Summer 2013

Issues aplenty but market continues to move ahead

Eagle's senior portfolio managers offer informed perspectives on the current market situation and potential investment opportunities.

Executive Summary

- Eagle Asset Management's equity and fixed-income portfolio managers regularly meet to discuss ideas, events in the financial markets and potential opportunities for investors.

- The domestic markets have had a terrific run but concerns about when – and how – the Federal Reserve will end its quantitative-easing program have dominated the news. Meanwhile, many companies are in strong shape even in the face of a persistent slow-growth environment.

- The general consensus is that growth will be harder for companies to find if the recovery continues at its current pace but that good investing opportunities exist in many asset classes.

- Eagle managers continue to believe independent, diligent research is paramount in selecting stocks and bonds for long-term investors.

EAGLE | Asset Management

Eagle's portfolio managers gather regularly to discuss market trends and how they are positioning their portfolios. Twice a year, we publish their comments.

The global economy still has areas of concern, especially in Europe and China. Meanwhile, there are mixed data points on the domestic front. Our managers' discussion included such topics as how and when the Federal Reserve will taper its quantitative-easing program; U.S. energy independence; what effects, if any, federal policy and politics have on markets; and – perhaps most interesting to readers – how they have positioned investment portfolios.

Included in the most recent roundtable were Chuck Schwartz (Small/Mid Cap Core); Dave Adams (Small Cap Equity); Stacey Nutt (Large Cap Core); James Camp (Fixed Income); John Pandtle and David Blount (Equity Income and All Cap Equity); Todd McCallister, Stacey Serafini Pittman and Scott Renner (Small Cap Core); Bert L. Boksen (Small Cap Growth and Mid Cap Growth); and Richard Skeppstrom (Total Return Portfolio).

How We Got Here

Cooper Abbott, Co-COO/Moderator: There's been some turbulence on the fixed-income side while equities this year have hit nominal all-time highs. What is the general "mood" of the market?

Bert Boksen: The economy is recovering from the 2008-09 disaster but it is not overheated. Maybe we will see gross domestic product (GDP) growth of about 2.5 percent, which is fine in the longer term. Stocks are not historically cheap on a price-to-earnings (P/E) basis but they are relative to other asset classes.

I've been doing this a long time and I know there will be another crisis of some kind. But you can't make money if you're always looking for the next crisis. We have had the "dot-com" blow-up and the 2008-09 episode and a lot of investors have those in the back of their minds. The first little correction comes along and they're ready to blow out of the market. And the next thing you know, the market is higher. The reality is: The markets are hitting all-time highs. We have survived crisis after crisis. We probably will have another one. But as an investor, you need to be involved in this equities environment.

Interest rates are going to gradually head higher. The debate is how quickly it happens.

Rising rates are not necessarily bad for equity markets as long as they don't spike up dramatically. We may have a minor crisis in the bond markets; that would not surprise me at all. The stock market might go up another 20 percent and then be down 10 percent after a correction. That's fine; that's how the market works.

The economy is improving and so I believe we are very safe in equities right now. Balance sheets are great. Rising interest rates clearly would help most financial companies. The technology sector has been a laggard but it has great balance sheets. A lot of large-caps have too much cash and I believe they're going to start buying smaller companies. In fact, I've been surprised it hasn't yet happened to the extent that I thought it would.

I've been in the bullish camp a while now, and I see no reason to change just because the market is up.

Stacey Nutt: I don't think anybody feels really comfortable that a lot of economic growth seems to be spurred by printing money. That said, we are not seeing any major issues in the market right now or in the global economy. There are some possibilities out there, including a yield bubble (investors plowing into income-oriented and high-yield investments in an effort to offset historically low interest rates) that may not be as obvious as the housing bubble had been but it's a little scary what can happen in a very short amount of time with very small moves in rates. Market dislocations are things we want to avoid getting hurt by. We diversify our portfolios so we are not overly exposed to yield or something like that so we are not crushed if a bubble bursts.

If someone has been in a really bad auto accident at some point, they could choose never to drive again. But that's not optimal. The better thing would be to take driving lessons, buy a car with better safety ratings, wear a seatbelt, things like that. But keep driving. I think many investors are choosing not to "drive" in the stock market. That's not the optimal way to behave going forward.

Richard Skeppstrom: One of the things I believe is different now than from the last 2½ years is that you've had this super-bear camp, a super-bull camp and reasonable folk somewhere in between. Many of the super bears say the economy simply can't grow with this much debt. And yet, the U.S. economy is at least improving. So I suspect some of the super bears will start to fade away.

Importance of Style Consistency

Moderator: Why is experience important in your investment philosophy? And what does that experience tell you about the importance of adhering to a particular discipline?

Chuck Schwartz: Consistency helps create your reputation. Consultants and due-diligence analysts, on behalf of their clients, want to know that you're going to do what they hired you to do.

Nutt: Experience teaches in a way that books never can because you feel things when they happen to you. And you definitely feel it when the market or sectors or stocks blow up on you. Experience burnishes individuals – and individuals working together as teams – over time.

Experienced investors know that you need to maintain consistency and adhere to one's style but they also know that, at the same time, there should be evolution. The balance between the two is tough.

McCallister: That is tough because part of being a good money manager is to identify when things really are different. Most of the time they're not. That's part of the evolution because those shifts are when you can make lots of money.

Camp: What I think everyone here works toward is the repeatability of process. Math and time conspire together so, as mentioned earlier, consistency with some measure of evolution is critical. Create a proper message about what you do and then strive not to stray from that.

Skeppstrom: The reality is that most people understand – they may not like it but they understand it – the market moves in cycles: some years you're up and others you're down. What people don't understand and really dislike is when a manager tries to move in cycles because that rarely works out.

If the U.S. economy isn't going to roll back over, if Europe is actually improving a little bit, if China doesn't fall out of bed, then we'll be in a different environment than we have been in a while because there won't be this camp saying, "Hey, we are going into deflation imminently."

James Camp: I will tell you that I am shocked at how "Fed-centric" the markets have become. I think it's naïve for us to sit here as portfolio managers and suggest that a 0 percent funds rate for three years doesn't have consequences or that $85 billion of asset purchases keeping rates down has not had an effect on the capital markets.

We are now going to deal with Fed tapering. Do we go cold turkey or is this now a permanent policy tool? What the tapering talk has done over the recent past is introduce volatility back into the markets. It suggests to me the financial markets and their recovery have benefited significantly because of monetary policy.

