

# VOLATILITY RULED IN 2011; WHAT LIES AHEAD IN 2012

Eagle's senior portfolio managers offer informed perspectives on the current market situation and potential investment opportunities.

## EXECUTIVE SUMMARY

- Eagle Asset Management's equity and fixed-income portfolio managers regularly meet to discuss current events in the financial markets, where they believe things are heading and potential opportunities for investors.
- Europe's sovereign-debt issues remain at the forefront but China's growth rate also bears monitoring. Economic news on the domestic front remains mixed and there are reasons for continued optimism.
- The general consensus is that growth will be harder for companies to find if the recovery continues at its pace but there are good investing opportunities in many asset classes.
- Eagle managers continue to believe independent, diligent research is paramount in selecting stocks and bonds for long-term investors.



Eagle's portfolio managers gather regularly to discuss market trends and what they are doing in their portfolios. Twice a year, we publish their comments.

The global economy still has some areas of concern, even though there are better data points on the domestic front. Our managers' discussion included such things as rising volatility and correlation, the tie between real estate and employment and – perhaps most interesting to readers – how they have investment portfolios positioned.

Included in the most recent roundtable were Bert L. Boksen and Eric Mintz (Small Cap Growth and Mid Cap Growth); James Camp (Fixed Income); David Blount, Ed Cowart and John Pandtler (Equity Income and Value); Todd McCallister, Stacey Serafini Thomas and Scott Renner (Small/Mid Cap Core); Dave Adams and Jack McPherson (Small Cap Core Value); Richard Skeppstrom (Large Cap Core); and Cooper Abbott (Co-Chief Operating Officer), who served as moderator.

**Moderator (Cooper Abbott):** Let's start off talking about 2011, which had a flock of swans: some white, some gray, some black. There was a tsunami and the nuclear crisis in Japan. Europe went from bad to worse. There were governmental changes in the Middle East. There was the U.S. federal debt-ceiling debate here and then the S&P downgrade. Market regimes changed across the period as well. What impact did these events have on your portfolios and views as a fundamental investor?

**Bert Boksen:** What strikes me about this market are the levels of pessimism and lack of confidence in the system. It started in 2008 with the financial meltdown and has continued. Long-term, though, I believe the system will recover and confidence will come back.

The year started out with good growth until the late spring when Europe became a concern and just about everything with a cyclical tilt hit the skids. We've recovered somewhat, but not fully. It seems like it has been more of a "risk-off" trade since things such as utilities, high-dividend payers and consumer staples led the charge higher.

The one sector of "traditional" stocks that has done well is technology, which has seen an uncommonly high number of takeovers and particularly of small-cap tech companies. That was a plus and a trend we

believe will continue. Large-cap companies have huge amounts of cash on their balance sheets. Interest rates are expected to stay low and the economy is projected to stay in a low-growth pattern. Consequently, I believe takeovers in tech will continue at a very, very high level.

What has surprised me is that interest rates have stayed as low as they have been. You wouldn't think that they would go this low and stay this low but the Federal Reserve has said it will keep rates at current levels.

I believe people are a little too scared about Europe. Whenever something is in the headlines like this, it tends to go away over time. It is an issue – Europe probably is in a recession already – but I believe the news already is embedded in valuations, which are uncommonly cheap today.

**Eric Mintz:** I've been a little more focused on the Middle East. We have seen concerning signs of weakening demand for oil but the market is rightfully focused on the risk that the situation with Iran deteriorates further. That is obviously supportive of triple-digit oil prices. Further, effects of the Arab Spring have stretched into winter. Saudi Arabia has

said it plans on keeping a close eye on production because it announced another significant increase in government spending to fund social programs in 2012.

**Dave Adams:** It would be accurate, in our view, to characterize 2011 as more of a defensively led year when analyzed in its entirety. However, there were significant upward and downward moves over the course of the year as macroeconomic sentiment globally ruled over near-term business fundamentals. It is more difficult over the short term to add value in this type of investment environment through stock selection because liquidity into selling pressure becomes more important. But longer term, this can create opportunities.

**Ed Cowart:** I believe valuations do matter and they will continue to matter over the long term but it may take longer for those values to surface.

I believe there is a support to the broad market that is not too far below where we are right now simply based on the earnings yield. That is, flip over the price-to-earnings (P/E) ratio. If you own an entire company, what would your rate of return be? If you owned the entire S&P right now, and assuming earnings don't collapse next year, you would make a 12 percent return. And, by the way, that 12 percent likely would grow at maybe 7 percent or 8 percent over time.

Put that up against a Treasury yield of 2 percent. The gap between those numbers is as wide as it was at the bottom in 1974. It's much wider than it was at the bottom in 1982. Remember six weeks or so ago when it looked like the bottom was falling out of the bottom of the market and we got down to about 1070 on the S&P, which was about 10 times earnings. That is where it stopped and then we had a nice rally on the other side of it.

My view of the macro environment is informed by the observation that we are in a post-financial crisis environment that nobody has ever experienced. The

issue remains: Who is going to take care of all the bad debts that are still out there? That was the issue in this country that we seemed to have worked out in a reasonable fashion. It's a far different beast in Europe where they simply don't have the architecture and singular decision-making authorities to address that question. They have the resources but they don't have a (former U.S. Treasury Secretary) Henry Paulson who can call into one room all the heads of major banks and say, "You're taking \$10 billion; we're going to fix the financial system or at least put a big bandage on it."

The closest thing we have to what's happening now is the post-Japanese-bubble environment. Valuation there didn't matter a lot either in the short term. What mattered was perceptions of economic growth. When it looked like economic growth was picking up, the market rallied. When it looked like it was turning down, the market would decline. The Japanese market essentially has gone sideways for 20 years but there have been tremendous rallies and declines in that time and if you were nimble enough to play them, you could have made a heck of a lot of money.

