

EAGLE VERMONT INVESTMENT TEAM

From Theory to Practice |
ESG Investing in U.S. Small-Cap Stocks



By Jason Wulff, CFA, and Sam Wells, CFA

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Reframing success in small-cap stocks

In the realm of environmental, social, and governance (ESG) investing, we see sustainability as a key driver of differentiation and ultimately a driver of alpha for companies that effectively incorporate ESG principles into their business practices. Among small-cap companies especially, we believe business outcomes are and will be increasingly tied to the successful creation and use of these strategies, making the effective implementation of ESG principles a competitive advantage for companies and investors alike. Moreover, we see these competitive advantages accruing to forward-thinking small-cap companies not at some distant point in the future, but right now.

Sustainability results from continual investment, particularly in intangible assets and especially in three areas:



Human capital



A Reimagined Brand



Innovation

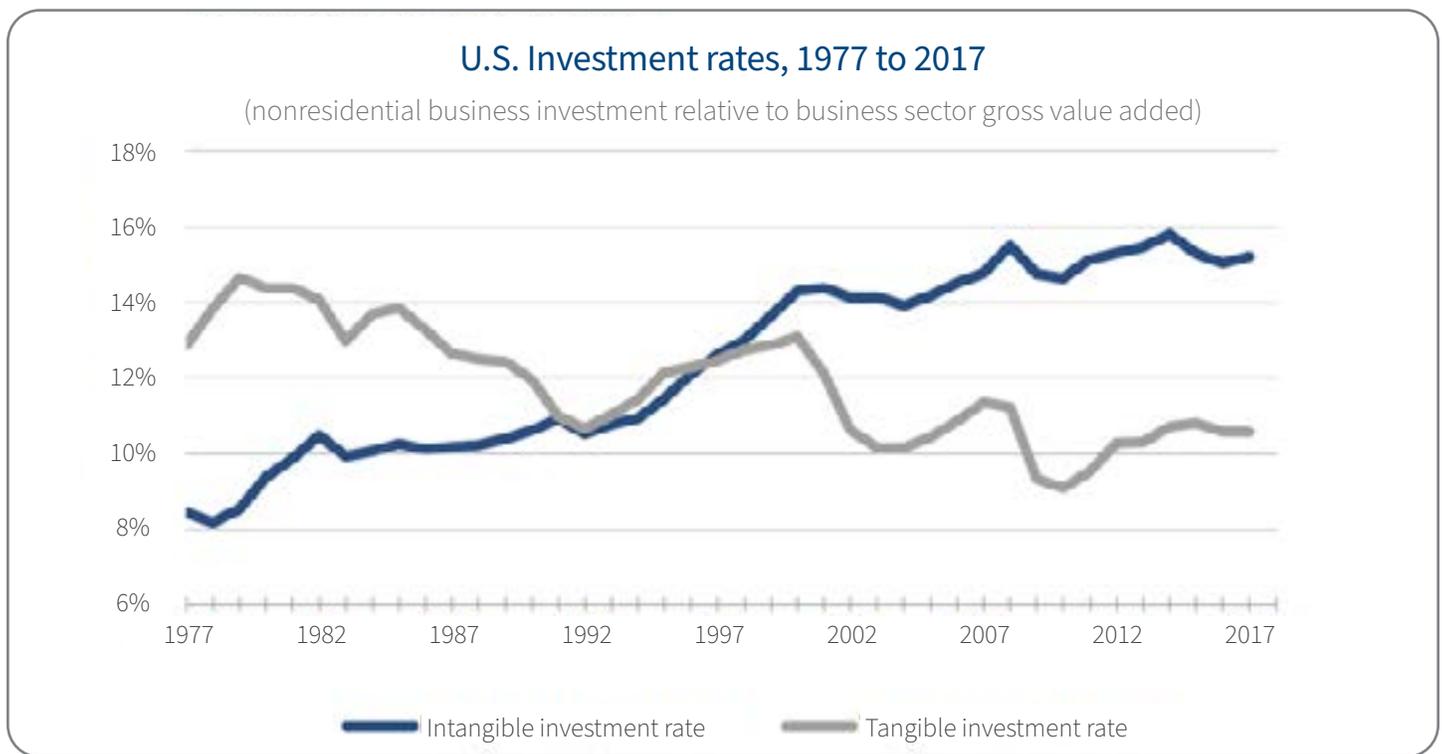
Small caps have a unique role as innovators in driving this transition to a more sustainable future. This future, however, is less and less tied to the traditional divestment-based approach to ESG investing, which has fundamental flaws. Instead, we believe asset managers should rely on regular and ongoing direct engagement with the company management teams as a primary tool to drive long-term alpha and value creation.

