Eagle Insight

EAGLE Asset Management
AN AFFILIATE OF CARILLON TOWER ADVISERS

Small Cap Growth

Second Quarter | 2019

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Market Overview[1]

Small-cap stocks posted positive returns during the second quarter as the Russell 2000® Growth Index (up 2.8%) and the Russell 2000® Value Index (up 1.4%) maintained their upward trajectory from earlier in 2019. Sector returns across the Russell 2000 Growth Index were broadly positive during the quarter, led by industrials (up 9.4%) while more modest returns were experienced within financials (up 4.7%) and information technology (up 3.6%). Energy (down 10.3%) was the primary laggard within Growth, while communications services (down 4.5%) and real estate (down 0.2%) also trailed the broader benchmark's positive returns.

Portfolio Review[2,3]

Eagle Small Cap Growth portfolios performed in-line with the benchmark Russell 2000 Growth Index on a gross basis (while slightly trailing on a net basis) during the second quarter. Positive relative returns were generated within the consumer staples and energy sectors, while the portfolios' materials also contributed to positive relative returns. However, soft relative results within the consumer discretionary and healthcare sectors, as well as below-benchmark results within portfolios' financials sector holdings, combined to effectively offset the portfolios' relative returns.

Tableau Software, which sells business-intelligence analytics software, saw shares jump at the announcement that the firm was to be acquired by Salesforce.com at a substantial premium.

Woodward makes control system solutions and components for the aerospace and industrial end markets. Shares rose as the firm's aerospace segment has continued to perform well, with the benefits of acquiring fuel injection technology provider L'Orange becoming more apparent. Gradual improvements within its subdued turbine segment appear to be steadily progressing in recent periods.

John Bean Technologies provides food processing technology solutions (packaging/sterilization of food products). Shares rose as the firm's end markets have increasingly recognized the efficiencies and value provided by John Bean's technologies as a part of the food products supply chain.

Aerojet Rocketdyne develops solutions for the aerospace and defense industries. The company benefitted from strong and increasing demand within its core end markets. Management continues to improve the firm's operational efficiency to support margin expansion and drive growth moving forward.

Wingstop saw shares rise as the combined tailwinds of its delivery service rollout. An increasing prevalence and usage of its online ordering platform also helped to drive positive results during the period.

Atara Biotherapeutics develops drug therapies focused on treating degenerative muscular conditions as well as cancer. Shares dipped during the quarter as one of the firm's ongoing phase-3 clinical trials, which is focused on the treatment of Epstein-Barre virus-related cancers, appeared to reflect lighter enrollment progress than previously expected. While disappointing in the near-term, we expect to gain additional clarity on the trial's progress in the approaching periods. Additionally, we remain encouraged by Atara's clinical prospects for the treatment of multiple sclerosis.

Small Cap Growth

At Home Group, an operator of home furnishings and accessories stores, has underperformed in light of reporting weak results and while also lowering forward expectations. In our opinion, the weak results were driven by a combination of poor weather and intensified competitive pressure which has persisted in the home furnishings space. We sold the stock.

Chart Industries manufactures equipment used primarily in the production and storage of liquid natural gas (LNG). Shares gave back a portion of gains from earlier in 2019 as investors digested the firm's recent announcement of a sizable acquisition, while recent softness in LNG pricing may have pushed out the timing of the development of large scale LNG export facilities.

FibroGen is a biotechnology firm engaged in the development of drug therapies for the treatment of conditions such as anemia, fibrotic diseases, and cancer. Shares dipped as the firm provided an update on a clinical trial assessing the safety profile of its chronic kidney disease (CKD) treatment candidate roxadustat which, given the mixed nature of the update, did not appear to provide sufficient clarity for investors.

Biotech company CymaBay Therapeutics develops treatments for liver and lipid-related diseases. During the second quarter, the company conveyed an interim update to a phase-2 trial for its drug candidate intended to treat a fatty liver condition, which failed to inspire investors. We remain constructive on the name, given the largely preliminary nature of the update and will continue to monitor developments.

