Eagle U.S. Small Cap Strategy -- A sub-fund of Raymond James Funds (UCITS umbrella under Luxembourg Law)

Costs, margins, labor are key

Eagle Asset Management Vermont Team
Sub-manager of the fund

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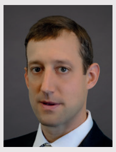

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What are the major issues or trends you think investors should watch most closely for the rest of 2021 and why?

We have our eye on several things. One is margin and cash flow trends as we move through the rest of the year. On the cost front there are some material cost headwinds: inflationary fears, the high prices of certain commodities, supply chain issues. Labor cost increases seem very likely in the current climate. Businesses also have all manner of COVID-related costs as they reopen. We wonder how investors have anticipated those potential margin issues. On the cash flow front: Corporate cash flows have looked exceptionally good in the U.S., but recall that capital spending has been curtailed due to COVID-19. We had a global economic slowdown and many companies were harvesting working capital during COVID, which boosted free cash flow numbers. We need to be cognizant of the fact that there might be some pressure on margins and cash flows.

Everyone in the investment community is talking and thinking about inflation and interest rates. We want to take a step back and think about what factors are driving that dynamic. There have been supply chain issues with semi-conductors and materials. We think that is largely transitory, but the bigger impact is the labor shortages we believe will happen. There's a serious issue going on today around labor. That issue might ultimately manifest itself through inflation or margin pressure – and likely a little bit of both. It's a little bit uncertain and it's a little bit driven by policies. From our investment perspective, we try not to take the bet on whether these things will result in higher inflation or not, or higher interest rates over the long term. We want to think about which companies are able to have better relationships with their employees, and already have capacity to manage an evolving environment. There is pent-up demand after the pandemic, and consumer balance sheets are strong, but there are potential headwinds like rising gas prices and the phasing out of stimulus.

Do you think the pandemic will engender lasting changes – behavioral or strategic – for companies, investors, or consumers?

The pandemic has led to a general re-evaluation of what's important in life. In the short term this could manifest perhaps as increasing focus on environmental, social, and governance (ESG) investing or employee relations. There are a lot of employees who are questioning what's important and wanting to work for organizations that offer meaningful opportunities. We're going to see divergence between companies that really can execute, that have invested in their people, invested in their capacity to grow and perform well. People are focused on factors like growth or value, when they should be asking "Is this company doing something of value and treating its employees right?"

If you remember coming out of the Great Financial Crisis in 2008-09, there was the same discussion: "This is going to ruin a whole generation, nobody's going to buy a house again, nobody's going to buy stock again." While the crisis did have a lasting impact, the long-term effects weren't as extreme as many feared. Eagle Vermont's investment process and philosophy has remained steady for a long time, and allows us to take advantage of macro-driven volatility in the market.

How are you approaching the significant stylistic volatility we have seen in small caps in order to find opportunities?

We definitely have seen this growing factor volatility. Risk management using factor analysis has always been at the core of our investment process, and watching the volatility makes us manage things even more closely. We've had to be a bit contrarian: When a certain factor is out of favor, we've been finding opportunities. We were buying tech and healthcare in March of 2020. Then financials and materials were way out of favor, in the third quarter of 2020 we were buying those over growth names, now we're back in an environment where the growth names are becoming more attractive. We're not taking large bets – it's just a matter of managing our risk exposure and maintaining balance.

Do you see the pandemic, or any other current factors, having a long-term effect on investors' interest in more responsible and sustainable strategies?

Employee engagement and safety are big issues coming out of COVID. Employers should have learned the value of having an engaged and dynamic and resilient workforce. Employees have started to ask appropriate questions of their employers: Do they have their back, how much do they care about safety, how much are they invested in their personal development and their place in the company. That's the "S" part of ESG, and we believe we will see lasting impact there. Under "E," many people working from home may be thinking more about the environmental impact of their daily commute. It might bring those things more into consciousness, and that translates into the investing world.

We noted in the first quarter of 2021 in particular the increasing amount of ESG disclosure from small-cap companies. The topic is coming up more often in quarterly earnings calls. What we hope is happening is that investors are realizing that ESG isn't a separate mandate or objective, it's a core part of business and ultimately a driver of shareholder value. Companies across all industries are discussing ESG; a lot of the social things currently but also environmental. We've noticed that conversations we've had behind the scenes with company leaders – say, around an issue of diversity – are being directly addressed in public communications.

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