Todd McCallister: The market does a pretty good job of anticipating what the Fed is going to do. I believe that by the time the Fed tapers, the market already will have anticipated what is going to happen. So, when the tapering actually occurs, nothing will happen.

Conversely, spending too much time looking at long-term issues is useless. You know what? There probably is an unsustainable debt ratio in the United States. Our government expects deficits to go back up in 2016 due to spending. The problem is that we would go out of business looking at these 15-, 20-, 30-year phenomena. The market anticipates but it doesn't discount that far ahead.

Ed Cowart: Many investors believe that a bull market is characterized by hope, optimism and good economic news but that's actually not true at all. It is only at the end of bull markets that good feelings about the market prevail. Most of the time, the market is climbing the proverbial "wall of worry."

Investors have been presented since this market advance began four years ago with an array of worries that make many wonder how the market can possibly be going up. That is how bull markets generally act. It will be getting close to the time to get more defensive when the case for stocks becomes clear to everyone and there is a rush to get invested "before it's too late." I believe we're still a long way away from that time.

John Pandtle: Can equities continue to rally in the face of rising interest rates? The answer is probably yes. That's what a recovery really is about. It's not going to be a straight line; instead, it's probably going to be bumpy. Sentiment currently seems very subdued.

Look at what happened in 1994 when U.S. and global bond markets were hit across the board. The S&P was down 2 percent that year. But it dawned on investors that the valuations in equities were compelling and that the backup in rates was, to some extent, a reflection of a better economic environment. There was a 25 percent-plus rally in '95 and '96 in the S&P. Interest rates may dislocate a bit but over the longer term, it's probably a good thing for the equity markets if it's a reflection of better and more sustainable economic growth.

Dave Adams: We strive to stay grounded because there's only so much we can do. We try to find where things are priced very accessibly and where they are not, and make adjustments along the way.

The market has been reactive. On the equity side, first-quarter money went into really defensive areas, such as healthcare, utilities and all yield-oriented securities. And that's happened only a few times in the last 50 years.

Camp: I wonder, from a simple standpoint, if no small part of the rush was, "I'm not getting any yield anymore. Where do I go? My money market is not giving me anything." The market is so near-term-focused.

One of the things I can't get my hands around is that there has been a pretty significant increase in real-estate investment trusts (REITs) and utilities … really, anything yield-oriented. But if we truly are going into a disinflationary period, why would I want to own the underlying portions of REIT if I believe their prices will be deflated?

One of the important consequences of artificially low yields is the allocation of monies to so-called "bond proxies," which include – among others – REITs, dividend stocks and levered closed-end funds. They are particularly sensitive to interest-rate increases and, in some cases, suffered double-digit mark-to-market declines during May's sell-off.

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>
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Moderator: "Income-generating" stocks have been very popular. Is that trend likely to continue?

Pandtle: It's an interesting time. About a third of the stocks in the S&P 500 Index have dividend yields greater than that of the Barclays Capital Aggregate Index. And those yields, on average, are growing 8 percent-9 percent. So, a global chase for yield has driven up the higher-yielding areas, such as utilities, telecommunications and consumer staples. Historically, we've aimed to strike a balance between pure dividend yield and growth in dividend income because we believe that balance is the best path to total risk-adjusted returns over time.

If you are someone who needs income in retirement, dividend-paying stocks still – even with the stock markets at or near peaks – offer a lot of opportunity if you tread carefully.

Camp: I think the same is true on the bond side. People are so starved for income – and they perceive bonds as "safe" – that they were just looking for the highest yield. But just reaching for yield – or buying products solely to create an income number – and not focusing at the same time on capital preservation doesn't make a lot of sense.

Moderator: There are lots of headlines about the U.S. economy: taxes, real estate, employment and federal-government drama. What forces are driving, and will continue to drive, the U.S. economy?

Cowart: In short, the U.S. corporate sector, which is a bright spot in an otherwise lackluster global economic environment, will drive the economy. U.S. companies are recording all-time highs in earnings, cash flow and cash on balance sheets. Moreover, despite a very good stock market over the past four years, valuations of U.S. stocks remain quite reasonable as earnings have risen nearly as much as stock prices.

Schwartz: The consumer numbers have been somewhat positive but it's a little hard to decipher. For instance, the highly populated areas in the Midwest and the Northeast were very cold throughout the spring and consumer spending numbers include energy. Maybe those numbers were a little higher due to people heating their houses. On the other hand, the sequestration was probably a 100 basis-point drag. So, it may have been a wash.

Real job growth is something we need. Corporate balance sheets are just huge right now and that is what executives get paid on. Hiring new people is not necessarily in their best interest if they see an uncertain economic environment. They may feel like hiring will come back to bite them personally if the economy stutters. So, they likely aren't going to invest in new facilities or aggressive hiring unless they believe their companies are losing market share or are otherwise missing huge opportunities.

Boksen: Higher taxes have been more than offset by improvements in housing values, which is very important. And a higher stock market is a big offset to those who are impacted by the higher taxes. The consumer sees it going in the right direction in terms of employment. It's not great but it's improving. Improving consumer confidence appears in reasonably robust consumer demand and, in turn, many stocks will reflect that.

Camp: I am a little bit concerned about what people are describing as a real-estate recovery because we believe so much of it has become investor-driven. The good news is that the "shadow inventory" and underwater loans are half of what they were at their peak. But what's happened is that we've shifted from an owner-occupied market to a renter-occupied market. That's not necessarily a bad thing but it will be interesting to see what happens when the investment companies that have bought so many of these properties decide to get out.

Meanwhile, the mortgage market – which functioned fabulously for 20 to 30 years as a risk arbiter and a facilitator of capital to real property – remains broken. It's moribund. Those who don't need mortgages are the ones who can get them. The investment companies have bought the mid-range inventory. I don't know that the consumer is benefiting as much as we think from this housing recovery until real people get housing.

Moderator: Talk about the possibility of U.S. energy independence and what it could mean for investors.

Adams: This obviously benefits U.S. oil producers. Twenty years ago, they would reinvest 95 percent of their cash flow to grow 1 percent-2 percent annually. And now, if they're drilling in some of the good shale regions, the better companies are producing 30 percent-40 percent free-cash flow. This could go on a while.