**David Blount:** Consumer confidence, which drives a lot of stocks, was at 77.5 in February and by August, it was at 55.7: a tremendous meltdown. That was not surprising, really, given all the bad news – floods and earthquakes, the Middle East and everything in Europe – in the newspapers. And November had an uptick in consumer confidence (67.7). It's lower than earlier in the year but it's up since August and continues to go up.

The double-dip recession talk has somewhat disappeared. There's still a lot of macroeconomic noise but after-tax corporate profits are nearly at all-time highs as a percent of gross domestic product (GDP). We've seen a little improvement in unemployment but historically, profits have led going into expansion mode. I know that we've come from a place where

the country was over-levered but it's nice to see some credit is flowing and consumer spending is growing.

Correlations may be high within certain sectors but they aren't high across all of them. For instance, the S&P's utility sector was up 16 percent through November while the financials sector was down 18 percent: a 34 percentage-point difference! It does matter for performance where you are in those sectors.

We may have added the most value, especially in Equity Income portfolios, this year by what we avoided: financials broadly and, more specifically, the big banks. We have sold some of our banks but we've added value in the sector through our real-estate investment trust (REIT) holdings.

We can take a quick look at the S&P consumer discretionary sector, which was up 4.8 percent. McDonald's, though, was up 28 percent after posting 6.5 percent same-store sales growth in Europe.

**Stacey Serafini Thomas:** The biggest challenge in 2011 has been reacting to all of the macro-related events we have seen, both domestically and abroad, and the subsequent volatility. It has been important to stay disciplined, not to react to every single macro-related event.

What's interesting is that all of the Russell indices – with the exception of the Russell 2000 Index, which was down 4.2 percent – essentially have been flat this year. That is fairly benign considering the volatility we've seen this year and compared to what we experienced in 2008 in the midst of the financial crisis.

I believe all of this macro volatility has made long-term stock-picking even more important. Identifying companies that are able to grow at a faster rate than the overall economy and that have done shareholder-friendly initiatives should allow investors to do well if they can withstand what likely will be continued volatility.

**Todd McCallister:** There were historically high correlations in the stock market this year, which makes it hard to be a fundamental stock-picker in the short term. It strikes me that the market broadly hasn't seemed to pay as much attention to valuation during this period. Market sentiment kind of piles into a few stocks – whether it was Netflix or Priceline.com or Salesforce.com – and then just get out.

**Scott Renner:** The news and the increased correlations are frustrating at times. In retrospect, though, it might not be that surprising. I believe investors tend to move in herds in times of uncertainty and we certainly saw that behavior.

Ultimately, valuation matters. But perhaps in the short term, valuation matters a lot less than the ability to discern whether companies will grow, whether they can take market share or have themes or cycles that will allow them to grow. Those are the companies that have been able to work in this kind of environment.

There are a couple of factors in favor of long-term investors, however. Market sentiment has improved a little bit recently but remains pretty poor. The Federal Reserve has said it is going to remain accommodative. And going back to valuation, you can look at a

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“I've never seen a bull market start with a positive economic scenario. You seemingly have to have something to worry about to get the market going.”

— Bert L. Boksen, CFA

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number of different measures and conclude that, for the most part, valuations are relatively unassuming.

**Richard Skeppstrom:** I think it makes sense to be honest about where the market is right now. And it is, in my view, right where it should be if we don't quite know where profits are going to go, if we have a recession or if we're going to muddle on through.

There has been a very high correlation among stocks and the favored flavor has changed pretty dramatically, pretty quickly. The markets went from a relatively hopeful beginning of the year to a real gnashing of teeth over economic contagion and recession during the summer and then back to, "Everything is going to be fine." I would echo that it is very difficult to use any kind of relative-value screening to pick winners and losers.

The U.S. consumer hasn't pulled back on spending despite all the negative news. We remain concerned about Europe and China. I spend more of my time now thinking about these larger issues than I ever have done. I believe you have to keep up with that when people are ignoring valuation completely.

What may have to happen to get the market to refocus on what's inexpensive and what isn't is a little bit of a pause. This has been a very difficult year and I believe next year is going to be just as difficult.

**Moderator:** The fixed-income market was just as busy as the equity side.

**James Camp:** In the fall of 2010, we had QE2, which elevated the markets, raised expectations for growth

and inflation and moved Treasury rates materially higher. Many prominent bond managers exited the Treasury market, believing it was the beginning of a sell-off in Treasuries. There was media-fueled fear of credit problems and widespread defaults in the municipal market.

Instead, 2011 brought just the opposite. Long-term Treasuries returned something like 28 percent. Other

parts of the debt market performed remarkably well. Long-term municipal bonds are up anywhere from 15 percent to 16 percent.

That said, "risk-on, risk-off" has been the theme for us on the bond side as well. The "risk-off" trade began in earnest in the summer when investors began demanding to be paid via higher interest rates to take on more risk.

Our low-beta credits are working and our performance relative to benchmarks has been getting better.

We will continue to stick with what we believe are high-quality bonds. Financial-company bonds are ridiculously cheap; however, we still don't trust their balance sheets and we won't invest in the unknown. Companies such as Bank of America will have to refinance tens of billions of dollars of guaranteed short-term loans they received in 2008 and 2009 from the federal government. And foreign sovereign debt, particularly in southern Europe, will remain challenged.

**Moderator:** Real estate and employment remain critical components of the U.S. economic recovery. Where do these stand: Are we in a recovery mode?

