Eagle Insight

EAGLE | Asset Management
AN AFFILIATE OF CARILLON TOWER ADVISERS

Small Cap Growth

Third Quarter | 2018

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Market Overview

Small-cap stocks continued their upward climb as the Russell 2000® Growth Index1 (up 5.5 percent) led the Russell 2000® Value Index (up 1.6 percent) during the third quarter. Sector returns across the Russell 2000® Growth Index were largely positive during the quarter, led by double-digit returns within communication services (up 14.2 percent), while information technology (up 8.2 percent) and health care (up 7.6 percent) also helped to boost benchmark returns. Energy was the sole declining sector within Growth, down 6.1 percent in the quarter.

Portfolio Review[2,3]

Eagle Small Cap Growth portfolios outpaced the benchmark Russell 2000® Growth Index on a gross and net basis during the third quarter. Solid absolute and relative returns within industrials as well as health care were the primary drivers of outperformance during the period, while positive relative results within the materials sector also helped boost the portfolios' positive relative results. Below-benchmark returns within the information technology and communication services sectors weighed slightly on the portfolios' broader outperformance during the quarter.

Teladoc Health is an industry-leading telemedicine provider that offers remote physician access to patients. Teladoc is benefitting from an increasing awareness of its compelling value proposition, while leveraging strategic acquisitions to expand its customer base and further drive growth.

Ultimate Software Group is a leader in the delivering payroll and other human capital management software for enterprises via Software-as-a-Service model. Investors demonstrated their appreciation for the company's unique competitive position in light of Ultimate Software's combination of solid, steady growth with healthy profitability.

Cognex manufactures machine "vision" systems used to monitor various aspects of manufacturing and distribution processes. The company continues to enhance its positioning as a key player within the growing factory and industrial automation and logistics markets.

Quaker Chemical, which primarily serves heavy industrial and manufacturing markets, continues to execute well, effectively integrating strategic and very complementary acquisitions to bolster growth drive market share gains.

John Bean Technologies provides food processing technology solutions (packaging/sterilization of food products). Shares rebounded during the quarter as strong quarterly results within the firm's core FoodTech segment helped to dispel investor concerns that previously weighed on the stock.

IPG Photonics makes lasers used for cutting and welding. Shares declined as the firm reported disappointing results and guidance, attributable primarily to tariff and trade war-related concerns hurting end market demand. We still believe in the secular growth story of fiber lasers replacing CO2 lasers, and the company's vertical integration strategy to fend off competition.

Weight Watchers saw shares give back some ground during the quarter after a strong run earlier in 2018. The firm reported solid quarterly results during the period; however, growth seemed to be moderating somewhat, causing what we view as a temporary setback. New programs and digital initiatives should result in renewed strong growth in the important January diet season.

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Visteon makes automotive-related electronic components and parts such as heads-up displays and infotainment systems. Recent softness in automotive production volumes in the firm's domestic and European end markets resulted in Visteon reporting lighter-than-expected orders during the quarter.

Construction materials provider Summit Materials saw shares wane as the firm missed quarterly estimates. The decline was attributed in part to a weaker-than-expected pricing environment within its cement segment as well as delays in projects which tempered cement volumes.

Floor & Decor operates home improvement stores with a primary focus on flooring, decor and insulation materials. The firm's results were challenged by difficult year-over-year comparisons. Floor & Decor also slightly reigned in forward guidance as housing market optimism appears to have shown signs of abating.

Outlook[2]

As we enter the fourth quarter, equity markets appear to be focused on several issues which could potentially portend the end to the extended bull market, despite extremely strong economic data. First and foremost, eyes are on the Federal Reserve (Fed). Is the Fed raising rates too high? Or too fast? While the Fed's actions may be appropriate longer term, interest rates are beginning to follow the rise in shorter duration rates. Already the important housing sector is slumping. The escalating trade war with China also threatens to dampen economic growth with certain sectors being disproportionately affected. We are of the opinion that it is in everyone's interest to resolve the trade dispute and ultimately it will be resolved; the question is, how long will it take? The November 2018 midterm elections are also a factor: if Republicans lose their majority in the House of Representatives, it could be seen as a setback to the Trump administration's pro-growth agenda. On a positive note, the underlying reason the Fed is raising rates is because the economy is so strong. Economic growth should approach four percent, unemployment is at record lows, wages are finally moving higher and consumer confidence remains high. It all presents an interesting puzzle for the remainder of the year.

The outlook for the energy sector appears balanced as oil prices have risen to levels that support a balanced market. Specifically, we believe that oil above $70/barrel will encourage drilling activity to grow production enough to meet demand. Risk to the upside in oil prices appears most likely to arise from a supply shock due to a decrease in production from unstable producing nations such as Venezuela. Conversely, we also see possible risks to the downside for oil prices from an economic slowdown in emerging economies, such as China. In the context of this balanced view, we remain optimistic on the outlook for oil production in the Permian Basin in West Texas and continue to believe that exploration and production (E&P) operators with attractive leasehold positions represent compelling investments.