Last, the importance of and growing opportunities offered by sustainable business practices have been amplified during the COVID-19 pandemic. There's real opportunity now and in the future for companies that have invested appropriately in some of these intangibles. We believe the core of an effective business plan for long-term success needs to include a mindset of shared values among management, investors, employees, and other constituents.

THE VALUE of ESG analysis

Our view is that some of the drivers behind ESG analysis are the result of changes in the nature of business models. Historically, the value of companies was largely a result of their physical assets, such as real estate, buildings, and machinery. Much more of their value today is the result of investment in human capital, intellectual property, innovation, and other intangible assets. These intangibles can include many different things, and some – like business processes, people, and corporate culture – are not adequately reflected in financial statements or are very hard to quantify. Ultimately, however, understanding these core assets

helps us identify more durable and resilient business models that we hope to use to ultimately drive alpha. Consequently, we see ESG as a primary means to analyze and value such intangibles. It's important to recognize that non-financial data represents a sizeable share of equity valuation, particularly in industries that rely on network-effect advantages and intellectual property. And that share is growing. As the chart below shows, the rate of investment in intangible assets, relative to gross value added, has been growing for decades, passing the relative investment rate for tangible investments in the late 1990s.



Source: Unpublished update to Corrado and Hulten (2010) using methods and sources developed in Corrado and Hao (2013) and in Corrado et al (2016) and Corrado et al (2017) for INTAN-Invest© and the SPINTAN project, respectively. The SPINTAN project was funded “by the European Commission FP-7 grant agreement 612774.” Notes: These U.S. estimates of intangible investment cover the business sector, similar to the coverage of the U.S. Bureau of Labor Statistics’ multi-factor productivity measures. They differ from the U.S. INTAN-Invest estimates, which are harmonized with estimates available for the EU. INTAN-Invest covers the total economy save NACE industry sectors O, P, Q, T, and U. The U.S. National accounts data used to develop these estimates are as of August 31, 2018.