**McCallister:** I was shocked to see the recent quarterly report from Robert Half, the staffing company. The

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"We maintain a positive outlook for small-cap equities. Operating margins for most companies in our universe are well below peak levels and stocks are trading at what we view as reasonable multiples."

— Jack McPherson, CFA

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chief executive said the country never has seen a snap-back as quickly as we've had during this recession compared to other recessions. They also were able to raise their fees.

They do temporary placement and now they're beginning to talk about permanent placements, which send their margins sky high because they get a big payment. This good news doesn't extend across the board in staffing companies, particularly those with a lot of exposure to Europe.

What I do believe is evident by way of staffing companies is that we have a two-part job market and a lot of the low-income distress is due to a total lack of a construction market. Construction had been the largest industry in many states and that's gone. There are only so many houses that can be built and if they're all built in a few years, there's not going to be a need for new houses for some time.

**Cowart:** Millions of the jobs that were created in the early 2000s were, in one way or another, housing-related: driving nails or making mortgage loans. And you're right: Those millions of jobs are never coming back to that extent.

And, there is a mismatch between skills needed and skills available. I know a young man who is graduating from Texas A&M with a degree in mechanical engineering. He already has a job in the energy field making \$95,000. A 22-year-old kid with a bachelor's degree! Those with degrees in English, though, probably are going to be looking for a job for a very long, long time. You likely can find a job today if you have a wide skill set in science, technology, engineering or math.

**Camp:** There has been some domestic wage growth, which had been anemic at best for a decade or so.

Labor and real estate are intertwined in a lack of mobility. Places that have weak housing haven't seen

jobs recovery. But people can't leave their homes to go to those places that have seen jobs recovery. So now we have people living in cars in North Dakota where there are energy-related jobs. The real-estate "anchor" is crimping labor mobility.

Bad debt in real property remains and has yet to be fully realized. I believe some major banks would need to raise capital – and that wouldn't go over well – if they had to price their real-estate holdings at current levels. The data is not much better when we look at the monthly reports on 30-, 60- and 90-day delinquencies, foreclosures and the so-called shadow inventory of houses that owners have all but walked away from but banks have yet to start foreclosure proceedings. Roughly one in five houses is underwater or delinquent so it remains a real problem in terms of balance sheets for companies and consumer wealth.

**McCallister:** One thing you can do is own apartment real-estate investment trusts. The market thinks these things trade down when there is financial stress but I would argue that multi-family real estate has access to financing that no other area has because they can tap Fannie Mae and Freddie Mac. It seems to me you can make an argument that if you're going to look out to 2015 and you own a well-run apartment REIT, you're going to probably be surprised on the upside.

**Blount:** When we look at commercial real estate, it too is a sort of skilled vs. unskilled scenario. Publicly traded REITs generally own Class A (the best rating) properties: the best malls, buildings in established markets such as New York City and Boston. Those properties have rebounded very nicely from the 2008 bottom and sit about 10 percent lower than at the 2007 peak. You can see that in our REIT holdings, which have done extremely well. High-end commercial real estate has come back; it's not at the peak but it's recovered quite a bit. However, there's a lot of other real estate on the other end of the spectrum you don't want to be involved in.

**Thomas:** I would make one comment just in terms of employment growth. Given where corporate balance sheets are and given where margins are, I wonder why we haven't seen a greater degree of corporate hiring. Historically, we would at these levels.

But maybe this summarizes the theme of 2011: uncertainty. Corporate management teams in the discussions I have had with them throughout the year have said they lack a clear picture. They don't know what is happening on the political side. They don't know what's happening in terms of how much healthcare expenses are going to be for their employees. That could be why temporary-staffing companies are posting good numbers. Temporary workers are a reasonably risk-free way for companies to add employees in the short until some of this uncertainty has been resolved.

The biggest inhibitor to employment growth this year has not been that companies can't afford it. It's that they won't until there is more certainty about what's happening around them. And I believe they realize that with 9 percent-plus unemployment – again, except for highly skilled workers – it will be easy to restock their payrolls if they believe the economy is going to really get moving.

**Skeppstrom:** I think companies aren't hiring here in the United States because they are hiring elsewhere. A big argument right now among analysts is whether the S&P is really earning \$100. Is that a normalized number? Or is it more like \$80? Margins are very high and they're high for a number of reasons, including that the technology and healthcare sectors have gotten to be bigger portions of the index and they're more profitable.

But it's also an issue of permanently lowering companies' cost of doing business as a way to grow their underlying earnings. There is now world-wide competition for jobs. I tend to think that these large companies are going to continue to move jobs

away from expensive people and, with increasing technology, away from people in general.

**Cowart:** I saw a study that suggested S&P companies' hiring was up 10 percent between 2009 and 2010. They're hiring people overseas and permanently lowering their labor costs. I'm sure we'll hear some stories about companies bringing jobs back to the United States but once a company has lowered its labor cost from \$30 an hour to \$10 or \$5 per hour, it's not going to be easy to reverse that.

The global supply chain and more effective use of technology have permanently raised corporate margins for large companies. Now, I don't know whether they're going to stay at this peak but I do believe we're not going to go all the way back to where we were. I don't know if the right earnings number for next year is \$100 or \$95 or \$105 but I am quite confident that we're not going to see earnings collapse anytime soon.

Corporate profits are at an all-time high vs. GDP. Wage earnings are at an all-time low.

**Blount:** One other issue that might suggest we could go even higher in profit margins is that we're making these comparisons of after-tax earnings of earnings per share (EPS) vs. GDP. They are at record levels and those things could reverse but interest expense has gone down quite a bit as have taxes. And if you look at things on a gross-earnings basis we're not at a peak yet. Those things could revert as well but gross earnings could exceed current levels as long as interest rates stay where they are and companies stay as deliberate as they have been.