Outlook[2]

Equity markets extended the strong performance of the first quarter, benefitting from a strong domestic economy as well as a presumably dovish Federal Reserve (Fed). Markets currently seem to be reacting to the bond market with particular interest in how it forecasts pending actions by the Fed. As of this writing, the bond market is forecasting a 50 basis point cut in interest rates at the Fed meeting in late July. However, the Fed may be in a bind: At its last meeting, it said it would act as appropriate to sustain economic growth, which the markets interpreted as meaning a rate cut is pending. However, recent domestic economic data has been positive, with the jobs number being particularly strong. President Trump's constant criticism of the Fed also seems to be further muddying the water. Needless to say, it will be an interesting meeting.

In the third quarter, equity markets generally shift their attention to the following year – or in this case, 2020 – which is an election year. Given the strength of the recent rally, generally slowing global growth, which continues to be impacted by tariff disputes, difficult earnings comparisons ahead and relatively expensive valuations, we would not be surprised by some volatility in the months ahead.

During the first six months of 2019, the energy sector has been one of the worst-performing sectors. Oil price volatility remains high as markets grapple with concerns over relentless supply growth in North America and weakening global economic data. Despite these concerns, our balanced view on the downtrodden sector is based on likely continued central bank easing and a possible extension of OPEC+ self-imposed production cuts. Equity market investors continue to favor the select few exploration and production (E&P) operators that are capable of generating free cash flow and growing production. Given current commodity prices, we believe that this "dual mandate" will continue to prove to be a challenging feat for an industry that is notorious for generating returns below its cost of capital. As such, we believe operators with access to the most economic resource base will continue to outperform, and we

Top 10 Holdings

Waste Connections
Planet Fitness
Woodward
POOL
Aerojet Rocketdyne
Quaker Chemical
Casey's General Stores
Chart Industries
Trex Company
Cognex

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Small Cap Growth

Second Quarter | 2019

	Top Securities	Average Weight (%)	Security Contribution to Return	Bottom Securities	Average Weight (%)	Security Contribution to Portfolio Return
Small Cap Growth	Chart Industries	1.87	0.63	Green Dot	1.19	-0.32
	Floor & Décor Holdings	1.32	0.62	Weight Watchers	0.29	-0.27
	Planet Fitness	2.20	0.58	Evolent Health	0.53	-0.25
	Loxo Oncology	0.58	0.54	AMN Healthcare Services	0.24	-0.13
	Woodward	1.92	0.48	Tivity Health	0.27	-0.10

*As of June 28, 2019. The information provided above should not be construed as a recommendation to buy, sell or hold any particular security. The data are shown for informational purposes only and are not indicative of future portfolio characteristics or returns. Portfolio holdings are not stagnant and may change over time without prior notice. Past performance does not guarantee future results. Please note that the holdings identified do not represent all of the securities purchased, sold or recommended for the composite. They are provided for informational purposes only. Eagle, its affiliates or their respective employees may have a position in the securities listed. Please contact your financial advisor to obtain the calculation's methodology and/or a list showing every holding's contribution to the overall composite's performance during the measurement period.

Investments in small-cap companies generally involve greater risks than investing in larger capitalization companies. These companies often have narrower commercial markets and more limited managerial and financial resources than larger, more established companies. As a result, their performance can be more volatile and they face greater risk of business failure, which could increase the volatility of a fund's portfolio. Additionally, small-cap companies may have less market liquidity than larger companies.

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. 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.

remain positioned accordingly.

The outlook for the industrials and materials sectors remains heavily contingent on two factors which are well known to investors. First, these cyclically sensitive areas of the stock market will continue to vacillate on investors' perceptions of progress – or lack thereof – in the ongoing trade negotiations between China and the United States. The timing of a final trade resolution – and whether one can be reached at all – will undoubtedly continue to be the primary uncertainty in the minds of investors. Perhaps more importantly, it will be top of mind for corporate executives across the globe who are making capital investment decisions.