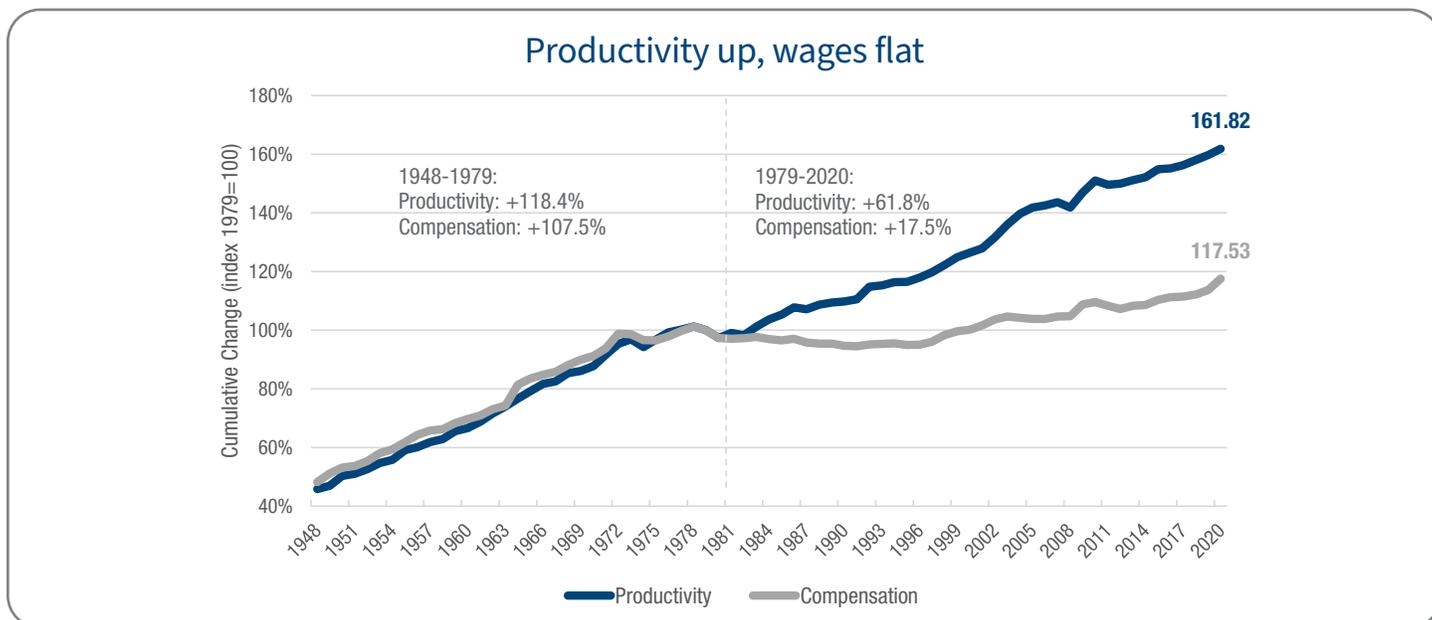
As business models have evolved to include the value of intangible assets, ESG analysis offers a framework that enhances investors’ ability to recognize and assess the value of intangible capital and to work with companies to maximize the creation of value across a range of intangible assets for all constituents. A commitment to engagement

with all stakeholders helps companies broaden their perspective on and competence at creating and growing value. In this manner, applying ESG principles in the areas of developing human capital, reimagining brand, and fostering innovation help drive long-duration alpha.

HUMAN CAPITAL: Underinvestment in companies' most important asset

The COVID-19 pandemic made clear that the No. 1 challenge facing many companies today is the task of attracting, managing, developing, and retaining talent. While it is generally acknowledged that human capital is often a company's most important asset, that asset has been broadly under-invested in since the 1980s. As the chart below shows, compensation

and productivity rose more or less in tandem in the 31 years from immediately after World War II through the late 1970s. But in the 41 years since then, productivity continued to rise, albeit less steeply, while growth in compensation for the typical worker has lagged dramatically. Compensation growth has trailed corporate profits and executive compensation as well.



Data are for compensation (wages and benefits) of production/nonsupervisory workers in the private sector and net productivity of the total economy. "Net productivity" is the growth of output of goods and services less depreciation per hour worked.

Source: Economic Policy Institute analysis of unpublished Total Economy Productivity data from U.S. Bureau of Labor Statistics (BLS) Labor Productivity and Costs program, wage data from the BLS Current Employment Statistics, BLS Employment Cost Trends, BLS Consumer Price Index, and Bureau of Economic Analysis National Income and Product Accounts. Data as of 12/31/2020.