**Moderator:** S&P all but said its downgrade of U.S. credit had as much to do with what it saw as a dysfunctional Washington, D.C., as whether the United States is "good" for its debt. What are your thoughts on the political landscape as we head to the 2012 elections?

**Thomas:** Taxes are a real risk. The economy has greatly benefited from overall consumer spending and it has behooved investors over the last several years to own those consumer stocks that are most exposed to the high-end consumer.

What no one wants to see is the high-end consumer decide to tighten the purse strings. Political winds can shift very dramatically, very quickly. The biggest risk to the strength of the high-end consumer is any political changes that are made with regard to taxes.

**Camp:** Policy measures previously have resurrected dinosaur industries, such as the auto industry. They've really been aimed at the financial system, which still needs to contract in my view. We have decided that we are going to allow wealth transfer from the savers by 0 percent interest rates and by growing portfolios of Treasury and agency bonds but I don't believe we've really done much to address structural issues.

The federal government cannot afford another four years of gridlock. There are so many things it is currently obliged to pay, including Medicare, Medicaid and Social Security, that there will be a major accident in the U.S. debt markets if the tax base isn't broadened. That's a problem.

Somebody is going to win the election and, one hopes, a policy will come out of that. It could be the current administration, which seems to have a tax-more, cut-less position, or a Republican, who likely would cut taxes and some government programs dramatically.

**Moderator:** In the depths of the crisis, bad debt almost brought down many big financial companies. How much "bad stuff" is still on their balance sheets? Where do they sit now?

**Camp:** I believe they're through a lot of it. I think there are a couple of suspects that we're concerned about more from a liability standpoint. Bank of America comes to mind with what it inherited via Countrywide. I think the write-downs are coming in piecemeal fashion because a wholesale move to align their debts with current prices would force them to raise more capital.

**Cowart:** The Federal Reserve has taken the approach that it needs to help the major financial companies through low interest rates. But that decision has hurt investors.

Ten years ago a person thought, "You know, if I can get \$1 million through savings and a 401(k), I'll make \$40,000 or \$60,000 a year off that and be fine." But that's not happening with interest rates so low.

We're seeing that in Equity Income now. We are starting to get institutional inquiries about a portfolio that long was considered something for retail investors only. We are getting, for the first time, interest from those who previously invested solely in fixed-income portfolios. They now realize 2 percent annual returns are not going to get them where they want to be.

**John Pandt:** Financials, and more specifically banks, sharply underperformed for the fifth consecutive year, despite a continued recovery in credit quality, earnings and capital levels against what appeared to be a cheap, or at least attractive, valuation backdrop during the early stages of 2011. Unfortunately, banks have a storied history of being notorious "value-traps"

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— Ed Cowart, CFA

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and we suspect many investors fell into the price to tangible book trap again in 2011.

We remained dramatically underweight U.S. banks in 2011 and continued to allocate capital instead to select Canadian banks and U.S. REITs. Fears of a systemic capital and liquidity shock emanating from Europe certainly impacted the relative performance of bank stocks but the bigger concern remains the future profitability of the banking industry given historically low interest rates that will continue to compress net-interest margins; slow economic growth, which constrains loan growth; and finally, regulatory pressure and uncertainty.

**Moderator:** What is the key to current events in Europe? What relevance do they have to your portfolios? How do corporations compare to sovereigns?

**McCallister:** It seems to me that governments around the world aren't getting their fiscal houses in order. There is a European Union and a European Central Bank but it's not truly a singular entity as far as fiscal policy goes. I think they will end up just printing money because they view inflation as a lesser evil than riots.

What's interesting to me philosophically is whether credit-default swaps are effective as insurance, which is what they were intended to be. Even if Italy and others groan under a crushing debt load, no one will ever utter the word "default," knowing the cascading events that will follow.

**Camp:** I've read some of the loan documents, which suggest that "voluntary default" isn't the same as a default. That seems a little cynical but perhaps offers a degree of realism that a credit-default-swap trigger for

a country even as small as Greece would have global implication. So, if you can't honor the contracts, you change the semantics and everyone agrees.

**Cowart:** The only part of Europe that has been growing is the northern tier: Germany, The Netherlands and Scandinavia. I believe one of three things is going to happen, and probably soon:

- The Germans will allow the ECB to print money to help their Southern neighbors;
- The EU essentially divides itself into a northern tier and a southern tier to acknowledge the productivity levels between the two regions simply are so divergent; or
- A country leaves the euro. The knee-jerk thought

is that Greece would be the country to leave. But maybe Germany is the one that really doesn't belong in the euro.

We've seen this train coming for two years now and the smart people are going to step off the track. I believe that our financial institutions have done what they can to insulate themselves from that. And I believe that our Federal Reserve will do whatever it takes to keep European banking problems from infecting our banking system.

**Boksen:** What may surprise people is the indirect, but significant, exposure U.S. small- and mid-cap companies have to Europe as suppliers to large-cap companies. They may produce auto-related products, electronics or components, for instance.

If a large company cuts back, it hurts the small guys as well. We've seen that in some of the small-cap industrial and materials stocks.

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"We believe 2012 holds greater promise in terms of buying very inexpensive corporate debt at prices we like."

— James Camp, CFA

**McCallister:** If you want to really look Europe straight in the eye, be a small- or mid-cap lab-equipment investor. About 30 percent to 40 percent of their sales come from Europe, which traditionally has been a source of research and funding.

**Camp:** What I don't understand is why debt holders aren't taking losses and why they seem to be more content to kick the proverbial can down the road. It makes people feel good in the present but it will keep growth at anemic levels or worse because of the long-term debt problems. Italy – the third-largest debtor in the world – had a default scenario recently in which short-term yields were higher than long-term yields. That's not tenable. The likelihood of an accident in the banking system over there is not zero.