The second factor that may determine the performance of the industrial and materials sectors will be the future path of the Fed's monetary policy. Indeed, both sectors have already benefitted year-to-date from the so-called "Powell pivot." The Fed chairman abruptly transitioned in a few short months from a policy hawk who bravely proclaimed that the fed funds rate was "a long way from neutral" to a dove terrified by future implications of an inverted yield curve. Further gains in the back of 2019 appear possible if the Fed can demonstrate its commitment to move towards easier monetary policy in the face of subdued inflationary data. We currently believe that a rate cut from the Federal Reserve will likely lead to a steepening of the yield curve and push investors into the more cyclically sensitive sectors of the market, which offer attractive valuations – especially relative to "growthier" areas of the market where multiples have expanded considerably.

In our view, the environment within healthcare remains poised to support greater-than-GDP growth rates given the combined tailwinds of an aging population, longer lifespans, the crippling impact of chronic conditions and new medical innovations. The adoption of high-deductible health plans, coupled with health savings accounts (HSAs), has forced employees to shoulder a much larger burden of their insurance premiums and other out-of-pocket healthcare expenses, ultimately encouraging patients to more closely scrutinize their care-related decisions. We also believe that consolidation through mergers & acquisitions (M&A) activity is likely to continue throughout the healthcare industry.

We strive to identify healthcare companies that offer disruptive technologies or services that will drive significant revenue growth for these companies for years to come. One example of this is the disruptive nature of telemedicine: This care innovation continues to see rapid adoption by managed care and health care systems, particularly due to the convenience of improved access to quality care at a lower cost compared to in-person primary care office visits. In addition, we continue to like companies that provide "cash-pay" products and services (e.g., aesthetics, veterinary products and services, as well as dental and orthodontic procedures) which tend to have little regulatory or reimbursement risk from the federal government. Finally, we continue to seek opportunities within the biotechnology industry, where many firms are developing revolutionary therapies to treat diseases and conditions that would have otherwise been chronic, expensive, or fatal.

The outlook for the financials sector remains mixed. Moderating economic growth, lower levels of interest rates and a flatter-to-inverted yield curve make for challenging fundamentals in the core banking space. Outside of core banking, we are seeing unique opportunities in the insurance space in the form of companies created post-Great Recession to underwrite private mortgage insurance. In addition, although the first half of 2019 was relatively modest from an M&A perspective, we expect that pace to accelerate through the balance of the year. We continue to favor smaller boutique M&A advisor opportunities which have been gaining market share from the larger firms. Additionally, we remain constructive on select U.S. consumer pawn operators who are exporting their business model to the faster growing and more fragmented markets of Latin America.

We remain optimistic regarding information technology-related spending as unemployment rates remain at multi-decade lows, and consumer confidence and small business optimism indicators remain healthy. With interest rates pulling back, technology spending should remain robust both at the enterprise and consumer levels. M&A activity within information technology has remained healthy and we would expect that, with strong balance sheets at the very large technology companies and a sympathetic political environment in Washington, real potential exists for that trend to continue. We remain focused on high-quality companies with strong management teams that are well-positioned to gain market share. Additionally, we are looking for names that benefit from long-term secular growth trends with themes that include cloud computing, artificial intelligence, mobility, e-commerce/digital payments, Internet of Things/smart home, factory/industrial automation, security software, e-gaming and alternative energy.

Within the consumer sector the key theme is focus on the Millennial demographic. Millennials spend more on experiences over goods. They prefer the flexibility of renting housing rather than purchasing a home. They buy predominately online and are heavily influenced by social media, particularly social media influencers. They prefer their meals delivered and eat fake meat. They spend heavily on their pets. These preferences are in sharp contrast to prior generations, and the changes have created both winners and losers within the consumer space. Companies that are doing well are able to address the needs of Millennials by merging social media with online retail and addressing these rapidly changing preferences.

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3. Source: FactSet.