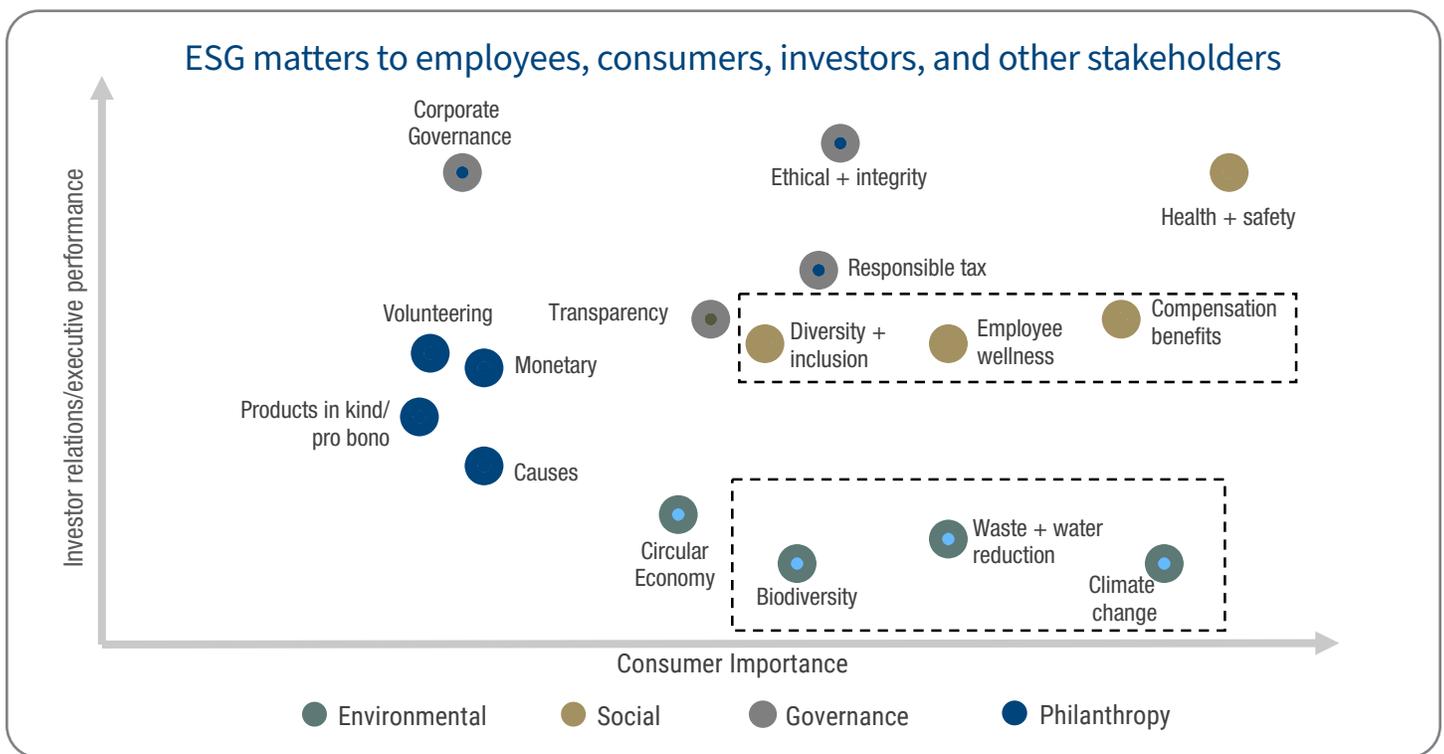
The consequences of this disconnection between productivity and overall compensation are stark: In 2021, CEOs of public companies made an astronomical 399 times the pay of the average worker. By comparison, in 1978 that ratio was 31 to 1. Meanwhile, as the pandemic persisted, U.S. job openings reached a record high, with 4 million more unfilled jobs than before the pandemic. Workforce participation in the United States has declined since the late 1970s and early 1980s. In an economy where labor shortages abound, women and minorities have become particularly under-utilized populations: The Black employment ratio trails the white employment ratio by 1.6% as of October 2022, and the labor force participation rate for women trails men by 11%.

In a labor market faced with these challenges, the expanded use of ESG principles is poised to play a critically important role helping employers attract talent and drive engagement. Consider the growth in the adoption of hybrid work environments. We suspect there is a growing divergence in engagement between well-run companies that recognize the competitive advantages to be gained from offering hybrid work arrangements where feasible and poorly run companies that have been slow to see how the ground beneath them has shifted or to react to that change. That, in turn, contributes to the expanding gap between those companies that have adequately invested in human capital and therefore have the people, the skill sets, and the engagement to drive better business outcomes and those that haven't and are suffering in this environment.