McCallister: I believe we're still pretty far from energy independence. We are supposed to produce 10 million barrels a day in the United States by 2020 but we consume 20 million barrels a day right now. Natural gas may replace oil as a primary fuel but oil prices will have to rise significantly – and stay there – for that to happen. We are not close to energy independence in the United States.

However, there are still ways to make money. U.S. chemical companies, which use oil to make their products, will benefit from lower costs. And U.S. refiners also will have an advantage. I believe natural gas prices will stay low because we produce so much now as a byproduct of oil drilling. Companies that operate storage facilities also are likely to benefit.

Pandtle: I believe that potential independence is real and it is a game-changer for the U.S. petrochemical industry. The margins for making ethylene, as an example, are five to six times higher for U.S. producers than they are for those in Europe and Asia.

We also like service companies. They don't drill; they provide the goods and services the producers need to extract and move oil or gas.

Boksen: We have a modest overweight in energy. One of our biggest holdings is Geospace Technologies, which makes seismic instruments used in monitoring oil and natural-gas reserves. They're replacing cables with wireless systems, which saves about 60 percent of the cost of laying cable. The stock was on a tear but now it's pulled back. And we're waiting for the next big contract.

Nutt: It's interesting to me that we talked earlier about how the market anticipates some things – in particular, the end of the Fed's quantitative easing – but there's some question now as it relates to the market identifying opportunities in U.S. energy production.

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>
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McCallister: Well, I believe most analysts and investors assume there's always a regression to the mean and they let that color their decisions. That reversion doesn't always happen in the short term. Think about how much money you would have lost if you'd decided to pull out of the equity market in 2003 on the assumption that net margins had to revert to their historical means. Those margins are higher now than they were then.

I believe the same phenomenon is occurring with oil and natural gas. Sure, I would like natural-gas prices to revert to their higher mean but I don't believe they will. You produce a lot of natural gas here when you drill lots of oil. Adding supply isn't going to push up prices.

Warren Buffett has made most of his money by investing in opportunities where things don't regress toward the mean. He bought railroads when they were expensive and people said, "Oh, those

prices are going to come back down." But he was right: The returns on rails have not regressed to the mean; in fact, they've gone up.

Moderator: We've had an election. We've had sequestration. We've had debt ceilings. Is what happens at the federal level still meaningful to the markets? How important is the Fed and other governmental interference? Does the market look at that or past it?

Camp: I think Ferderal Reserve Chairman Ben Bernanke is doing the heavy lifting for everybody. I think that if he were able to speak candidly, Bernanke might say he is tired of having to be the enabler but – for companies – there remains a lot of uncertainty about the fiscal side of the equation that is an overhang. I don't think any of us have seen anything worse on the fiscal side. There is no meaningful tax reform. There is no meaningful regulatory reform. And we have yet to absorb Obamacare.

Bernanke has stated a desire to use the capital-market recovery to create a "wealth effect," essentially arguing that financial-asset recovery would help spur consumption. We can argue the veracity of this but higher-risk assets are benefiting from the zero-rate policy and asset-buying.

Now, the Fed is actively discussing concerns about asset bubbles and disruptions in the Treasuries and repo (overnight) market because of its activities. The Fed appears to be softening the requirements of 6.5 percent unemployment and 2.5 percent expected inflation as a condition for slowing its asset-buying. The Fed is trying to decouple QE from the funds rate. The sell-off in May/June clearly spooked Fed members, who are now trying to convince markets that slowing QE is not the same as "tightening."

Skeppstrom: Obamacare is a great example of unintended consequences. I know successful small-business owners who are artificially capping their employee rolls at 49 so they don't trip the healthcare requirements.

We're not hearing much about fiscal stuff now because changes in the capital-gains rate probably drew forward a couple billion dollars in taxes, which is taking the heat off the issue for a while.

Boksen: The reality is the market has been ignoring Washington. The market doesn't seem to care right now. There are greater forces pushing the market higher and it is ignoring bad news. The market is ignoring all the fiscal issues that would scare the pants off people in a different environment.

Pandtle: One government issue not getting a lot of attention broadly is the regulatory pressure on financial-services companies. The U.S. banking industry's profits last year eclipsed the pre-crisis high of 2007. But as we go forward, the normalized return on equity for the industry is going to be about 60 pecent-70 percent of what it was. Half of that is because they have to have more capital on their balance sheets. The other half is them getting nickel-and-dimed on a number of regulatory issues, such as service charges and interchange fees. The government is still writing rules! Further, there's a new consumer financial-protection bureau getting ramped up and that's undoubtedly going to add additional compliance costs to the banks as well.

That will have broad long-term impacts: If banks have to hold more capital and face less profitability, that likely will mean less lending to help fuel the economy.

Camp: Qualified mortgage-lending standards are another issue. That's like putting a tighter noose on underwriting for residential mortgages. It's not hard to see how that could affect the housing recovery.

Moderator: What ramifications, if any, will the Detroit bankruptcy have on the broad municipal market generally, specific bonds and on pension obligations?

Camp: It will be important to watch. We saw when Stockton, Calif., and others filed that it appears courts are writing bankruptcy law on the fly. We don't believe this is the beginning of a slew of municipal defaults but it's critical to see how general-obligation holders are treated relative to the pure unsecured-debt holders. The bond market obviously will be watching because how it gets treated now will dictate whether Detroit will be permanently locked out of the capital markets. Detroit's situation is unique – particularly its demographics – and it was a long time coming.

But yes, there will be headlines that move prices. But I think this actually does a good job of highlighting the importance of the due diligence we do.

Moderator: We talked about the domestic economy. What are your thoughts on Europe and China?

Skeppstrom: Europe could be better if they would just change a few things. The question is if they will. My big worry is that Europe will not change and there will be all these young adults with no money, no car, no job. I think that's a bad combination. There could be big problems in Europe. Even if their economies pick up a bit because of an improving U.S. situation, I still think there could still be social problems.

Momentum in the market?

Nutt: Do you think there's a lot less momentum investors out there now driving the market than there were years ago? The reason I ask is because momentum investors are the ones who, when something has an earnings mess, they're gone and the stock gets rocked.

Boksen: Yeah, but momentum investing is popular in bull markets because it works. I believe we're starting to see it creep back into the market.

Nutt: There's such a scarcity of growth across the economy that when there is a company that looks like it is growing sales-wise, it gets bid up quite a bit.

Boksen: I see momentum at play in stocks such as LinkedIn. It's a good company but what about the valuation? I can't get past it, but it's in the mid-cap benchmark. If you don't own it, you get crushed.