**Blount:** One difference between the U.S. situation and Europe is that there you can't really separate the countries from the banks. They are essentially one entity. So, you can't just say, "Oh, this French bank can default and France will be fine." Because the whole thing – the bank and the country – would go down at the same time.

**Moderator:** China and Asia broadly remain opaque but important. What are your thoughts on a slowdown there and the impact that could have on your portfolios?

**Skeppstrom:** We bought Peabody Coal because it has a very profitable business in metallurgical coal in Australia, which is a big supplier to Chinese steel. I subsequently sold it because a significant portion of its profitability comes from China. That country has been on a 20-year investment spree in concrete and steel but that could slow dramatically and stay slow for quite a while. In that case, they don't need metallurgical coal and what is now selling at \$300 a ton will sell for \$90 a ton. Stockholders will get destroyed because there will be no way for the company to meet growth estimates.

**Boksen:** It's hard to know what the real growth in China is and what the Chinese government is going to do. That makes it a challenge to know what to do because you don't want to take overweight positions in companies with a lot of exposure to China but, at the same time, it's probably the strongest global growth area.

**McCallister:** They have grown for so long by throwing labor and capital at their issues, which is something a country can do for only so long. At some point, there has to be growth in areas other than where the government is involved. GDP in China in 1960 was \$3 dollars per person. It's \$5,000 per person now.

It's interesting to me there are housing bubbles in some areas of China. People are making money there but they're not really allowed – or have the opportunity – to load up on consumer goods so they have a 40 percent savings rate and residents buy hard assets, such as housing.

**Blount:** We own a lot of multinational consumer companies that like to put up slides about China because of its great growth potential. But when you ask about it, you realize China is still a small portion of business to companies such as Procter & Gamble or General Mills.

China is building a middle class, which has been the "holy grail" for Coca-Cola and companies like it. The Chinese are getting there and some U.S. companies are making inroads but it's going to be very slow.

The Chinese government is in an interesting position. So many things are manufactured there, which in turn drives up their wages. That's good for the Chinese people as it relates to raising their standard of living and building a middle class. But it means some companies now may look to even cheaper places – Vietnam, for instance – for their manufacturing plants.

**Cowart:** We have a bifurcated economy – the Walmart economy vs. the Nordstrom economy – here in the United States. China has one, too, but it’s the modern economy vs. the stone-age economy.

If you bring a person from the farm making a dollar a day into the city where he’ll make \$10 a day, that’s a pretty significant upgrade in growth and spending prospect. The important dynamic is how fast China can continue to modernize without some kind of debt implosion along the way.

**Moderator:** Are we seeing a bubble in gold?

**Skeppstrom:** I have no idea what gold’s value is. It is, in my view, a hedge in case governments just start printing money. I don’t think it’s going parabolic anytime soon. But I think it has the possibility of going parabolic at some point in the future.

**McCallister:** What has interested me is how poorly some of the gold miners have performed vs. gold. You might have thought you were helping your equity portfolio by owning gold-mining companies but some are down 15 percent-20 percent for the year. Part of the problem, of course, is mining companies have to get the gold out of the ground, which is not easy.

**Blount:** There is now the ability to buy gold without buying gold in a physical form, which required insurance and a secure place to store it. It was a pain for most people to own gold. Buying gold now is easy so perhaps some of this was pent-up demand.

**Cowart:** It’s hard to know how much the market already is anticipating \$1,600-an-ounce gold. That’s the biggest problem I have with gold: There’s no way to value it. That said, I view it more as an insurance policy. You have insurance on your house but that doesn’t mean you want your house to burn down. It’s kind of the same way with gold. If you think hyperinflation is coming, it probably makes sense to own a bit of it.

**Moderator:** Inflation: Is it an “if/when” proposition?

**McCallister:** China remains a deflationary force as long as they can support their currency purchases. We will see inflation when China does.

**Blount:** Core inflation numbers are pretty subdued but there has been food and gas inflation, which impacts lower-end consumers in particular. Kroger indicated in its most recent quarterly report it had to pass along 6 percent food inflation. That forces consumers, especially those on fixed incomes, to re-evaluate shopping priorities and as a result, Kroger had only flat sales as volume shrank.

Moderate inflation is good for most people. We own food distributor Sysco and they’re struggling with this issue too. If prices get too high, people pull back. Companies haven’t been able to maintain their margins on inflation, which is where a company would benefit.

**Thomas:** This gets us back a little bit to the split work force and split economy we were talking about earlier. It appears some “fast casual” chains – think Chipotle, Starbucks and Panera – are stealing market share from casual diners, such as Darden (which runs – among others – Red Lobster and Olive Garden). The “fast casuals” have gained so much share but I don’t believe it’s because overall restaurant traffic is up; it’s up at lower price-point restaurants.

**Moderator:** Interest rates are low but dividend-paying stocks – seen as “stodgy” a few years back – have been in vogue. Perhaps you can touch on that as well as stock buy-backs.

**Camp:** The market currently is split between yield safety and non-yield safety. Yield is going to get crushed by risk if the markets start to rise and are sustained by consistent, better economic moves. If we had a “risk-on” rally that’s really rooted in better economic news – out of China and/or the United States – we’re going to see a massive rally in areas without a lot of yield.

**Cowart:** If there's a huge equity rally, we'll suffer on a relative basis in Equity Income portfolios, for sure. You can see that even now. If the market is down, we pick up 30 or 40 basis points. But we lose 30 or 40 basis points of relative performance if the market is up 200 points.

