Value

First Quarter | 2018

Ed Cowart, CFA
Portfolio Co-manager

David Blount, CPA, CFA
Portfolio Co-manager

Harald Hvideberg, CFA
Portfolio Co-manager

Value investing is based on the potential for a company's stock price to rise based upon anticipated changes in the market or within the company itself. Value stocks have historically been sensitive to economic cycles and investor sentiment that can affect volatility and risk.

Market Overview

After gaining nearly 6 percent to start the year, the broad U.S. equity market (as measured by the Russell 1000® Value Index) traded lower (-2.8 percent) in the first quarter for the first quarterly loss since 2015. A spike in volatility triggered the selling, followed by fears over potential regulation of many of the market's best-performing technology stocks. The selling intensified as news from Washington centered on new tariffs against China, sparking fears over a potential trade war endangering a $600 billion relationship. This quarter also featured new Federal Reserve Chairman Jerome Powell leading his first increase in the Federal Funds rate; Congress passing a spending bill; and oil prices trading higher, further increasing inflation concerns.

Portfolio Review[2,3]

Eagle Value portfolios outperformed (on a gross basis) the benchmark Russell 1000® Value Index during the first quarter. Stock selection within the industrials, information technology and real estate sectors was particularly strong. However, stock selection in healthcare, financials and materials proved weak.

Microsoft announced impressive quarterly revenue growth, particularly in the cloud business. Margins also continued to grow impressively.

Cisco Systems returned to revenue growth after facing headwinds during its transition to a recurring-revenue model. The company also announced it would bring back all foreign cash ($65 billion) and return it to shareholders. Cisco increased its dividend 14 percent and added $25 billion to its share-buyback program.

Total System Services also announced strong earnings on accelerating growth. The company said it should be a beneficiary of the new U.S. corporate-tax package.

PNC Financial announced positive quarterly earnings. The company is expected to benefit from U.S. corporate-tax reform and will now have a 17 percent tax rate. A higher 10-year Treasury also benefited the company as it is highly asset-sensitive.

Results were better-than-expected at BB&T. The company continues to progress on the operating-leverage front, leading to a solid earnings outlook.

Wells Fargo stock underperformed primarily as a result of the Fed's announcement that it is placing an asset cap on the bank, thereby preventing it from growing beyond 2017 levels. The cap is expected to reduce earnings 1 percent-3 percent, which we believe is a modest headwind, and we are hopeful that it is lifted by the end of this calendar year. Finally, we note that the Fed didn't identify any new issues.

Citigroup underperformed due to a lower degree of perceived asset-sensitivity in a rising-rate environment. Banks' balance sheets can change with fluctuations in interest rates and those that are perceived to have their assets reprice more slowly underperformed.

Devon Energy announced lower-than-expected earnings; however, it said the miss was due to a change to a more conservative accounting measure. Positively, the company announced a new three-year operation plan, including selling more than $3 billion of non-core assets while increasing production by 25 percent. Devon plans to reduce leverage with excess cash-flow while returning the rest to shareholders.

Zimmer Biomet rallied into the end of 2017 led by enthusiasm for the appointment of its new chief executive. The stock underperformed in the first quarter after the new executive team provided conservative commentary around the timeline for a turnaround of the business.

Celgene suffered a disappointing setback with the pushout of FDA approval timelines for one of the company's most important new-drug candidates. The stock's underperformance reflects this delay and investor frustration with the company's execution over the last six months.

Outlook[2]

The U.S. stock market entered 2018 looking a lot like 2017: low volatility, a broad advance led by large technology stocks and investors optimistic (if not complacent). But something changed around mid-January. Volatility resurfaced with a vengeance. The proximate cause of the early downdraft in stocks was growing concerns about inflation and interest rates. But as the quarter unfolded, volatility continued, new concerns arose about a trade war with China and there was real questioning of some large-cap tech companies' business models added to the mix. Consequently, the U.S. market recorded its first quarterly decline since 2015.