I believe a lot of people play the relative game: "Well, I have to have at least an index weight on a LinkedIn even though I can't stomach the multiple because it's going up and it's killing me."

Adams: It shows up in a lot different ways. If regional banks have any growth characteristics, they can get bid up to really high levels on a relative basis for a bank because growth managers inherently don't own many. They'll pay three times tangible book because they think the company is a fast grower.

McCallister: The problem will only be solved when there's a fiscal union to go along with the monetary union. That could be 10 or 15 years from now. The issue is that it really helps to have control of your own currency. Right now, the European Central Bank (ECB) controls the currency but each country maintains its own fiscal policy.

Camp: Yields in the Eurozone have come down from the catastrophic highs of a year or so ago. The markets have the French 10-year bond at around 2 percent. Sure, Greece is still 9 percent but that's the periphery. It seems to me Eurozone debt has moved off the front page, at least for now, and the capital markets are treating it sort of benignly.

Cowart: Much of Europe struggles with austerity and recession, Japan is trying to get its monetary policy finally right after 20 years of failing. Meanwhile, China faces the difficult transition from an investment- to a consumer-led economy and other emerging markets experience all manner of growing pains.

Pandtle: I think one of the issues there is that the euro seems fundamentally overvalued. The euro needs to come down. It will be interesting to see if Japan's new economic-reinflation experiment works. Will Germany have to react because it might be less competitive on the export front in the face of a stronger Japan? Would that finally get Germany off its hardcore austerity kick and remove the stranglehold it seems to have had on the ECB balance sheet?

Nutt: I don't think the Germans culturally will be able to do that. It's not in their DNA to say, "We should print money."

I wonder if we're looking at a sort of long-term, slow-moving currency war. All we can see are little pieces. We don't have the capacity to understand such drawn-out events so we hyperfocus on what's happening today. So with the 24-7 news cycle, we have overreactions to every data point. But in reality what is happening is a very drawn-out, potentially difficult currency war among the United States, Japan, Europe and other places. But as was suggested earlier, I can't let what might happen 10 or 15 or 20 years from now cripple my day-to-day decision-making.

Japan is interesting. I think their situation is much more positive than the short-term returns might indicate. Our fundamental models are showing some very powerful benefits from what they're doing. Their auto makers … the economy in general is really benefiting from what is going on there.

In China, we've moved away from exporters and toward the Chinese consumer. I believe the overall economy there is continuing to slump. It's not stopping but it's slowing and it probably begins to turn more inward.

Where We Are

Moderator: We've talked about some macroeconomic topics so let's turn now to talk a bit about what has been happening at the asset-class or corporate level.

Schwartz: Revenue growth for small-cap stocks is up a little more than 4 percent while profits are up a little more than 3 percent. They were a little better than mid caps. Large caps had negative revenue growth but have had positive EPS growth.

Skeppstrom: Large caps are getting hurt by the Eurozone issues.

Healthcare is interesting to me. We are going to see a big change over the next couple of years in terms of where healthcare spending goes and how that is going to work out. But in general, you've seen people defer spending on healthcare here when they're under pressure at work. Perhaps we've crossed over the amount of cost-sharing that actually impacts people and makes them decide whether they get that prescription. I believe that is going to be important because it's a huge portion of earnings and of the economy.

Boksen: The thing that struck me the most about this earnings season is how forgiving the market was on the companies that missed earnings estimates. Those things dropped and then almost uniformly came right back up. That's a sign of a bull market. If it were a bear market, those companies would have been torn apart.

Schwartz: A lot of companies were talking about increasing their dividends to try to get their multiple up and return cash to shareholders. There wasn't – as we said before – a lot of expansion talk about facilities and new hires but there was a lot of talk designed to get more interest in their stocks.

Nutt: There weren't a lot of surprises earnings-wise. There's been an awful lot of fervor about panic here, panic there. But as companies have issued their earnings and fundamentals show themselves, it turns out it's been pretty benign over the last few years. Maybe it goes back to 2008 or '09 but there's a lot of emotion built into people so they're going to react or overreact on a regular basis. Companies miss earnings estimates by a few pennies and there's this enormous overreaction and then they come back the next quarter and exceed estimates by a couple of pennies.

I believe there was a benefit to the near-death experience many companies had several years ago: efficiency. Companies are efficient, they're holding on to capital and they are able to generate earnings better than they used to.

McCallister: There must be an overarching belief the economy is, in fact, getting better. If people thought we were late in a business cycle, the reaction to missed revenues would be, "If you're missing now, what's going to happen down the road?" You have to miss two or three times now to convince.

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Moderator: What is happening on the mergers-and-acquisitions (M&A) front?

Adams: It's always great as a small-cap manager to have a GE or IBM snap up one of your companies that you feel is fully valued at a 30 percent premium. But we're not seeing a lot of that lately. One of the things we're hearing from small-cap companies is that sellers are holding out for bigger premiums. There is a sense that companies that survived the downturn believe they are worth more than the offers they're hearing.

Boksen: I thought there would be more than what we've seen. There is cash on balance sheets and it's a relatively slow-growth environment. I would have thought that we would be seeing three or four deals every Monday. I think we had a little spike at the end of last year to beat new tax laws and now maybe there's a little bit of a lull because of that.

Importance of Active Management

Moderator: Do you believe we've seen the market move as it has for the last few years based entirely on fundamentals or are there other factors at work?

McCallister: It used to be that markets were made by small brokerage firms who got loans from big brokerage firms. When they got scared, they stopped making a market in particular stocks. Now, ETFs and asset allocation provide the equity. Buy-sell decisions are being made at the asset-allocation level, not the stock level. It used to be that small-cap managers in particular didn't have to pay attention to what others were doing because there were so many places to make money. Now, ETF-based flows into the indices' biggest names drive performance and so not owning those companies effectively can be shorts against the benchmark.

The drive I see behind ETFs is a notion that an investor can get out tomorrow if she believes the world is going to fall apart. Of course, that never works because by the time you realize the world is "bad," you can't get out.

Boksen: I believe ETFs are the best thing that has ever happened to the small-cap market because they provide liquidity. If you are doing your job right and you know your stocks, you should be able to outperform an ETF in theory. The herd-like moves they make provide opportunities to buy good companies that drop for no reason.

