JUNK VS. GEMS: WHICH DO YOU WANT?

EAGLE | Asset Management

One old adage says a rising tide lifts all boats. That may be true but a rising tide does not lift all boats equally. The boats that seem to rise most dramatically on a rising tide are those that were aground: Now they're floating! It is harder to detect the increase among those whose captains kept their vessels safely in the middle of the harbor.

Tides are cyclical and so, too, is the stock market. The boats that remain perilously close to shore during high tide will find themselves grounded again when the tide goes out. Eagle's Small/Mid Cap Core team is focused on finding those ships with prudent captains.

The Russell 2500 Index recently had its biggest quarter (between April and June of 2009) since the second quarter of 2003. Our Small/Mid Cap Core portfolios posted positive returns but lagged the benchmark. That is exactly what happened in the second quarter of 2003 and for the same reasons. Low-quality stocks outperformed high-quality stocks: the very ones our team prefers to own.

What has happened over the last quarter? First, consider that one-third of the stocks in the Russell 2000 Index (which comprises 75 percent of the Russell 2500 Index) more than doubled!

The stocks with the highest gains since the March 9 low have been those with the lowest return on equity:[1]

- Those that more than doubled – which represented 34.5 percent of the Russell 2000 Index – had a median ROE of -5.2 percent.
- Eagle's Small/Mid Cap Core portfolio's median ROE was 15.25 percent at the end of the second quarter.

The stocks that are expected not to earn money in the next 12 months have performed better recently, which is an historic anomaly. Companies that have produced earnings have outperformed those that didn't by more than 300 percent since 1991.[1] Non-earning companies have outperformed those with earnings in the past but, with the exception of the 1999-2000 technology bubble and 2003, that outperformance typically fades after four or five months.

Why? The stock market, over time, favors solid stocks with consistent earnings growth. It wants companies that, in essence, do what they say they are going to do. And Eagle's Small/Mid Cap Core has done that for our long-term clients.

SMALL/MID CAPS

- Mathematically, it is easier for small- and mid-cap companies to grow at a faster rate – and for a longer period – than it is for larger companies.
- There are well more than 2,500 small- and mid-cap companies marketwide, making Wall Street coverage thin or non-existent.
- And, Wall Street coverage of those stocks may thin further as a result of firms' mergers and downsizing.
- This growing information gap creates an opportunity to find companies that exhibit signs of a catalyst before they are widely recognized among investors.

WHY NOW

- Historically, small- and mid-cap stocks generally have outperformed coming out of the last 10 recessions. Post-World War II recessions (there have been 10 of them) have lasted, on average, 9.6 months.[2]
- The longest post-war recessions (December 1973-February 1975 and August 1981-October 1982) were 14 months long.
- We are more than 19 months into the current recession.

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What happened after 2003's low-quality rally? Eagle Small/Mid Cap Core portfolios cumulatively outperformed (on a net basis) the benchmark Russell 2500 Index by more than 10 percentage points over the next five years.[3] (The Small/Mid Cap Core program outperformed its benchmark by 1.45 percentage points on a net basis since its inception through June 30, 2009.[4])

Eagle's Small/Mid Cap Core program employs a thorough, bottom-up stock-selection process to identify growing small companies that are reasonably priced. Many of these companies are selling innovative goods and services that are transforming the way we live and work, and are found in a wide range of industries. The driving force behind each investment decision is to look beyond price-to-earnings multiples and stated growth rates to buy companies that have sustainable advantages that will allow them to outperform over the long term.

The team's consistent, disciplined application of its investing philosophy has helped keep long-term clients "off the rocks" and we believe it will continue to do so.

Please call Eagle for more information about our Small/Mid Cap Core separately managed account.

Small/Mid Cap Core Managers:

Todd McCallister, PhD, CFA — Portfolio Manager

- Joined Eagle in 1997
- 22 years of investing experience as portfolio manager and analyst
- B.A., with highest honors, University of North Carolina (1982)
- Ph.D. in economics, University of Virginia (1987)
- Earned his Chartered Financial Analyst designation in 1996

Stacey Serafini Thomas, CFA — Portfolio Co-manager

- Joined Eagle in 1999
- 12 years of investing experience as portfolio manager and analyst
- B.A., *cum laude*, Harvard University (1997)
- Earned her Chartered Fiancial Analyst designation in 2002

[1] Source: Bank of America-Merrill Lynch
[2] Source: Satuit Capital Management
[3] Time period: Jan. 1, 2003, through Dec. 31, 2008. Eagle Small/Mid Cap Core portfolios had a net cumulative return of 5.34 percent vs. a cumulative return of -4.80 percent for the Russell 2500 Index.
[4] The inception date for the Eagle Small/Mid Cap Core program was July 1, 1997. Eagle's net annualized performance between then and June 30, 2009, was 6.39 percent vs. 4.94 percent for the benchmark Russell 2500 Index. The calculation of the performance data includes reinvestment of all income and gains and is depicted on a time-weighted and size-weighted average for the entire period. Calculations include reinvestment of all income and gains. Performance is shown after (net) the deduction of both management fees and transaction costs. Performance figures include all of Eagle's retail managed accounts. All composite performance data through 2008 have been verified by an internationally recognized accounting firm. Performance data for the current year have not been audited and are subject to revision. No inference should be drawn by present or prospective clients that managed accounts will achieve similar investment performance in the future. Because accounts are individually managed, returns for separate accounts may be higher or lower than the average performance stated above. Investing in equities may result in a loss of capital.
The risks associated with investing in small- and mid-sized companies are based on the premise that relatively small companies will increase their earnings and grow into larger, more valuable companies. However, as with all equity investing, there is the risk that a company will not achieve its expected earnings results, or that an unexpected change in the market or within the company will occur, both of which may adversely affect investment results. Historically, small- and mid-cap stocks have experienced greater volatility than other equity asset classes, and they may be less liquid than large-cap stocks. Thus, relative to larger, more liquid stocks, investing in small- and mid-cap stocks involves potentially greater volatility and risk. The biggest risk of equity investing is that returns can fluctuate and investors can lose money.

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