. We are cautious on the consumer sectors.

In healthcare, the potential for change persists on a policy level in Washington but we continue to find opportunities in the equipment and diagnostic areas industries. Those companies improve outcomes, control costs and benefit

Top 10 Holdings

NICE
HEICO
LabCorp
South State
Diamondback Energy
Catalent
STERIS
Snap-on
Ultimate Software Group
LKQ

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.

Smaller Company **Strategy**

Fourth Quarter | 2017

	Best Securities	Average Weight (%)	Security Contribution to Portfolio Return	Worst Securities	Average Weight (%)	Security Contribution to Portfolio Return
Smaller Company Strategy	Diamondback Energy	1.37	0.40	Forum Energy Technologies	0.67	-0.16
	Burlington Stores	1.33	0.36	Medidata Solutions	0.77	-0.14
	NICE	2.89	0.36	Black Hills	0.84	-0.14
	FLIR Systems	1.74	0.32	Prestige Brands	0.89	-0.12
	John Wiley & Sons	1.18	0.28	Primoris	1.01	-0.11

* 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.

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. Further, a reduction in the corporate-tax rate, cash repatriation and research-and-development tax credits bode well, we believe, for the sector.

We also remain constructive on both the industrial and materials sectors whose companies generally appear to be beneficiaries of improved economic conditions here and abroad. We believe our holdings will benefit from lower corporate taxes and pricing power driven by higher levels of inflation. In materials, we continue to like certain packaging companies' characteristics, including relatively steady demand, often pass-through commodity pricing and steady cash generation. 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 look forward to all the challenges and opportunities that 2018 will undoubtedly offer. 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