Nutt: I view passive management as just another style – value, growth, passive, momentum, etc. – and it is subject to the same cyclical laws as the other styles. Something works, becomes the "it" thing and eventually other styles – sometimes dramatically, sometimes quietly – outperform. I believe the same thing will happen with ETFs. Active managers will start outperforming because they will make money trading on fundamentals and investors will start moving that direction.

Camp: What's interesting on the bond side is that ETF volatility is markedly worse than it is for the underlying securities. I view the ETF complex almost like I viewed such things as credit-default swaps. It is the latest and greatest – great liquidity, low pricing, index returns – product that inevitably fails when there's volatility or where there is a rotation.

For example, Meredith Whitney spooked the municipals market in 2010. That turned out to be the best buying opportunity we ever had in the asset class and it produced some of the best relative performance we ever had.

The municipal ETF last month was down two-fold what a similar tracking bond would be. We believe bond ETFs can be dangerous because they're often naively invested. If there is an accident in the fixed-income market, we believe it will come from ETFs.

Skeppstrom: It's honestly surprising. Management teams often do what they see their competitors doing. Somebody needs to kick it off to get it going. However, stocks have been working pretty well so they may not want to mess with that.

Camp: Private equity could be a catalyst here as well with close to a trillion dollars in liquidity sitting there. Maybe we'll start to see more leveraged buyouts.

Moderator: Where are you currently seeing investing opportunities? What is the market giving you and how are you positioning portfolios?

Schwartz: We run a conservative-growth style and we focus on three things: quality, valuation and balance. When we talk about quality, we mean the quality of a company's management team and its business model. Does it consistently produce a lot of cash? If it is a cyclical company, does it have "higher highs" and "higher lows" than its peers as it goes through a business cycle?

On the valuation front, we are very strict on the buy side and the sell side. We are also very patient investors: We may wait two years after identifying a company we want to buy to ensure we buy it at what we believe is the right price. We consider ourselves investors in stocks, rather than traders of stocks. We have had 35 percent turnover in the last three years, which is very low for growth-leaning small- and mid-cap managers.

And finally on balance, we are growth managers but align more to core benchmarks especially for sector balances. We don't typically have the high overweight positions in technology, healthcare, consumer discretionary and some of the higher-beta sectors like many growth managers do. That is all about taking some risks out of this asset class for our investors.

> *"The reality is: The markets are hitting all-time highs. We have survived crisis after crisis. We probably will have another one. But as an investor, you need to be involved in this equities environment."*
>
> – Bert Boksen

Some sectors where we're seeing opportunities are technology and industrials. Technology has underperformed for 18-plus months now so we see some good values there. There may be increased mergers-and-acquisitions (M&A) activity because some larger companies can see beneficial acquisitions at current valuations.

An example would be Cognex, which designs systems for factory automation. It's a domestic company with a very real potential for international growth. Many emerging economies have rising middle classes, which means factory wages are going up. It is becoming more compelling for companies to rely on automation because labor isn't as cheap as it once was.

Adams: We are more of a value-oriented manager with a bottom-up focus. That said, we want to be aware of macroeconomic issues and how they might impact the companies we own. We look for companies that are a bit hidden, misunderstood or

disliked when we buy them and we want to see a catalyst that will improve the business over time.

So we are really focusing on the business. We are not pure contrarians but we may get involved in companies a little bit sooner than other managers. We traditionally have had fairly low turnover that's been even a bit lower in the last couple of years as correlations have spiked in the market.

From a positioning standpoint, we somewhat overweight in the more economically sensitive areas, such as industrials. Conversely, consumer discretionary is probably our biggest underweight position and has been for some time. But to be clear, that's where we are finding the most compelling companies; it is not a top-down statement that we're bullish on all industrial names or bearish on all consumer discretionary companies. We recently have found compelling names across almost every industry.

On Assignment is a great example of one of our holdings. It is a specialty staffing company that had been grossly mismanaged. We bought it about eight years ago because we believed its new management team had the wherewithal to undo prior mistakes and unlock the company's real value. Since then, that new team has transformed the business from largely healthcare staffing to information technology-based staffing, where there is huge demand for On Assignment's professionals such as project managers.

Cowart: There is a cornucopia of investment opportunities created by the intersection of slow overall economic growth, low inflation and interest rates along with a thriving corporate sector.

Pandtle: With Equity Income, we have a preference for high-quality companies with well-established businesses, good cash flow, strong balance sheets, management teams that are good stewards of shareholders' capital and have a demonstrated track record of being able to create the free-cash flow to pay – and often raise – dividends annually.

On the All Cap Equity and Value side, we do have a valuation orientation but we also want to make sure we have growth. We call it value and reasonable growth, or VARG. We believe value is the first criterion to consider when evaluating an investment opportunity but we don't ignore growth. We need to see evidence of reasonable growth, which is a component that we believe helps keep us out of value traps.

We have found valuation opportunities in some of the more cyclical sectors and we've tilted away from some higher-dividend stocks that we believe may be a bit overvalued. Sectors such as technology, consumer discretionary, industrials and financials are where we have been putting more money to work. We have been pulling back from telecommunications and, probably for the first time in 10 years or so, we do not currently own any utilities.

Boksen: We typically look for companies with accelerated earnings growth, companies in transition, companies that have some sort of a catalyst for improvement. It could be company-specific (e.g., a new product, an acquisition or investiture) or it could be industry-wide.

We try to be, in the small-cap environment in particular, early before everyone knows about those

catalysts and stocks get bid up. When you get it right, you can get both terrific earnings growth and you get an expanded price-to-earnings (P/E) ratio as the growth rate starts to accelerate.

An example of that would be Universal Electronics, a small-cap company we have known for a while. They make a remote-control device for TVs, have more than 90 percent market share and no debt. Here's a 25-year-old company that suddenly has a whole new business opportunity because of a cell-phone app that allows you to control your TV with your cell phone. Here's a monster new business opportunity. They have a contract with LG and I believe they're working with Apple.

We try to put a portfolio together of those type of names and we like to own them long term. We water our flowers and if things are not working out, we pull our weeds. Not everything works as well as Universal.

McCallister: We try to buy good firms that have good market positions without overpaying for them. We are very specific about what a good firm is: It has to have good market share. A young company has to have improving profitability. A mature company has to have proven profitability.

An example would be Monotype Imaging, which is the kind of business you would want to give your child. The business started out resizing fonts for printers but, with the explosion of cell phones and tablets, it does the same work on the digital front. The market is huge and its only real competitors are open-source software, which doesn't have the same sophistication.