REIMAGINING BRAND: ESG matters to consumers and other stakeholders

An effective commitment to sustainability differentiates businesses, helping to attract both talent and customers, particularly among younger generations. We see, even in our own job searches, that millennials want meaning in their work, want to work at companies that have purpose, and want to work at companies that are good stewards of the environment and that care about building diverse workforces. In a Barkley & Jefferies survey, 69% of millennials surveyed said they wanted to work at a company with similar values as their own. By comparison, only 58% of baby boomers said the same.¹ A separate survey found morale to be 55% higher and employee loyalty 38% better at companies with strong sustainability programs.²

We likewise see signs that consumers care as well, and that some consumers are willing to pay up for products from companies with good social and environmental track records. In 2021, 48% of consumers surveyed said they had shopped or purchased from a company that behaved in a more socially and environmentally responsible way, according to the Barkley & Jefferies survey. That was up from 33% in 2019. Moreover, these preferences became more pronounced over the course of the pandemic. The same survey found that 53% of consumers said ESG was more important to them than it had been 12 months before, and 60% said they had become willing to pay more to support environmentally and socially responsible brands.



Source: The Purpose Action Gap: The Business Imperative of ESG, p. 38, Barkley + Jefferies, September 2021.

Meanwhile, surveys found that company executives perceive that they perform best in areas of corporate governance and social concerns – we would question some of that data on social performance – even as they acknowledge that they do not do enough from an

environmental standpoint. While companies are coming to grips with the expectation that they have a broader responsibility than in decades past, there is room for improvement.

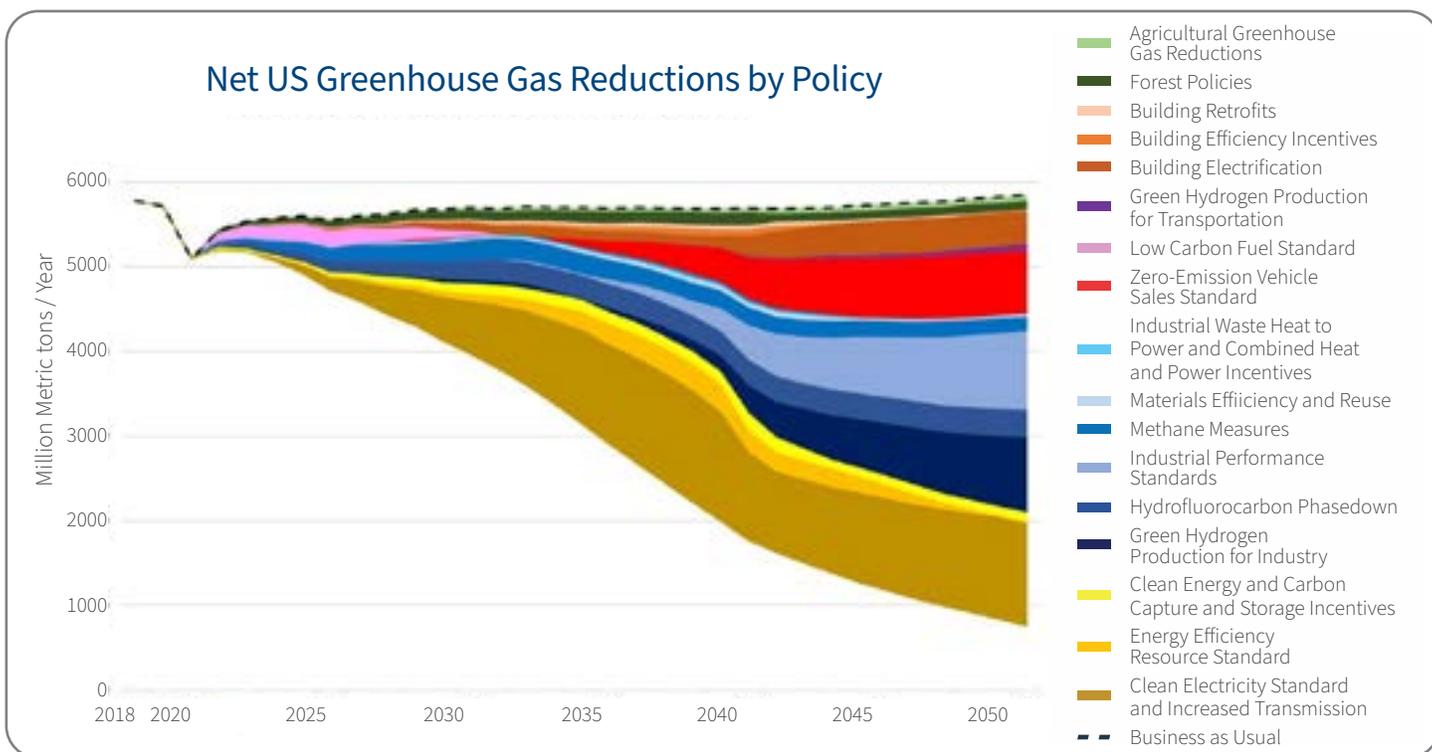
¹ The Purpose Action Gap, Barkley & Jefferies, September 2021.

