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Crown Holdings

IHS

Amphenol

VF

CME Group

Allied World Assurance

Beckman Coulter

John Wiley & Sons

Owens-Illinois

Hasbro

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Market Overview | Junk stocks performed poorly in the second quarter after their record-breaking relative performance last year and into the beginning of 2010. The low-quality rally came to a screeching halt this quarter as the lowest return-on-equity (ROE) quintile returned -16 percent.

Why the sudden break in performance patterns? We believe the worry this quarter was that the economy will fall back into a recession. Bond markets historically tend to “discover” problems before other markets do and high-quality, long yields fell throughout the developed world with rare exceptions. (The exceptions included Spain, Portugal and Greece, which were raising concerns about sovereign-debt contagion spreading throughout the euro zone). The 10-year U.S. Treasury yield, which approached 4 percent in May, is now less than 3 percent. Rates are now as low as they were in the post-Lehman Brothers panic episode. Some of the downward pressure on rates is due to a safe-haven trade: German and U.S. bonds are essentially benefiting simply because they are not, say, Greek bonds. Nevertheless, this drop in yields was unexpected to us, especially so early in an economic recovery.

We believe this may mark a turn in the markets we have discussed for some time. And, given the magnitude and length of low-quality stocks outperformance, we also believe that quality stocks have room to run.

Portfolio Review | In addition to the market finally turning its attention to high-quality stocks, the takeover of Sybase helped our returns. Specifically, we saw strong relative outperformance from the materials and industrials sectors. In materials, containers and packaging as well as metals outperformed. RockTenn traded higher after the company reported earnings at the end of April. The company continued to increase operating efficiencies while still seeing dramatic price volatility in the cost of some of its cardboard-making materials. Silver Wheaton, which we bought at the beginning of the quarter, buys the rights to purchase silver at a fixed cost from high-quality mines. It traded up on news of two significant purchases and we took the opportunity to sell the stock at a profit.

Industrials benefitted from commercial services and professional services. We believe Stericycle was the benefactor of potential cleanup efforts from the Gulf oil spill, yet company management indicated it should be immaterial. We will monitor the position closely as it nears what we believe is a full valuation. IHS was up after beating earnings and revenue estimates through a mixture of acquisitions and sales growth.

The financial sector was a source of underperformance this quarter; Real-estate investment trusts (REITs) and diversified financial services were the industries that were affected the most. We were underweight in REITs, a sector that held up better than the rest of the financial sector. In diversified financial services companies, Leucadia has traded lower on little news, but Leucadia owns a large portion of Jeffries, and that firm struggled with other investment banks year-to-date.

The energy sector was also a source of underperformance following the tragic spill in the Gulf of Mexico. National Oilwell Varco traded lower throughout the quarter in spite of beating earnings. We feel that their exposure to the Gulf of Mexico is limited and that they might see more interest in their blow off preventers due to companies wanting to update these for environmental safety concerns. Noble Energy also lagged but we believe the company will fare better due to its diversification (e.g.,

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Benchmark Index:

The Standard & Poor's MidCap 400 Index is a capitalization-weighted index that measures the performance of the mid-range sector of the U.S. stock market. It is not possible to invest in an index.

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they have global onshore operations), a strong balance sheet and a solid orders backlog.

Outlook | We had long argued that the stock market seemed to be pricing in a V-shaped recovery through the second half of 2009 and the first part of 2010. We were puzzled to some extent by the market's rush into what we viewed as risky, very pro-cyclical areas that we avoided. Our hypothesis is that the economy would experience a short-term V-shaped recovery sparked by inventory replenishment (one half of the first quarter's real gross domestic product growth was due to inventory adjustments), after which the economy would resume a slow-growth path. Recent stock and bond returns suggest to us, however, that even a slow recovery may be in doubt. It increasingly looks to us like our hypothesis may have been a little too optimistic.

What makes this recovery different? The most significant thing, in our view, is housing. Housing is a key engine for economic recovery and growth in terms of jobs, demand for consumer goods and local tax revenues. However, we are not seeing those things now due to the huge overhang of existing inventory. In addition to housing, a slowdown in China, financial issues in Europe and increased household savings rates may hinder economic growth.

We are bottom-up stock pickers and not macroeconomists but – consistent with recent macroeconomic news – we are finding pockets of value in what are considered the market's more stable, defensive areas. In the finance sector, we are overweight insurance (e.g., Allied World Assurance). In the consumer area, we are underweight retail and restaurants and overweight publishing and media (e.g., John Wiley). In basic materials, we are overweight packaging (e.g., RockTenn, Owens-Illinois and Crown Holdings) in lieu of commodity names. In technology, we are overweight software and services (e.g., Fiserv and Check Point Software) instead of hardware. We also own a smattering of defense stocks (e.g., Oshkosh and L-3 Communications). The free-cash-flow yields of stocks in the areas mentioned above are at or above 10 percent. Economic growth may restrain the overall market level but we believe the stocks we own offer a solid risk-vs.-return balance.

Earnings estimates for 2011 are too high, in our view, if there is a lackluster recovery. Perhaps the second quarter's poor performance accounts for the realigned expectations. The good news, in our view, is that the market is nowhere near the panic it experienced in the fall of 2008.

In summary, our view is that free-cash-flow yields and earnings yields are near all-time highs, both on an absolute basis and relative to Treasury rates. We prefer to own stocks that we believe will be able to sustain their free-cash-flow levels in a slow-growth economy and, perhaps, grow a little faster than their peers. Our returns, by sticking to this long-term strategy, had been weak while the market was fixated on low-return, cyclical stocks. However, we believe the market may be turning its attention to the types of stocks we prefer to own in light of last quarter's returns and low bond yields.

Investing in mid-cap stocks may involve greater risks than investing in larger, more established companies, including the risk of more volatile trading than with large-cap stocks.