> *"We say we don't buy shares of GDP but, rather, shares of companies. We believe you almost always can find good valuation opportunities and some good growth. It's still the case today."*
>
> – John Pandtle

Stacey Serafini Pittman: Consumer stocks have experienced significant outperformance relative to the overall market since the recession of 2008-'09. That is understandable given the gradually improving employment picture, low interest rates, stable energy prices and – perhaps most importantly – the wealth effect from higher home prices. Most consumer companies are largely domestically focused, which has also made the stocks relative "safe havens" during periods of worry over slowing international economies.

We believe that the backdrop for the consumer will continue to improve, even in a modest GDP-growth environment. However, valuations largely reflect that reality. We see pockets of opportunity – industries such as autos, leisure and media names – within the consumer sectors. Spending on autos – and other big-ticket purchases such as recreational vehicles and all-terrain vehicles – is still depressed relative to historical levels and should continue to improve even if interest rates increase slightly from today's levels. Home buying should also continue to improve, although the valuations

of homebuilders – and most retailers or distributors tied to homebuilding activity – are unattractive. We also believe that early-cycle consumer stocks, such as specialty retailers, will be relative underperformers as the consumer shifts more of his or her dollars toward durable purchases.

Scott Renner: We continue to like the technology sector because it remains a consistent source of names that are both conducive to our investment style and trading at reasonable valuations. One of the more exploitable themes for us within the sector remains the concept of finding good businesses that are being ignored by the market, either because there's an assumption that technological advances are rendering these businesses obsolete or there is a negative company history overshadowing positive value-creation by current management. Technology is maturing as a sector but there are always new segments of growth across all technology industries that capture the market's fancy. The most recent of these would include three-dimensional printing companies, social-networking companies and cloud software applications that deliver real-time business analytics or monitor security in commercial and government network infrastructures.

In the rush to own these new sources of growth, investors often abandon companies that still have substantial market share, solid growth visibility and management teams that know how to grow free cash and allocate that capital efficiently. Instead of focusing solely on the promise that these new growth themes bring, we focus on whether investors have either unfairly punished legitimately strong business models that are more defensible than the market is giving them credit for or ignored some legacy companies that are remaking themselves by investing in areas that can deliver attractive growth. That approach has led us to names like Echostar within communications equipment, j2 Global within internet software and services and Heartland Payment Systems within information technology services. We believe that this approach gives us the opportunity to deliver excellent risk-adjusted returns over a long-term investment horizon.

Skeppstrom: I came to the realization a little more than a year ago that we are stuck in this macroeconomic-driven boom-bust cycle. When I first got into the business, I was certain that no one could time these kinds of things because I didn't see any evidence of it. But over the last 15 years, I've seen plenty of evidence of it: the extraordinary accommodation and incredible low-interest rates from the Federal Reserve, money flows in the direction where the highest returns are.

That said, I am very constructive especially on the U.S. market. Companies are in good shape. Profit margins are high, which means it will be more difficult to grow, but the one thing that I think we could all agree on is that it's surprising so many companies were OK coming out of the last Fed-caused disaster (in 2008).

Nutt: The cycles that Richard mentioned are what we tend to try to embrace. We assume that cycles will occur repeatedly at the company, industry, sector and even the global-economy level. There are a lot of reasons for that: government policies down to new technologies. At the stock level, very few

public companies go bankrupt and very few of them become Apple … and even the Apples start to slide.

We look to embrace cycles and model how human beings react to them. We also look at the interaction between sentiment and the fundamentals that are going on inside companies or industries or sectors. We watch the shift from early in a cycle – where there is real negative anchoring-type behavior – when nobody believes it is actually happening to the end of a cycle when everybody believes it is going to go on forever and there is too much optimism.

A great example of this kind of behavior over the last 15 years is the "smart phone." First, everyone believed Motorola was going to take over the world and then it was Nokia that was going to take over the world and then it was BlackBerry and Apple. But now, people wonder if it will be Samsung or Google to take over the world. But they won't either.

We look for evidence of interaction between sentiment and how fundamentals are moving so that we can take advantage of that by way of capturing higher earnings growth. We use a lot of quantitative tools to do that so we approach it a little bit differently than the other managers here.

We have many different products but we see patterns. Right now, we are underweight consumer staples across the board. We have independent portfolio managers on all these different products but all are ending up underweight staples. We are overweight the auto industry. That means we own suppliers in the small-cap portfolios and the manufacturers themselves in large-cap portfolios. In our emerging markets, we had been slightly overweight Hyundai in Korea but we are now starting to favor Japanese automakers because of what is going on there.

Moderator: How about fixed income: What's going on in the taxable and municipals markets?

Camp: The fixed-income market has gone through a series of fits and starts over the last couple of years where the market has anticipated an imminent rise in interest rates and has created quite a bit of headlines in the popular press. I think that in May we had the first real trial balloon on what will happen when the Federal Reserve exits its stimulus plan. The 10-year Treasury backed up what I consider a pretty modest – in the grand scheme of things – 40 basis points and the asset classes that were yielding the most – including real-estate investment trusts (REITs), closed-end bond funds, high-yield corporate bonds and other highly leveraged instruments – were hit significantly. It was an important time because it validated what we had been saying for some time: Building portfolios merely for yield is a mistake that leaves clients susceptible.

What we are doing in our portfolios, for lack of a better phrase, is "de-risking." We believe that many of the structural things we have seen in the bond market over the last four or five years ultimately will have a bad end. That end likely won't be the same as what happened in 2008 but it will certainly create more risk than we like to take on. For example, trading capacity for fixed income is down about five fold from the peak in 2008 while, at the same time, there has been a proliferation of bond-like products that have attracted investors understandably frustrated by 0 percent rates on their short-term investments.

In a world where the 10-year Treasury is roughly 2 percent, a 6 percent yield is three fold the risk. In a 4 percent world, that number would have looked like 12. We believe the taxable bond market is overextended and overleveraged. There is a lot a data that is suggesting that net investor credit is almost back to all-time highs.

Consequently, we are keeping our corporate-bond exposure inside five years. Our credit qualities are migrating higher. There are things going on in the corporate world that are non-bond-holder-friendly. Those things are very good for stocks but share buybacks, re-leveraging and special dividends are not good for bondholders generally.