The outlook for the industrials and materials sectors has – broadly speaking – diminished as investors grapple with the sustainability of the current economic expansion. Taking a cue from the uptick in interest rates, investors have grown increasingly concerned that 2019 could represent the peak in the economic cycle and are re-rating valuations accordingly. This dynamic is especially notable in early-cycle industries such as housing and automobiles, as share prices have declined despite higher earnings. Against this backdrop, we continue to favor companies that are exposed to secular growth drivers which can help offset headwinds in a more sluggish economic environment.

In our opinion, the current environment remains

Top 10 Holdings

Ultimate Software Group
PTC
Waste Connections
Teladoc Health
Cognex Corporation
Planet Fitness Class A
Penn National Gaming
Quaker Chemical Corporation
Trex Company
Pool Corporation

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	Top Securities	Average Weight (%)	Security Contribution to Return	Bottom Securities	Average Weight (%)	Security Contribution to Portfolio Return
Small Cap Growth	Teladoc Health	1.69	0.75	IPG Photonics	1.25	-0.47
	Ultimate Software Group	2.02	0.45	Weight Watchers	1.03	-0.38
	Cognex	1.75	0.43	Visteon	1.06	-0.34
	Quaker Chemical	1.50	0.42	Summit Materials	0.55	-0.21
	John Bean Technologies	1.36	0.39	Floor & Decor Holdings	0.42	-0.20

*As of Sept. 28. 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.

poised to support greater-than-GDP growth rates within the healthcare industry given the combined tailwinds of an aging population, longer lifespans, the crippling impact of chronic conditions and new medical innovations. 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 scrutinize their care-related decisions. We also believe that consolidation through mergers & acquisitions (M&A) activity is likely to continue throughout the health care industry.

We strive to identify 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 and subsequently tend to have little regulatory or reimbursement risk from the federal government. The ongoing innovation of telemedicine continues to drive rapid adoption by managed care and health care systems, particularly due to the convenience of improved access to quality care at a lower cost compared to conventional primary care office visits. We continue to pursue opportunities in biotech firms developing revolutionary and innovative therapies to treat diseases and conditions which would have otherwise been chronic, expensive, or fatal.

The outlook for the financials sector remains constructive in our view – albeit with some persistent headwinds. Couple the flattening of the yield curve with an environment where loan demand has remained lackluster, and we see the Fed moving rates higher and the bank stocks underperforming. We expect this tug-of-war between the Fed and the market to continue and we prefer banks with asset-sensitive balance sheets that will benefit from Fed moves over time. Beyond the macroeconomic-level drivers within financials, we see opportunities in firms exposed to areas of the country experiencing outsized job and employment growth. The environment for deal-making remains relatively favorable where opportunities exist for boutique investment banks to grow and take share from the much larger bulge bracket firms. We are also seeing opportunities in the consumer payments space as payment methods evolve in response to millennials' banking behavior. Finally, we believe select domestic U.S. consumer pawn operators possess the potential to leverage their business models abroad, with expansion into Latin America providing growth prospects to complement their more mature core domestic operations.

Consumer stocks had a strong third quarter, led by good performance from specialty retailers.

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Looking to the fourth quarter, strong performance is expected to continue as consumer confidence remains near historic highs, unemployment is low and, belatedly, wages are starting to creep higher. Importantly, the set-up for the holiday season appears favorable as early expectations are for a strong holiday season. In our view, most retailers have developed a stronger balance between brick-and-mortar and online capabilities. While the consumer looks healthy, certain consumer stocks may be in the crosshairs of higher tariffs. With the Federal Reserve continuing to raise interest rates, housing as well as housing-related stocks figure to perform poorly.

In the current environment, the domestic economy appears poised to continue growing at a robust pace and although emerging markets have seen some pressure, the overall global macroeconomic trends have remained strong. As such, we remain optimistic regarding technology-related spending into 2019. With lower tax rates flowing through corporate America, technology spending should remain robust both at the enterprise and consumer levels. Furthermore, unemployment rates continue to tick down while both consumer confidence and small business optimism remain healthy. Despite recent interest rate increases, we would expect merger and acquisition (M&A) activity to continue given very strong balance sheets at the very large technology companies, in addition to a sympathetic political environment in Washington. We remain focused on high quality companies with strong management teams that are well-positioned to gain market share. Additionally, we continue to pursue investment opportunities that benefit from long-term secular growth trends with themes that include cloud computing, artificial intelligence, mobility, e-commerce/digital payments, smart home, factory/industrial automation, security software, e-gaming, and alternative energy.

3. Source: FactSet.