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Top Holdings

Thoratec
Lufkin Industries
Rovi
Genesco
American Medical Systems
Ansys
Tibco Software
Cash America International
Varian Semiconductor Equip.
BJ's Restaurant

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Market Overview | The Russell 2000 Growth Index declined 9.2 percent in the second quarter. Value underperformed growth (the Russell 2000 Value finished -10.6 percent respectively) and large caps underperformed small and mid caps (the Russell 1000 declined 11.4 percent). All major sectors in the benchmark posted losses, with energy down most significantly.

Portfolio Review | On an absolute basis, we saw the most significant decline in financials and the strongest performance in consumer staples. Relative to the benchmark, healthcare and energy outperformed due to strong stock selection. The top three stocks for the quarter were Thoratec, Coinstar and American Medical Systems. Medical-device company Thoratec exhibited strong stock performance due to stronger-than-expected interest in left-ventricular-assist devices (LVADs) for the treatment of patients with end-stage heart failure. Thoratec is the market leader and likely will remain so for the next several years as the market grows rapidly. This will lead, in our opinion, to solid revenue and earnings growth. Self-service vending-machine operator Coinstar appreciated after announcing a very strong quarter and increasing its earnings guidance. Increased revenue from Redbox, which highlights the company's earnings leverage, propelled the solid performance. Medical-device company American Medical Systems traded sharply higher after announcing a great quarter and raising earnings guidance. Revenue growth and earnings expansion are expected to accelerate in the second half of 2010 with the launch of five new products/line extensions and entry into the Japanese market in early 2011.

Relative to the benchmark, financials and information technology underperformed. In financials, our investment in mortgage insurer MGIC Investment pulled down returns due to macroeconomic concerns and our semiconductor investments lagged in information technology. Our three lagging stocks for the quarter were Genoptix, FormFactor and Huntsman. Genoptix is an independent clinical laboratory. The company has grown very rapidly, consistently beating estimates, but it recently started hiring a significant number of new sales representatives in anticipation of ongoing growth. We believe that it will take several quarters to complete this process so we sold the stock. FormFactor, a supplier of testing equipment for computer memory, was supposed to benefit from a recovery in sales of computers and servers. However, the company has had several execution missteps, including trying to transition manufacturing to a lower-cost region during the recovery. We sold the stock. Chemical producer Huntsman declined due to weakness in the euro-zone and concerns over a slowdown in China. We continue to hold the stock as we believe those concerns are overblown.

Outlook | Equity markets are laboring under a deluge of poor economic news. Despite government stimulus, private-sector unemployment remains stubbornly high. Most government programs seem aimed at providing entitlements rather than promote job growth. Forecasts for economic growth in 2011 have dropped to about 3 percent. That might be a stretch as government stimulus programs begin to run out. The administration's anti-business policies have hurt healthcare companies, oil drilling and potentially financial services. Prospects of higher individual, as well as capital gains, taxes are an incremental negative. Given the poor economic outlook, interest rates figure to stay low at least through year-end. We believe equity markets will be range-bound until there is greater clarity on economic growth for 2011.

Given the austerity measures being implemented in Europe and troubling signs of weakening real estate markets in China, the near-term outlook for commodity prices has deteriorated. As such, we

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Benchmark Index:

The Russell 2000 Growth Index is a market-weighted total return index that measures the performance of companies within the Russell 2000 Index having higher price-to-book ratios and higher forecasted growth values. It is not possible to invest in an index.

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have reduced our overweight exposure to energy and moved to a modest underweight in materials. Despite our concerns over a likely moderation in global economic growth, we continue to hold a positive long term view on oil prices. Within the industrial sector, we maintain our favorable bias toward companies with exposure to commercial truck and aerospace end-markets. The outlook for the aerospace industry is bolstered by increasing production rates for new aircraft as well as solid growth in air travel. For the second time in recent months, Boeing announced plans to increase production rates of its 737 aircraft as global air traffic increased 11.7 percent in May, according to the International Air Travel Association.

In the technology sector, global macroeconomic concerns have caused investors to take a “de-risking” stance in the near term, as we await more data that may help indicate how the recovery may play out. Thus far, demand has held in and management teams remain cautiously optimistic. However, the “de-risking” has caused stock valuations to fall and we are now finding more stock ideas with attractive growth profiles trading at what we view as reasonable valuations. Projecting whether healthcare reform would pass was a challenge but predicting how it will be implemented – and the unintended consequences it likely will bring – seems nearly impossible. There are, however, a few industry groups that we believe will benefit from healthcare reform or stimulus dollars including healthcare IT and hospital revenue cycle and supply-cost management.

After a strong first quarter, consumer stocks retreated sharply in the second quarter. Unemployment remains stubbornly high and government stimulus programs will ultimately run their course. We remain bearish on most consumer discretionary groups with the exception of gaming-equipment suppliers, which we believe should benefit from the continued expansion of gaming into new jurisdictions.

Investing in small-company stocks may involve greater risks than investing in larger, more established companies. These companies often have narrow markets and more limited managerial and financial resources.

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. Investing in small- and mid-cap stocks may involve greater risks than investing in larger, more established companies. These companies often have narrow markets and more limited managerial and financial resources. 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.