On the municipals front, headline risk is the phrase word of the day. We're seeing honest-to-goodness bankruptcies, including Detroit declaring the largest municipal bankruptcy ever. The buy-and-hold investor often gets hurt when those moments happen. So, we as active managers construct well-researched portfolios. We look at monthly financials. We look at demographics. We look at such things as debt covenants. This really crosses over the municipal market and the corporate market where there is event risk building.

Overall, I do not have an imminent concern about the Treasury market because I believe we will continue to have a pretty benign environment in terms of quantitative easing, though slowing – for previously mentioned reasons – will continue until the Federal Reserve sees the country at a 6.5 percent unemployment rate or inflation ticks up. We are less concerned about an imminent change in the rate markets; rather, we are concerned about an unwind of leverage because it is out there.

Where We Are Heading

Moderator: Interest rates are low. There seems to be this certainty they are going to move up. Why do investors still need bonds?

Skeppstrom: Companies and governments need to borrow; therefore, we need somebody to lend them the money.

Boksen: Bonds probably will rally now because there is such an overwhelming consensus that rates are going up. And generally, markets have a way of surprising you: What 99.9 percent of people believe is "right" or is going to happen is usually wrong.

Camp: That's so true. If you surveyed economists over the last 20 years, the overwhelming month-over-month consensus was that rates are biased higher. That has been a decidedly incorrect forecast.

There is a fundamental difference between a buy-and-hold bond strategy and an actively managed product. The reason people do not want to own bonds right now is because they are making a forecast. But, as we've discussed, the markets have a way of rejecting consensus opinions. The benefit of active managers is that we can handle when those things happen because we're not locked in to particular bonds.

On the tax-sensitive side, municipal bonds may be the last tax haven for high-net-worth clients. Further, municipal bonds have more yield than many of their taxable counterparts. It is going to continue to be a viable and sought-after asset class.

On the taxable side, I will say this: There is going to be a moment – and I think it is getting closer than some believe – where some of the behemoth bond

funds will have an episode with credit or liquidity that will create opportunity as it did for us in ’08. We are nimble enough to take advantage of those opportunities.

Size is going to be an issue for the ETF complexes and the mega fund companies. They’re obligated to redeem shares when money flows out. They sell simply because they have to sell and yet there’s a liquidity problem in the market. It is impossible at this moment in time to get an outright bid on $50 million in corporate bonds. Imagine the problems those running multi-billion-dollar funds are going to run into, just as they already have over the last couple of months. We’re setting up our portfolios to take advantage of the other side of that liquidation.

Would I recommend an over-allocation to fixed income? Absolutely not. But I have no problem recommending a market-weight allocation right now. I will not suggest U.S. Treasuries are a screaming buy but I also don’t have a really dire forecast for them. We are the currency of reserve. We are the store of value. The vast majority of U.S. Treasuries are not owned by individuals but, rather, by central banks. The world is racing to the bottom in terms of raising currency and I believe that will be supportive of U.S. debt prices for the next couple of years. Also, with the backup in yields, the United States now has the highest 10-year Treasury yield among industrialized countries, except for Italy and Russia.

Moderator: There is significant money in bonds or in cash. What gets investors back into equities?

Schwartz: When people feel richer, their risk appetite definitely will go up. People feel richer when they have positive equity in their homes. Increased real wages also would help on this front.

Pandtle: We say we don’t buy shares of GDP but, rather, shares of companies. We believe you almost always can find good valuation opportunities and some good growth. It’s still the case today.

Nutt: The economy is moving, but slowly. I think when people see GDP move higher than where it is right now, they will say, “Oh, this is real. This is sustainable.” When people start believing it’s sustainable, they’ll invest in it.

Boksen: The same two things as always: greed and fear. A combination of continuing strong equity markets and a weak bond market gets people back in.

Markets take on a life of their own frequently and as the market makes new highs, it attracts new investors and new assets. Markets go to extremes. If you have a bull market, it doesn’t end with a plateau and then go down. It’s not going to go flat for a year and go down. It tends to spike up.

I don’t believe current valuations are crazy. There is no bubble. There is a lot of momentum in the market and it feels like we could get a correction any day. I’m more scared when I’m not worried about something. You have to enjoy bull markets because they don’t come around that often.

McCallister: I believe housing is the key because it drives a lot more than we’re willing to admit.

Moderator: Discuss your broad outlook for the next 12 to 18 months.

Adams: We’re positioned for a continued economic recovery. We’ll be grinding it out and trying to

take advantage of any disruptions. We believe the market will keep going up; however, it won't be linear and it probably won't be at trajectory of the last seven months.

We like some of the industrial names, particularly in niche companies that have been overlooked or beaten up over the last couple of years. There have been times in the last five, 10 years where almost nothing seems to be a buy but that doesn't feel like the case right now.

Schwartz: Rising interest rates generally are good for small- and mid-cap stocks so we're not afraid of rates creeping up. We favor technology and industrials, particularly in terms of valuation.

Pandtle: We believe the trajectory of profit growth will slow but profits will remain a key driver of U.S. equities. It is going to be more important to pay attention to valuations going forward because there has been a bit of divergence in the relative values of certain sectors. Some of the sectors perceived to be more defensive or to be yield-focused have become a little more risky.

The U.S. economy is picking up steam sustainably, particularly in housing and auto production and energy production continues to gain momentum. We look at energy, technology or industrials and even some areas of financials and see better growth opportunities along with better valuations.

David Blount: The consumer continues to heal from wounds incurred in the financial crisis. The consumer "patient" has moved from the emergency room to a recovery room but is still in the hospital. Consumer confidence has risen dramatically from the bottom in early 2009 but is still 25 percent below the peak in mid-2007. Similarly, the unemployment rate is down from the peak and yet is more than 66 percent higher than it was at its most recent bottom. Challenges this year – including payroll and other tax increases along with federal tightening (the "sequester") – have been offset somewhat by rising home and stock prices.

Nutt: I believe there's going to be a tug of war between government stimulus around the world and real growth. Governments, as we're seeing now in the United States, are going to start saying, "OK, what happens if we ease up on the accelerator just a bit?" They're going to put it right back on if growth decelerates or if there's a bad reaction.

The goal over time is for the economy to keep itself going. The jury is still out on when that will happen. Japan's experience over the last 20 years gives me pause about how long it might take.

