

## Management

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## Characteristics

Total net assets (millions)	\$74.41
Number of holdings	181

## Top Holdings

HTC  
Sberbank  
BG Group  
Hang Lung Properties  
BHP Billiton  
Fraport  
Rio Tinto PLC  
VTB Bank  
Royal Dutch Shell  
Baidu

## Market Overview

The first quarter was dominated by the natural and nuclear disasters in Japan as well as tensions that spread through many Middle Eastern and North African countries. In the aftermath of Japan's March 11 earthquake and tsunami, markets around the globe fell sharply. Within a relatively short time, most developed markets stabilized and by month-end, with the obvious exception of Japan, rebounded to neutral or slightly negative territory.

In March, emerging markets offered a picture unlike the first two months of the year and outperformed their developed counterparts. Emerging Asia was the strongest region for the month as many anticipated Japanese production that was disrupted by events may be absorbed by neighboring countries. In addition, investors became more confident that inflationary pressures and accompanying monetary tightening in the emerging markets may not derail the longer term growth story. Despite this rebound, emerging markets underperformed developed markets for the full quarter.

Developed European quarterly results were particularly good, helped by a strong euro which advanced approximately 5.8 percent vs. the U.S. dollar. Near quarter-end, Europe's parliament approved the formation of a permanent European Stability Mechanism ("ESM") which comes into effect in mid-2013. This was met with a second downgrade to Portugal by Standard & Poor's who cited fears the country may have to restructure its debt and force bond holders to accept losses after 2013. Greece was also nudged lower into junk status by the rating agency. Ireland agreed to inject as much as €24 billion into four of that country's banks with all of this news serving as a reminder that the sovereign debt crisis is far from over. Despite these ongoing dynamics, the peripheral countries of Greece, Italy and Spain were some of the best performers in the first three months of the year.

## Portfolio Review

The fund underperformed the benchmark for the first quarter despite strong performance in March. Broadly speaking returns in March were driven by the allocation between developed and emerging markets and Japan, largely an underweight to Japan and overweight to emerging markets. Also contributing to the month's return was our sector allocation within developed markets and our country and stock selection within emerging markets. For the quarter, the positive impact from emerging market country and stock selection was not enough to offset the negative effect from stock selection decisions in developed markets. This developed market drag came primarily from the financial and consumer discretionary sectors and to a lesser extent, sector allocation, mainly the underweight to financials

and overweight to materials. Cash positioning also detracted during the quarter, largely due to a hedge into the Japanese yen and a hedge out of the euro.

Our active share, measuring the portion of the portfolio which differs from the benchmark, is now higher than it has been in over four years, as we maintain a high level of conviction within our international equity strategies. A large component of our positioning reflects a positive long-term outlook for emerging markets, in particular, domestic consumption over export-driven growth.

China and Russia are two countries where we substantially differ from the benchmark (overweight positioning). For some time, investors have been focused on the aggressive tightening China instituted at the beginning of 2010 and the possibility that it would lead to a hard landing for the economy. In March, we began to see a change in sentiment across emerging Asia and equities saw strong returns. We believe inflation in China is a cyclical, not structural, problem for the economy's continuing development. We also believe the People's Bank of China is closer to the end than the beginning of its policy tightening cycle and anticipate that the slowdown in the Chinese economy will be gradual and sustained as we move into the second quarter. We believe China is in the early stages of a multi-year period of strong consumer growth. To capitalize on this belief, we have investments in a wide variety of businesses including supermarkets, department stores, specialty retailers and select shopping mall developers. Our positioning in China had a slight positive impact during the quarter with shares of Baidu (internet search engine in China) and China National Building Material outperforming.

Russia is another country where we view the developing consumer story to be very attractive. For years, the country's economy was largely dependent on natural resource exports. However, as the country moves to diversify the economy towards increased domestic consumption, we have seen a growth in consumer credit which is supportive of these longer term objectives. For both the month and quarter, Russia was a strong performer and had a positive impact on returns. Contributors included Sberbank, Ojsc Rosneft, Gazprom and Jsc Vtb Bank.

