

Eagle Fixed Income

FIRST QUARTER | 3/31/12

EAGLE | Asset Management

Market Overview

The bond market in aggregate was modestly positive in the first quarter, despite the first meaningful shift higher in interest rates since the third quarter of 2010. As measured by the Barclays Capital U.S. Aggregate Index, the bond market earned 0.30 percent for the quarter. We noted last quarter, "The Long U.S. Treasury bond now has outperformed stocks (as measured by the S&P 500) at essentially every interval from one to 30 years. We like to highlight this development but we stress it is hard to see this trend continuing in perpetuity." It certainly did not take long for that trend to reverse.

As interest rates moved higher across the yield curve, longer bonds underperformed those of earlier maturities. The Barclays Capital Long U.S. Treasury Index lost 5.8 percent during the period and Treasuries in general (as measured by the Barclays Capital U.S. Treasury Index) fell 1.29 percent. Two main factors were responsible for the market movement in the quarter: Europe and the domestic economy. The details of a \$100 billion Greek-debt swap were agreed upon. The debt swap is not by any stretch a panacea but it should achieve the near-term objective of solvency. Locally, U.S. economic releases showed positive momentum on several fronts. However, there are those with suspicions that the unusually warm winter biased the releases higher. Still, both of those factors allowed the market to move through the first quarter with a little less nervousness than we have experienced in recent years. Moving to corporate debt, financials outperformed industrials and utilities in both total and excess returns. Government-related issues underperformed Treasuries by 1.88 percent. Securitized-products returns were positive across the sector with commercial mortgage-backed securities (CMBS) leading the way, followed by asset-backed securities and agency mortgage-back securities (MBS).

The Federal Reserve and inflation

The Federal Reserve maintained its target of 0 percent-0.25 percent for its benchmark short-term interest rate during the quarter. Further, it extended its prediction of near-zero rates from mid-2013 to late 2014. The move came as the Fed unveiled a more comprehensive communication policy that it hopes will provide more policy transparency to market participants. The Fed is including in its communications: post-meeting press conferences, a university lecture series and a more descriptive representation of the various Federal Open Market Committee (FOMC) member opinions and expectations.

In our view, this is simply an attempt by the Fed to support the markets without actually creating additional money and thus increasing the risk of runaway inflation. It is no surprise that this process alteration occurs at a time when various measures of inflation are at or above the level at which the Fed is comfortable. Should the economy stumble and these measures of inflation decline, we believe that additional easing is likely.

Corporate Market Review

Credit spreads – the difference between Treasuries and lower-grade credits – moved tighter in the first quarter on the momentum of serviceable bank earnings and economic releases that surprised to the upside. It was little surprise to see financial institutions lead the charge as we have observed this scenario at various times during each of the past three years. Financials spreads tightened 110 basis points during the period and earned a 5.07 percent total return as a group. Industrials and utilities spreads were firmer as well, showing 36 basis points and 27 basis points of improvement, respectively. The industrials sector earned a total return of 0.76 percent while utilities lost 7 basis points. Finally, consistent with a rally in risky assets: Baa-rated securities outperformed higher-rated securities by a comfortable margin in the first quarter.

Our stance remains defensive and we maintain our sector weightings from the beginning of the quarter. We are slightly underweight the financial sector, including a bias against money-center banks. Credit, especially finance, has rallied in the early stages of the year and we would expect that, in the absence of negative headlines, this will be a common trend. That said, we still believe significant headwinds remain for the large banks with regard to the housing market and regulatory environment. In addition, the majority of the low-interest temporary liquidity guarantee program (TLGP) borrowings are maturing and the banks will have to refinance at appreciably higher rates. We remain overweight utilities and industrials and place emphasis on businesses with predictable cash flows and modest leverage. Again, we see the trend of narrowing risk premiums continuing in the absence of negative economic releases and poor developments in Europe. However, we are positioned to outperform when this trend breaks.

Municipal Market Review

Following tremendous performance of municipal bonds in 2011, the first quarter of 2012 resulted in slight gains across all maturity ranges. The Barclays Capital Seven-year Municipal Index returned 0.26 percent for a quarter

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Separately Managed Accounts (SMA):

Taxable:

High Quality Taxable
Core Fixed Income
Managed Income Solutions

Tax-free:

High Quality Tax-Free
Special Fixed Income
Managed Income Solutions

Mutual Fund:

Investment Grade
Bond Fund

Please consider the investment objectives, risks, charges, and expenses of any fund carefully before investing. Contact Eagle at 800.421.4184 or your financial advisor for a prospectus, which contains this and other important information about the funds. Read the prospectus carefully before you invest or send money.

