Smaller Company Strategy

Second Quarter | 2018

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Market Overview

The second quarter was a strong one for small- and mid-cap equities, with the Russell 2500™ Index gaining 5.7 percent for the quarter. A rebound in energy and real estate names led the advance, which was also aided by continued strength in healthcare stocks.

Small-cap equities seemed to exhibit "risk-on" characteristics despite less pronounced performance among different asset classes. Specifically, the smallest capitalization stocks showed the most strength with the Russell Microcap® Index up 9.97 percent while the Russell 1000® Index (representing large-cap stocks) was up only 3.57 percent. According to Bloomberg, those stocks with higher price volatility and higher trading volume relative to their size outperformed less volatile and less frequently traded issues.

We believe the relative outperformance of smaller capitalization and more volatile and actively traded securities may be the result of investors rotating allocations away from large-cap and multinational equities (impacted by softer international economies and mounting trade pressure) and towards small-cap equity.

Portfolio Review[2,3]

The Smaller Company Strategy underperformed the benchmark Russell 2500™ Index. Much of the underperformance appears to be due to our preference of stocks with higher market capitalization and less price volatility. The relative underperformance was generally broad-based across most sectors, but most impactful to energy and materials, and not the result of many stock-specific issues. Our information technology sector stocks outperformed in the second quarter.

Software company NICE continued 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. Continued cost controls and financial discipline are being reflected in improved profitability, inspiring further confidence among investors.

Semtech makes analog semiconductor products. Strong bookings and success in its LoRa business (low-power long-range logistics/tracking) helped drive stock performance.

Pinnacle Foods outperformed following the news that the company has been acquired by Conagra Brands for an implied price of $68 per share in cash and Conagra stock.

Medical software provider Medidata delivered over 18 percent revenue growth in the second quarter. At least one of their software modules is used by the top 25 pharmaceutical companies. Medidata is also aiming to reduce costs to the healthcare system by streamlining data.

Investment bank Evercore saw earnings well above estimates. Large merger and acquisition activity continues to be elevated due to easing regulatory hurdles and approval of some contested acquisitions, as well as continued low financing costs.

Berry Global makes plastic products. The company has been unable to increase pricing fast enough to offset increasing costs. Negative headlines describing the impact of improper plastic disposal on the environment has resulted in some changes to customer preference and have weighed on shares. We continue to like Berry and note a successful record of achieving price realization, expanding into new product

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.

categories often through acquisition and focus on continuous efficiency.

Spectrum Brands underperformed due to numerous fiscal second-quarter challenges, including weather-related issues and problems with new greenfield manufacturing and distribution facilities. As a result, management lowered its fiscal 2018 guidance. The company also announced its CEO and director was stepping down. We continue to like the company's proven acquisition track record, strong margin profile and free cash flow generation.

Reinsurance Group of America is the largest independent reinsurer of life insurance products. The stock underperformed as first-quarter earnings disappointed due to elevated mortality – possibly due to a bad flu season. Despite the possibility of continued mortality headwinds, we modestly added to the position, as we believe management's focus on more complex transactions and conservative management style will result in relatively steady earnings and cash generation over longer periods.

LKQ supplies aftermarket and recycled products to vehicle repair shops. The company's shares underperformed due to weather-related issues in North America and software-related issues in the United Kingdom. We remain shareholders given the favorable macro trends in both North America and Europe, including an aging vehicle population, increasing miles driven and a secular shift away from original equipment manufacturing parts given the rising cost environment.

Cooking equipment maker Middleby performed poorly following their announcement of quarterly earnings. We were disappointed to see lower margins and uneven revenue results driven by a reorganization of the company's distribution channel. Consequently, we sold the stock.

Outlook[2]

Second-quarter equity market returns rebounded as investors digested strong earnings and got their first look at the recently enacted corporate tax cuts. Results were particularly strong among small-cap companies. We believe this reflects growing concerns about global trade friction and investor preference for U.S.-focused business models.

Our cautious optimism continues to be supported by solid fundamentals, particularly in the United States. For the remainder of 2018 we expect to see strong earnings, solid GDP and wage growth, continued low unemployment and moderate increases in inflation and interest rates. The Federal Reserve plans to continue tightening monetary conditions, but we believe it will do so with restraint. While we do see some signs of softness in Europe, the central bank there is continuing its aggressive quantitative easing (QE) efforts. Emerging market volatility demands investor attention but looks stable for now.

Near-term volatility will likely be driven by global trade and tariff discussions as well as U.S. midterm elections in November. Valuations are looking stretched in some parts of the market; however, we are confident in our ability to find pockets of opportunity through our focus on fundamental analysis and differentiated franchises.

As we enter the third quarter, our portfolios maintain an overweight position in the healthcare sector. We continue to find opportunities in the equipment and diagnostic areas of healthcare, where companies improve outcomes, con-

Top 10 Holdings

NICE Ltd Sponsored ADR
Berry Global
STERIS
Laboratory Corporation of America
Snap-on
Arch Capital Group
LKQ
Ultimate Software Group
Columbia Banking System
Reinsurance Group of America

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	Top Securities	Average Weight (%)	Security Contribution to Portfolio Return	Bottom Securities	Average Weight (%)	Security Contribution to Portfolio Return
Smaller Company Strategy	NICE	3.23	0.33	Berry Global	2.23	-0.38
	Semtech	1.25	0.31	Spectrum Brands	0.98	-0.27
	Pinnacle Foods	1.45	0.27	Reinsurance Group of America	1.93	-0.27
	Medidata Solutions	1.08	0.27	LKQ	1.75	-0.23
	Evercore	1.36	0.27	Middleby	0.75	-0.20

* as of June 29. 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.

trol costs and benefit from the demographic tailwind inherent in the sector. Technology also continues to be a focus for us: these companies should benefit from improved capital spending and focus on operating efficiency. In our view, emerging trends such as IoT (internet of things), automation and AI (artificial intelligence and machine learning) will be tailwinds for the foreseeable future.

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.

In the financials sector, we believe modest reflationary trends and lower corporate taxes will be positive. Relative to other parts of the market, valuations do not appear as stretched.

We remain cautious on the consumer sectors. Tax cuts should put more money in consumers' pockets and we will hopefully see some improvement in wage gains. However, the traditional consumer landscape remains challenging.

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 well-managed, differentiated businesses.

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3. Source: FactSet.