**Thomas:** But maybe your investable universe is bigger over the last couple of years. Some of our mid-cap and even our small-cap companies have been able to grow and are still paying out 2 percent-3 percent dividend yields. Companies want to put this excess cash and cash flow to work.

**Cowart:** One big difference between now and five or 10 years ago is that there are many technology stocks now paying dividends. We haven't bought any because we've been a little bit concerned about the fundamental backdrop but there are names like Intel and Microsoft that qualify in spades for our programs.

**Blount:** Another consideration on dividends is how they're treated tax-wise, which is something that could be put into play after the next election. Once dividends and capital gains were both taxed at 15 percent, management teams no longer could stand at podiums and say that buying back stocks is more tax-efficient.

Many executives prefer buying back stock vs. paying dividends. Stock buy-backs can be finite: You can't buy any more if the price goes up too much or you own all the outstanding shares. It's hard, on the other hand, for companies to stop paying dividends once they start. The worst-case scenario – though we believe this is a low-probability outcome – for our

investors would be that Congress reverts back to a structure where dividends are taxed at a higher rate than capital gains. In that case, companies likely would increase buy-backs.

**McCallister:** There has been another significant change about stock buy-backs. It used to mean a little more because it was unusual and generally, it was almost a form of insider buying. Now, so many companies have cash and, for the reasons David suggested, they figure buying back stock is an easy way to deploy their stockpile.

**Moderator:** What are your views, as active fundamental managers, on ETFs?

**Boksen:** I love them because they create better liquidity in the small-cap market.

**Cowart:** I heard a man at a recent conference probably correctly suggest that ETFs are a great way to own stocks that you shouldn't.

**Camp:** That's true. The biggest fixed-income ETF last year was the double short of the 10-year Treasury. So, in my view, ETFs absolutely invite betting into markets that most people probably don't need to be involved in.

Also, ETFs' liquidity and relatively low cost has left many managers now believing they can go anywhere to create "absolute return" strategies. That historically has been a losing proposition vs. good fundamental asset allocation and having good portfolio managers in different spaces.

**McCallister:** In theory, a good active manager ought to be able to win over the long term against people who

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"I've never seen sentiment as bad as it is right now. ... And that's the environment that typically sets up a better market going forward."

— Ed Cowart, CFA

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trade on rules. The real problem for investors in ETFs is when they buy limited ETFs vs. something that replicates the entire Russell 2000 Index, for instance. There are names that never saw any trading volume that are all of a sudden getting trading volume, not because of fundamentals but rather simply because they are in an ETF. The moves those stocks will see should create buying opportunities for active managers.

**Moderator:** Let's talk about what you think the next year brings and names you have in your portfolios.

**Renner:** One of the advantages we have heading into 2012 vs. 2011 is that we were kind of hopeful heading into last year and then got crushed by one crisis after another. Sentiment is more negative now and I believe that may actually create a more bullish backdrop going forward. What's key is to find companies that you believe will continue growing regardless of what the economy does.

Cardtronics is a company we believe fits that description. Cardtronics is basically the largest non-bank-owned ATM network in the United States and they also do business in Mexico and the United Kingdom. Nearly 90 percent of its business is U.S.-based and the company has carved a nice niche for itself. If you walk into Target or a convenience store and you see an ATM, it probably belongs to Cardtronics. They also have created an ATM network for small banks. Those banks can compete against larger banks that have their own ATMs by engaging Cardtronics to install and operate ATMs.

The company has done a nice job of making acquisitions and continuing to build its network. Earnings have been growing 20 percent-30 percent a year and the stock is still trading at a mid-teens multiple.

**McCallister:** I believe we will continue to see modest growth and currently, the market is cheap. Energy is

something to watch because prices there are the most likely governor on growth.

One energy name I like is Oil States, which is essentially a motel company. They provide housing to oil-company workers in remote locations. The exploration and production companies pay Oil States. Sagging oil prices don't crush Oil States; they will merely slow the company's expansion rate. And projections for the oil-shale work in Canada, for instance, suggest that may be a 15- or 20-year phenomenon.

**Thomas:** I believe 2012's big opportunities will be in growth stocks. Investors likely will re-rate companies in terms of multiples as some level of uncertainty seeps out of the market and I believe growth stocks will benefit disproportionately from that.

I currently believe there are two types of growth stocks: stable, trusted growth stocks and distrusted growth stocks. In my view, the stable-growth stocks may be a little bit expensive. That's not to say they won't continue to do well; however, I believe the bigger opportunity to make money going forward is in those distrusted names.

One example is Sandisk. Skepticism about it has to do with the type of memory it makes. And it is in a tight industry; however, its gross margins have been incredibly stable over time. It's currently trading at only six times forward earnings, excluding cash, which is a discount to its peers.

**Blount:** We continue to see sort of a sluggish economy going forward. It doesn't sit well with us as Americans to accept that things could be slow for years but that's probably the reality. We're comfortable in this environment earning a 3.6 percent dividend yield, a figure that has grown 9 percent per year. Tell me a better inflation hedge than that.

We want to own – even knowing we might underperform in “risk-on” rallies – those companies

we view as high-quality with investment-grade balance sheets and good dividend yields. It's simply not a good time, in our view, simply to chase yield if it means buying low-quality companies.

We recently bought the toy company Mattel, which has proved to be fairly recession-resistant over the years. Its P/E multiple has shrunk over the last 10 years but its earnings have gone up. The basics of the company fit us: It has great cash flow, a 3 percent-plus dividend and 9 percent dividend growth. Mattel has focused on cash flow and has been improving its operations.

People thought electronic games would make physical toys obsolete but that hasn't been the case. What's interesting is that while birth rates haven't increased, toy-makers are another beneficiary of Baby Boomers. Grandparents are spending money on their grandkids! It used to be that a little girl had one Barbie doll at her house. But now, she has that Barbie at home and more Barbies at her grandparents' houses as well.