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Asset-backed securities and mortgage-backed securities are created by pooling loans from a variety of sources and issuing bonds that are backed by these loans. Creditworthiness stems from the credit quality of the underlying loans, as opposed to corporate bonds in which creditworthiness is derived from the earning power of the issuing company. The primary risk of these securities is interest-rate risk. Rising interest rates might cause loan principal prepayments to slow, resulting in less available principal to invest at prevailing higher rates. Conversely, rate decreases might accelerate prepayments, leaving more dollars to invest at lower rates.

Investment grade refers to fixed-income securities rated BBB or better by Standard & Poor's or Baa or better by Moody's.

Convertible securities and preferred stock combine the fixed-income characteristics of bonds with some of the potential for capital appreciation of equities and, thus, may be subject to greater risk than pure fixed-income instruments. Unlike bonds, preferred stock and some convertible securities do not have a fixed par value at maturity, and in this respect may be considered riskier than bonds. Convertible securities may include convertible bonds, convertible preferred stocks and other fixed-income instruments that have conversion features.

Investments in high-yield bonds and convertible securities are subject to the client's authorization, as set forth in the Investment Management Agreement. Such investments may be subject to greater risks than other fixed-income investments. The lower rating of high-yield bonds (less than investment grade) reflects a greater possibility that the financial condition of the issuer or adverse changes in general economic conditions may impair the ability of the issuer to pay income and principal. Periods of rising interest rates or economic downturns may cause highly leveraged issuers to experience financial stress, and thus markets for their securities may become more volatile. Moreover, to the extent that no established secondary market exists, there may be thin trading of high-yield bonds, which increases the potential for volatility.

characterized by strong demand for municipal bonds and limited "new-money" supply. The relative cheapness and scarcity value of tax-exempt bonds were major factors in keeping municipal yields low during January and February. The Barclays seven-year index returned 1.07 percent in January and 0.11 percent in February. The lackluster returns of February led into the negatively biased March due to tax payments, further compounded by rising Treasury yields. The Barclays seven-year index returned -0.91 percent in March. Eagle views the characteristic weakness of March and early April as a buying opportunity and participated in high-quality new issues of essential-service revenue bonds and large healthcare systems.

The majority of deals during the quarter was used to refund outstanding debt. Less than 35 percent of the \$78 billion of debt issued during the first quarter of 2012 was "new money." That \$78 billion is nearly 64 percent more than was issued at the same time in 2011 but there were 3 percent fewer "new money" deals this year than the first quarter of 2011. The limited new money and refunding deals were easily absorbed by the strong demand, demonstrated by 30 weeks of consecutive inflows to municipal mutual funds. Many deals, especially for lower-rated entities, were increased to help meet demand as investors reached for yield.

That appetite for yield led securities with greater credit risk to outperform high-grade bonds. Given the spread compression, we do not believe this is the time to invest in lower-rated credits, especially as multiple-notch downgrades become more common at rating agencies. These "super downgrades" can have detrimental effects on the preservation of principal municipal bonds typically offer. Eagle remains committed to ongoing due diligence and strives to stay ahead of these rating-agency changes. We have taken advantage of tighter credit spreads to sell certain positions that we believe pose above-average downgrade risk throughout the quarter, especially local general-obligation bonds. Downgrade and headline risks remain elevated but, in our view, default risk is low. Another risk to the municipal market stems from political uncertainty.

In February, President Obama released his fiscal year 2013 budget proposal, which threatened municipal-tax exemption. The proposal caps the value of tax preferences at 28 percent, which would require higher yields to compensate investors. Eagle believes this proposal will, once again, be unable to gain traction and any tax reform will not occur until after elections. Municipal-market participants already have voiced concerns and are working together to educate Congress about the increased borrowing costs municipalities would require should the tax-exempt status of bonds be eliminated. We are monitoring the situation closely and will adjust portfolios if necessary. A heavy reinvestment period is on the horizon and with municipal-to-Treasury ratios near 100 percent, the asset class is – in our view – likely to attract continued demand.