At the same time, I'm encouraged by the U.S. economy. We traditionally have been entrepreneurial. Part of that is letting companies go under, which is something we are more willing to do than many other countries are. That cycle – businesses grow, mature, die – is the key for strong economies and we historically have had it here in the United States.

Skeppstrom: I have a couple of concerns. At the top of the list is Europe. Spain and Italy have the wrong currency and I don't understand how they're ever going to get out of that. German currency should be much stronger and I don't see how they are going to grow out of that, especially now that Japan has weakened its currency. Japan will now be competition with Germany since they export many of the same types of products. My other concern is

China. There are warning signs they've borrowed too much money and there are problems within their banking system. Further, I believe China will slow more before it picks up again.

So when I think about an equities allocation, I'm perfectly happy investing domestically right now. Earnings growth is going to be challenged but I don't see any reason to suspect anything terrible will happen because the economy isn't going to roll over. It's not; it's picking up steam. I think you will see the stock market continue to push higher.

Better earnings are likely to show up in areas that are not too expensive. That could be energy and technology. Dividend-generating companies probably won't go down a lot as long as interest rates don't go up too much. They just won't go anywhere.

Boksen: I believe the market continues higher. We can get surprised, of course, but I feel pretty good about things right now. There probably will be some sort of a correction to shake people up in the next 12 months but who knows when it comes. And when it does, I believe it will fall in the category of a normal correction. It is not going to be a crisis like '08.

We like financials and particularly capital-market firms, which should benefit from improved trading and higher interest rates. We like tech: it hasn't moved, it hasn't kept up. I do believe that with the economy picking up and technology company valuations where they are that there will be more acquisition activity. And we always like the gaming industry. The catalyst for growth there is going to be internet gaming, such as online poker.

Renner: We don't expect the market to continue to go straight up without correcting but the general backdrop remains favorable. Led by the housing recovery, the economy finally is beginning to gain a bit of momentum and – thanks to a confluence of factors – we are not seeing a corresponding pickup in inflation. That has positive implications for the market as well as the multiples that investors are willing to pay to own equities.

Meanwhile, companies remain in great shape with respect to their balance sheets and margin profiles. External shocks are always going to manifest themselves at some point but based upon what we can see right now, we remain optimistic about the general outlook for the market.

Camp: We will be examining what the unwinding of the great quantitative-easing experiment will look like. What is the time table for it? What are the consequences that may show themselves over the next 12 to 18 months because of it? Bernanke will probably step down in early 2014. It is my assumption that Janet Yellen, who is equally dovish, will be the next Fed chairman.

We have a little bit more of a skeptical eye toward residential property than some. I would like to see what happens if 30-year mortgage rates go above 4.5 percent. Can the economy handle 2.5 percent or 3 percent rates on the 10-year Treasury? We are now 80 percent to 100 percent higher in yields than the lows this summer. History tells us that those types of rate moves can spell trouble for the real economy. That is something we will continue to watch very closely.

Small Cap Equity

Dave Adams, CFA

- 23 years of investment experience
- B.S. (1985) and M.S. (1989), Boston College
- Earned his Chartered Financial Analyst designation in 1993

Jack McPherson, CFA

- 23 years of investment experience
- B.S. in finance, Northeastern University (1990)
- M.B.A., Babson College (2005)
- Earned his Chartered Financial Analyst designation in 1994

Small/Mid Cap Core

Chuck Schwartz, CFA

- 22 years of experience as a portfolio manager and analyst
- B.S., University of Colorado (1985)
- M.B.A., University of Louisville (1989)
- Earned his Chartered Financial Analyst designation in 1999

Matthew McGeary, CFA

- 14 years of investment experience as a portfolio co-manager and analyst
- B.A., Kenyon College (1993)
- M.B.A., Indiana University (1999)
- Earned his Chartered Financial Analyst designation in 2001

Betsy Pecor, CFA

- 16 years of investment experience as a portfolio manager and analyst
- B.S., University of Vermont (1988)
- M.B.A., University of South Florida (1999)
- Earned her Chartered Financial Analyst designation in 2002

Equity Income/Value

Ed Cowart, CFA

- 41 years of investment experience
- A.B., Dartmouth College (1969)
- Earned his Chartered Financial Analyst designation in 1977

David Blount, CPA, CFA

- 29 years of investment experience
- B.S. in finance, University of Florida (1983)
- Earned his Chartered Financial Analyst designation in 1993

John Pandtle, CFA

- 19 years of investment experience
- B.B.A. in finance, University of Georgia (1993)
- Earned his Chartered Financial Analyst designation in 1998

Jeff Vancavage, CFA

- 14 years of investment-related experience
- B.S. in aeronautical science, Embry-Riddle Aeronautical University (1990)
- M.B.A., University of Florida (2001)
- Earned his Chartered Financial Analyst designation in 2006

Large Cap Core

Stacey Nutt, PhD

- 20 years investment experience
- Ph.D. and M.B.A., Georgia Institute of Technology
- B.S., Oral Roberts University

Fixed Income

James C. Camp, CFA

- 24 years of investment experience
- B.S., Vanderbilt University (1986)
- M.B.A. in finance, Emory University (1990)
- Earned his Chartered Financial Analyst designation in 1993

Small and Mid Cap Growth

Bert L. Boksen, CFA

- 36 years of investment experience
- B.A., City College of New York (1970)
- M.B.A., St. John's University (1977)
- Earned his Chartered Financial Analyst designation in 1981

Eric Mintz, CFA

- 18 years of investment experience
- B.A., Washington and Lee University (1995)
- M.B.A., University of Southern California (2001)
- Earned his Chartered Financial Analyst designation in 2000

Total Return Portfolio

Richard Skeppstrom

- 22 years of investment experience
- B.A. in mathematics (1985) and M.B.A. (1990), University of Virginia

Institutional Small Cap Core Team

Todd McCallister, Ph.D., CFA

- 26 years of investment experience as a portfolio manager and analyst
- B.A., with highest honors, University of North Carolina (1982)
- Ph.D. in economics, University of Virginia (1987)
- Earned his Chartered Financial Analyst designation in 1996

Stacey Serafini Pittman, CFA

- 16 years of investment experience as portfolio co-manager and analyst
- B.A. in government, cum laude, Harvard University (1997)
- Earned her Chartered Financial Analyst designation in 2002

Scott Renner

- 21 years of investment experience as an analyst
- B.S., University of Florida (1990)
- M.B.A., University of South Florida (1993)

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