Mattel is also making a big push in international markets, including developing countries where burgeoning middle-class consumers aspire to buy their children "real" Barbie dolls. Further, Mattel partners with entertainment entities such as Pixar in the movie *Cars Two*, which had international scenes. Other companies, such as World Wrestling Entertainment, nearly automatically partner with Mattel in overseas deals because Mattel already has a footprint.

**Pandtle:** 2012 should bring some clarity for financial institutions because global regulators should finalize the new capital rules and implementation time line. We believe that will allow several overcapitalized U.S. banks to begin returning more capital to shareholders in the form of rising dividends and share repurchases, which could pave the way for a meaningful improvement in the relative performance of U.S. bank stocks. However, value traps remain and

so we will remain extremely selective if we decide to increase our exposure to U.S. banks.

**Cowart:** I believe 2012 is going to look a lot like 2011. The corporate sector is in solid shape but there will be sluggish growth. Europe will remain in the news and various crises – some familiar, some new – will bubble up from time to time. I believe what remains key is trying to own companies that are going to do well in a difficult environment and luckily, we have a lot of companies out there in really good shape. That's what keeps me fairly optimistic about the market. Historically, when valuation spreads between stocks and bonds are as wide as they are right now, when you have a 10-year rate of return for the S&P 500 at virtually zero ... well, most of the risk is out of the market. I don't know whether we're going to have a big bull market but I don't believe there's a lot of risk right now on the valuation front.

I believe we're going to grind out a decent rate of return in stocks next year. Unfortunately, it's not going to be a straight line. There's going to be a lot of volatility, a lot of angst. I've never seen the sentiment as bad as it is right now. If you go to a cocktail party, your friends say, "Stocks? Why would I want to do that?" And that's the environment that typically sets up a better market going forward.

One thing I'm going to watch as an investment opportunity is energy. Geologists have found maybe 100 years of natural gas locked in shale that would have been ignored a decade ago. Companies such as Halliburton and Schlumberger have developed technology that now enables us to take gas out of those rocks and create a sustainable, renewable resource there. Some shale deposits also contain oil. And, for the first time since 1970 when Alaska's North Slope came on line, we are seeing a significant increase in domestically produced oil primarily from the Dakotas and South Texas.

The Eagle Ford shale formation in South Texas (it runs nearly to Dallas) has three geologic sections:

- One is dry gas, which is natural gas currently selling for about \$4 per thousand cubic feet. It's almost not even worth looking for at that price.
- There is an area with both dry gas and liquids; and
- Finally, there is the very profitable oil-only section.

EOG Resources is an attractive name that, unlike its peers in the space, still has room to grow. EOG has the oil-only section all across South Texas. This probably is the most important property for any one company in 40 years. Three years ago, EOG was 80 percent dry gas and 20 percent liquids. EOG has completely reversed that without really missing a beat along the way. I believe a larger energy company likely will buy EOG at some point but even if it doesn't, the company likely will just continue running very profitably for some time.

**Jack McPherson:** We maintain a positive outlook for small-cap equities based on a combination of current fundamentals and longer-term opportunities. At the end of 2011, operating margins for most companies in our universe are well below peak levels and stocks are trading at what we view as reasonable earnings multiples based on historical trends, providing comfort that we are far from overvaluation territory.

Also, despite the global macroeconomic issues we've discussed and the U.S. election cycle, which likely will stoke continued volatility, we are hopeful that gradual resolution will provide clarity for investors to act more decisively in the coming years.

**Adams:** Much of the extreme volatility over the last couple of years has been more sentiment-driven than fundamentally supported. We strive to take advantage of market volatility and strategically add to and subtract from positions. The correlation of stock-price movements has been exceptionally high (greater than 90 percent) at times over the past two years, it

adds significant challenges in adding value through pure stock selection. Ultimately, fundamentals and valuation are the key determinants of investment returns over extended periods. Volatility may increase in the coming months or quarters but we believe our focus on long-term opportunities will provide solid risk-adjusted returns for our clients.

**Mintz:** I am excited about several broad trends in energy. The pursuit of oil shale has led to a renaissance of drilling activity in North America; however, the application of these new technologies such as horizontal drilling and fracking is still in its early phases. That is what's exciting because it likely means the economic returns will continue to improve and that, in turn, could lead to the "discovery" of more recoverable oil.

A great case in point on this is Continental Resources, which is the largest leaseholder in the North Dakota Bakken shale region. Continental recently said it had successfully drilled a well that targeted a separate zone only 50 feet deeper than where it previously was drilling and is apparently saturated with oil. However, I was even more interested when Continental said it is exploring various techniques that would allow it to target both zones with a single well. That has profound implications because not only will the amount of oil produced per well increase, it would potentially do so with only modest cost increases. That obviously would improve their returns exponentially.

**Boksen:** I've never seen a bull market start with a positive economic scenario. You seemingly have to have something significant to worry about to get the market going. And so when you have resolution, or at least partial resolution, of some of these issues we've discussed then the market will probably rally.

Small-cap stocks remain inexpensive if you believe the earnings-growth estimates, which for the Russell 2000 are about 20 percent next year. If you back

out of financials, the index trades at about 13 times earnings and 20 percent of the Russell 2000's stocks are priced at less than 10 times earnings.

In terms of our portfolio, I like to look at where the biggest risks are and I would say that's currently Europe. We're trying to underweight some of our industrials and materials, where we had an overweight position earlier in 2011.

The consumer space has been a really good space for us, which kind of defies logic with high unemployment. But the fact is, the U.S. consumer – at both ends of the spectrum – has been healthy and we've stayed focused on the domestic market.