² Harvard Business Review, as of Oct. 21, 2016.

INNOVATION: Decarbonization will transform all parts of the economy

When we think about the environment and ultimately about climate change, we see decarbonization as one of the most profound transitions coming in the next couple of decades: one with material impacts on all parts of the economy. At the moment, the cost of carbon emissions has yet to be adequately reflected in company financial statements, but that cost is growing for all companies. More importantly, the transition to a less carbon-intensive economy will create opportunities for innovative companies across all sectors. The growth

of renewable energy and electrification are mega-trends, but we're also looking at companies that are simplifying their supply chains; changing business models to participate in a less-wasteful and more circular economy; and driving increased efficiencies across operations, building design, and resource consumption. The chart below highlights the potential for different actions across many parts of the economy to help achieve a net-zero carbon emissions objective.



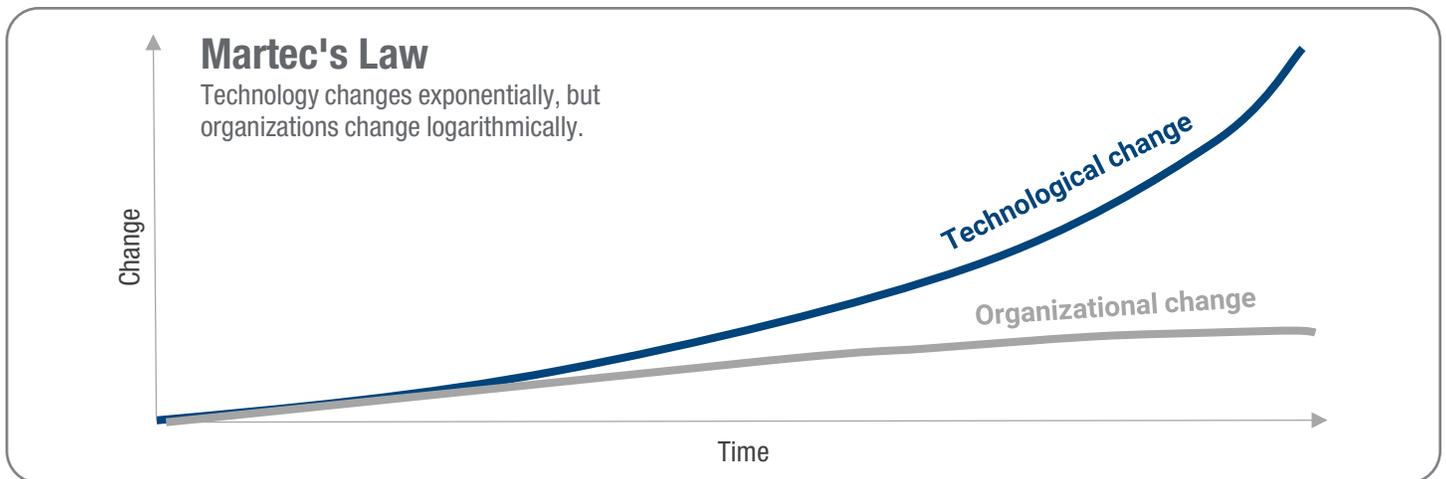
Source: Modeling The Climate Crisis Action Plan; Energy Innovation, June 2020.