One of the more significant market turnarounds during the quarter was India. In the lead up to the country's much-anticipated budget announcement in February, equities declined. However, the actual announcement came and went without much fanfare. Early in the quarter, fear over the Reserve Bank of India's interest rate hikes also had a negative impact on the market. While some expected to see a hard landing scenario, similar to the concerns in China, recent data releases

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show encouraging signs (although inflationary risks still remain). We also see some improvements on the current account front and will continue to closely monitor forthcoming data. With these encouraging signs, in March, India posted the one of the best returns among both developed and emerging markets. Unfortunately, these strong returns were not enough to offset the volatility witnessed in January and February and overall exposure to the country detracted for the quarter. In particular, positions held in iShares MSCI India Index Fund, Larsen and Toubro as well as ICICI Bank underperformed.

Finally, within emerging markets, strong positioning in emerging Asia (outside China) also proved beneficial, in particular, exposure to the smartphone market with the position held in HTC. The smartphone market grew 96 percent from the third quarter of 2009 to the third quarter of 2010 and we expect strong growth to continue as consumers opt for more convenient and personal mobile connectivity.

As the Japanese market struggled to recover from the tragedy that struck the nation, our underweight positioning was positive for results. For several years we have been underweight Japan. Fundamentally, we have long viewed the nation as a slow-growth story plagued by an aging population and very high levels of government debt. Their national debt is troubling; before recent events, it was already more than twice GDP and there is little question that more debt issuance will be necessary as the task of rebuilding begins. Japanese banks, which hold the lion's share of this debt in the form of Japanese Government Bonds, could face daunting financial challenges if Japanese sovereign credit comes into question.

Developed markets outside of Japan had an overall negative impact on performance. An underweight and security selection in the financials sector was the quarter's biggest drag. We continue to have deep concerns about the solvency of many European banks and believe actions such as government liquidity programs are allowing them to be ignored. The situation was again brought to the forefront at the end of March when the Irish government announced that four of the country's banks needed to raise an additional \$34 billion to cover problem loans (bringing the country's total bank bailout bill to \$99 billion). Spain failed in its efforts to merge troubled savings banks raising concerns that the country may also be underestimating the depth of its banking crisis. Given that banks own much of the debt in question (aggregate European

bank exposure to sovereign debt from the peripheral European countries is approximately €1.8 trillion or roughly twice the market value of their equity), we feel the crisis will ultimately fall on the banks and in turn, any resolution will be painful to shareholders. This viewpoint leads us to continue underweighting European banks, which performed well in the quarter, and therefore detracted from relative returns. We are, however overweight U.K. and select Nordic banks.

A materials sector overweight as well as individual stock selection detracted. Positions held in Market Vectors ETF Gold Miners, Silver Wheaton and Barrick Gold (Canada) underperformed. The sector, including metals and mining companies and precious metal holdings, was a notable highlight in 2010. We continue to believe that the supply/demand characteristics of several commodities and raw materials such as gold, iron ore, copper and coal remain favorable and oligopolistic firms have pricing power and strong profitability potential.

Healthcare selections in the developed world helped quarterly returns, particularly Novo Nordisk, Essilor and Fresenius. We believe that successful healthcare companies will be those that bring not only innovative solutions for the world's growing disease burden but also work proactively with governments to provide affordable, quality healthcare. Changes in emerging market populations are causing a shift in healthcare needs. First, growing incomes are allowing people who were never before able to afford drugs and medical treatments to gain access. Governments are also developing public welfare systems similar to those that have long existed in the developed world. In addition, dietary changes of many emerging market citizens have led to increased prevalence of Western style diseases such as diabetes. As such, we are trying to capitalize on pharmaceutical and healthcare companies that are poised to answer increased demand.

*International investing presents specific risks, such as currency fluctuations, differences in financial accounting standards, and potential political and economic instability. These risks are further accentuated in emerging market countries, where risks can also include possible economic dependency on revenues from particular commodities or on international aid or development assistance, currency transfer restrictions, and liquidity risks related to lower trading volumes. 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.*

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Benchmark Index:  
The Morgan Stanley Capital International All Country World-ex US Index (MSCI ACWI-ex US) is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global developed and emerging markets.

Artio Global Investors is the subadviser to the Eagle International Equity Fund..

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