We have a big overweight position in shoes by owning three companies. They've all done well but they remain inexpensive. The shoe industry has become a real feel-good kind of thing. It's a relatively inexpensive splurge on something people do need. People know Genesco has been a long-term holding and it's continued to do well.

We also like vitamins and health, primarily because of Baby Boomers. We own big positions in Vitamin Shoppe and GNC, both of which have done well.

Herbalife, which is an interesting story, has been a home run for us. This is a multi-tiered marketing company that is doing extremely well in South America and other emerging markets because it's meaningful in those places if a family can pick up a few thousand dollars per year selling stuff to their friends and neighbors. They've been in China for a couple of years and have grown rapidly there.

If you look at 2012 at the margins, things look to me like they are getting a little better. Employment is getting slightly better. The domestic economy is pretty good. The election can only help. Republicans figure to gain more seats in the House, where they already

have control, and possibly take the Senate as well even if President Obama wins re-election. The worst outcome is to get four more years of gridlock.

So when 2012 is over, I believe we'll have solid low-double-digit-type returns, which wouldn't be all that terrible.

**Skeppstrom:** One thing I believe you can hang your hat on here is that it would be hard to make the economy go much slower, unless the high-end consumer decides to pull back. Beyond that, I just don't see how we get into a shallow recession. I think we muddle through. Stocks are cheap generally and stocks I believe are particularly cheap include finance and technology. The last things we put into the portfolio were finance and technology and I suspect the next time we add, it will be finance and technology again. I think healthcare in the large-cap space could be a value trap because those businesses are all exposed to the government to a large degree now.

**Camp:** One big difference between the fixed-income world and the equity world is we are seeing bifurcations and lack of correlations among asset classes. I mean, you're definitely seeing it in the euro zone where there are winners and losers and you can see that in their yields. In terms of their bond yields, you can see it in their corporate space where financials are lagging badly while industrial names are holding in.

I don't think we'll see anything from the U.S. Federal Reserve other than probably more asset purchases. They have more transparency, which is good. What's clear is that credit markets aren't buying into – at least at the same level – the relatively upbeat things we hear from the equity world. We'll have to see how it plays out.

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There were so many “the sky is falling” scenarios forwarded at the end of 2010. And yet, the market is performing beautifully and credits are actually improving for the names we own. On the municipal side, tax receipts are solidifying and we believe there is significant structural support for that market to continue doing very well, which is good news for the 10,000 or so Baby Boomers retiring every day.

We believe 2012 holds greater promises in terms of buying very inexpensive corporate debt at prices we like. It gives us pause that the deleveraging that we had hoped and thought had occurred may not have occurred on the levels that we would be comfortable

with as debt managers. But importantly for us and our investors, our continued lack of correlation to the broad equity market should be beneficial.

**Moderator:** Headwinds from 2011 are likely to continue into 2012, with new twists and opportunities. Volatility – while challenging in the short term – can create unique opportunities for long-term investors with a focus on business fundamentals, company specifics and a reasonable investment horizon. Ultimately, valuations matter and the current tone of negativity may present a reasonable environment for active, experienced investors.

Past performance does not guarantee future results.

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# EAGLE'S PORTFOLIO MANAGERS

## Small Cap Equity

### Dave Adams, CFA

- 21 years of investment experience
- B.S. (1985) and M.S. (1989), Boston College
- Earned his Chartered Financial Analyst designation in 1993

### Jack McPherson, CFA

- 21 years of investment experience
- B.S. in finance, Northeastern University (1990)
- M.B.A., Babson College (2005)
- Earned his Chartered Financial Analyst designation in 1994

## Small and Mid Cap Growth

### Bert L. Boksen, CFA

- 34 years of investment experience
- B.A., City College of New York (1970)
- M.B.A., St. John's University (1977)
- Earned his Chartered Financial Analyst designation in 1981

### Eric Mintz, CFA

- 16 years of investment experience
- B.A., Washington and Lee University (1995)
- M.B.A., University of Southern California (2001)
- Earned his Chartered Financial Analyst designation in 2000

## Small/Mid Cap Core

### Todd McCallister, PhD, CFA

- 24 years of investment experience
- 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

- 14 years of investment experience
- B.A., cum laude, Harvard University (1997)
- Earned her Chartered Financial Analyst designation in 2002

### Scott Renner

- 19 years of investment experience
- B.S., University of Florida (1990)
- M.B.A., University of South Florida (1993)

## Large Cap Core

### Richard Skeppstrom

- 20 years of investment experience
- B.A. in mathematics (1985) and M.B.A. (1990), University of Virginia

## Fixed Income

### James C. Camp, CFA

- 22 years of investment experience
- B.S., Vanderbilt University (1986)
- M.B.A. in finance, Emory University (1990)
- Earned his Chartered Financial Analyst designation in 1993

## Equity Income/Value

### David Blount, CPA, CFA

- 27 years of investment experience
- B.S. in finance, University of Florida (1983)
- Earned his Chartered Financial Analyst designation in 1993

### Ed Cowart, CFA

- 39 years of investment experience
- A.B., Dartmouth College (1969)
- Earned his Chartered Financial Analyst designation in 1977

### John Pandt, CFA

- 17 years of investment experience
- B.B.A. in finance, University of Georgia (1993)
- Earned his Chartered Financial Analyst designation in 1998

## Head of Investments

### Cooper Abbott

#### Co-Chief Operating Officer and Executive Vice President of Investments

- Joined Eagle in 2003
- 14 years of investment-industry experience
- B.A., highest honors, Brown University (1991)
- M.B.A., University of Pennsylvania (2001)



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