When we talk with management teams of companies in our portfolios, we want to know – regardless of the part of the economy they are in – how they think about a few key questions:

- How will this transition impact their business?
- How they can better position themselves from a cost perspective or from a demand and innovation perspective?
- How they can capitalize on this massive trend?

We believe small-cap companies are in a unique position to take advantage of some of these trends because they're often nimble enough to adapt to accelerating

technological change. By contrast, large caps often have entrenched, monopolistic businesses, and we see them tending to look at ESG from a risk mitigation lens. Conversely, small caps tend to be innovative disruptors, which can set up sustainability as an alpha opportunity for those companies. Moreover, since small caps are often capital-constrained, they rely heavily on intangibles to drive disruption, innovation, and differentiation. Along with being more nimble, we see small caps as being more willing to work with different stakeholders and to pivot to create true value for all constituents. In this context, management teams with a long-term perspective are better-equipped to turn challenges and dynamic change into an opportunity.



CHALLENGES of ESG analysis

This may have been controversial to say even a couple of years ago, but there is a growing awareness that the traditional divestment-based approach to ESG has fundamental flaws. They include:

- The available data is limited, with little standardization. It also often is backward-looking and rarely reflects industry biases or tendencies.
- Ratings can provide very limited value, particularly for the small-cap universe. Reports from the non-profit Carbon Disclosure Project (CDP) cover 67.1% of the S&P 500 Index, but only 4.4% of the Russell 2000® Index.
- A fixation on metrics has potential negative consequences. For example, a company can reduce its output of greenhouse gases by divesting part of its business without fundamentally changing the more general outcomes. In contrast, the Eagle Vermont team looks to invest in companies working toward a zero-carbon future.
- Divestment has little economic impact. That's because in a world awash with liquidity, companies that divest assets simply to unload a potential ESG problem on someone else can typically find capital elsewhere.

OUR INTEGRATED APPROACH TO ESG: Focus on engagement

Because we believe sustainability is a key driver of long-term alpha, ongoing engagement is core to our approach to working on ESG issues with the companies we own. The goal of this integrated engagement is to better understand how companies operate and to encourage long term-value creation. For the first part – understanding a company's material issues and key business drivers – we use both financial modeling and the Sustainability Accounting Standards Board's industry-specific criteria for identifying sustainability information that is financially material to understanding how an organization creates enterprise value. From there, we define an ESG thesis that we validate over time using any information we can find and have regular and ongoing engagement with management teams on steps being taken to address the thesis. Ultimately, we

believe that the manager-to-manager conversations we have with companies have meaningful impact. In those conversations, both sides have an aligned interest on value creation and in sustainably generating strong returns.

As you can see in the table on the next page, these conversations address a broad range of issues. For example, a plastics manufacturer we own is working with a major fast-food chain to build more recycling capacity into its production of cups and to make its business processes more circular. Particularly in small caps, we are looking at implementing these principles from an opportunity perspective as opposed to a risk-mitigation perspective. In the past, this kind of discussion was maybe a little more theoretical. Not anymore. Today, it's material, it's timely, and it's a growing part of the small-cap opportunity set.