The volatility and concerns continue as we enter the second quarter. But stepping back from the day-to-day ups and downs of the market, we continue to believe that the underlying fundamentals are sound. None of the normal, historical precursors of recession and bear markets are present. Economic growth is solid almost anywhere one looks around the world. In the United States, we expect gross domestic product (GDP) growth to improve from the approximately 2 percent annual rate it has been stuck at since the financial crisis now nearly 10 years in the past. After years of underinvestment, domestic capital spending is poised for acceleration. Led by surging employment growth and abetted by somewhat better wages and lower taxes, household incomes are growing again. Housing construction activity, which historically has been a key driver of U.S. economic growth, is set to accelerate based on demographics and underinvestment since the crisis in 2007-2008. Earnings growth this year should approach 20 percent, boosted by the recently enacted tax bill and faster GDP growth.

To be sure, there are concerns on the horizon … but there always are. The Federal Reserve likely will continue to normalize interest rates this year. There is a grand debate about how many times the Fed will raise rates. Our position is informed by the straightforward observation that gradually rising interest rates – from a low level, impelled by stronger economic growth – historically have not been an impediment to higher stock prices. We believe there is still enough slack in the global markets for goods, commodities and labor to keep inflation at or below most central banks' 2 percent target.

It is possible to paint a dire picture based on a spreading trade war with China and that possibility cannot be ruled out completely. But, in our experience, it is wiser to position portfolios for the most likely outcome and not for a high-risk-but-low-odds result. We believe that, in spite of some real economic concerns and grievances, the impending "trade war" is mostly political posturing and neither side would benefit from a significant escalation. That said, we have to acknowledge leaders make irrational mistakes and, until the air clears, this concern likely will weigh on stocks. Further, it may prevent stronger earnings growth from being fully translated into higher stock prices.

Market corrections such as the ongoing one often have ushered in a change in market leadership. We believe it is quite likely that the technology sector – and especially social-media companies – may struggle for a while. Business models are being questioned if not attacked outright, valuations

Top 10 Holdings

JPMorgan Chase
PNC
Microsoft
Honeywell
Prologis
Union Pacific
BB&T
Citigroup
Delta
Wells Fargo

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.

Value

First Quarter | 2018

	Top Securities	Average Weight (%)	Security Contribution to Portfolio Return	Bottom Securities	Average Weight (%)	Security Contribution to Portfolio Return
Value	Microsoft	4.18	0.27	Wells Fargo	3.19	-0.43
	Cisco	2.34	0.25	Citigroup	3.49	-0.32
	Total System Services	2.65	0.20	Devon Energy	1.21	-0.31
	PNC	4.29	0.18	Zimmer Biomet	2.71	-0.26
	BB&T	3.24	0.14	Celgene	1.65	-0.25

* 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.

seem extreme and the sector is approaching the same share of the market's capitalization that it held during the "internet bubble" that disastrously ended in 2000. A commonly referred to grouping of the most popular technology stocks (a social-media stock, the world's largest online retailer, an online entertainment company and the world's largest search-engine company) sell at 133 times current earnings and 73 times 2018 estimates. That compares to about 17 times earnings for the S&P 500. These four stocks also comprise nearly 8 percent of the S&P 500's market capitalization.

We expect, on the other side of this correction, a much more "democratic" market with many more stocks and sectors showing good performance on the basis of earnings and attractive valuations. We believe a reversal of the dominance of growth stocks compared to value stocks may well be under way. Also, we would expect an attraction to companies with growing dividend streams to re-emerge in a still-low interest-rate environment.

[1] Frank Russell Company (Russell) is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes. Russell® is a trademark of Frank Russell Company. Neither Russell nor its licensors accept any liability for any errors or omissions in the Russell Indexes and/or Russell ratings or underlying data and no party may rely on any Russell Indexes and/or Russell ratings and/or underlying data contained in this communication. No further distribution of Russell Data is permitted without Russell's express written consent. Russell does not promote, sponsor or endorse the content of this communication.

[2] 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.

[3] Source: FactSet.