ESG engagement in action

Examples from the Eagle Vermont portfolios

Company	Market cap	Industry	Issues, challenges, opportunities, and responses
Business Process Outsourcing	\$4.1 billion	IT Outsourcing	<ul style="list-style-type: none"> • Key issues: Diversity and inclusion (D&I) • Gender discrimination lawsuit cast spotlight on lack of diversity • Immediate engagement with company executives • Management recognition of problem and being open to change • Initiation of strategy to improve diversity: New Chief Sustainability Officer, promotions, and disclosure of targeted metrics • D&I a pillar of broader ESG strategy, focused on talent development among others • CEO discretionary incentive compensation tied to ESG initiatives • Ongoing engagement: Continued work on D&I
Service Provider for Non-Profits	\$3.3 billion	Software	<ul style="list-style-type: none"> • Key issues: Excessive management compensation, employee turnover, data breach • Missed deadlines and high employee turnover • Excessive executive compensation despite underperformance • Pandemic response: Cut 401(k) match, shifted incentive compensation, and laid off employees • “Pivot toward profitability”: Better alignment with incentive compensation structure • Engagement with management resulted in disagreement • We sold the stock
Consumer Packaging & Plastics	\$8.5 billion	Packaging	<ul style="list-style-type: none"> • Key issues: Manufacturing waste, carbon emissions • Largest global plastics producer • Acknowledgement of waste issues and commitment to change: <ul style="list-style-type: none"> → Billion-dollar investment in recycling capacity → Join Alliance to End Plastic Waste • Commitment to increase recycled feed stock from 5 to 10% by 2025 (600 million lbs) • Alignment with consumer packaged goods industry to achieve sustainability goals • Explicit water, energy, and greenhouse gas reduction targets • Ongoing engagement: Issue resolution critical to long-term value creation
Industrial Bearings Manufacturer	\$5.4 billion	Machinery	<ul style="list-style-type: none"> • Key issues: Efficiency, safety, corporate governance, and disclosure • Strong operating history but ESG red flags • Poor governance, limited board diversity, and excessive CEO pay • Constructive dialogue with hesitant management • Multiple conversations yield significant disclosure improvement • Ongoing engagement: Executive compensation, governance, disclosure
Supply Chain Management	\$5.3 billion	Software	<ul style="list-style-type: none"> • Key Issues: Diversity, employee retention • Long-time commitment to community involvement and educational engagement • Formal corporate programs targeting education inequalities • CEO outreach to employees during racial tension in 2020 • Investment in human capital driving high employee engagement • Ongoing engagement: Emphasize that engagement and D&I initiatives drive value creation

Risk Information

Investing involves risk, including risk of loss. Diversification does not ensure a profit or guarantee against loss.

Investments in small-cap companies generally involve greater risks than investing in larger capitalization companies. Small-cap 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.

Value investing is based on the potential for a company's stock price to rise based upon anticipated changes in the market or within the company itself. Value stocks have historically been sensitive to economic cycles and investor sentiment that can affect volatility and risk.

ESG/Sustainable investing may incorporate criteria beyond traditional financial information into the investment selection process. This could result in investment performance deviating from other investment strategies or broad market benchmarks. Please review any offering or other informational material available for any investment or investment strategy that incorporates sustainable investing criteria, and consult your financial professional prior to investing.

Disclosures

Index or benchmark performance presented in this document does not reflect the deduction of advisory fees, transaction charges, and other expenses, which would reduce performance. Indexes are unmanaged. It is not possible to invest directly in an index. Any investor who attempts to mimic the performance of an index would incur fees and expenses which would reduce return.

The investment strategy will include only holdings deemed consistent with the applicable Environmental Social Governance (ESG) guidelines. As a result, the universe of investments available to the strategy will be more limited than strategies not applying such guidelines, which may cause it to perform differently than similar funds that do not have such a policy.

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Sam Wells was a vice president and portfolio specialist for Raymond James Investment Management until his passing in October 2022.

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Definitions

Alpha is a measure of the difference between a manager’s actual returns and its expected performance, given its level of risk as measured by Beta. A positive Alpha figure indicates the manager has performed better than its Beta would predict. A negative Alpha indicates the manager performed worse than expected based on its level of risk. Thus it is possible for a manager to outperform an index and still have a negative Alpha. In general, however, the higher the Alpha the better.

ESG refers to Environmental, Social, and Governance factors used in measuring the sustainability and societal impact of an investment in a company or business.

Energy policy definitions

Source: The Energy Policy Simulator, an open-source policy analysis tool by Energy Innovation Policy & Climate, a non-partisan think tank based in San Francisco.

Agricultural greenhouse gas (GHG) reductions — The agricultural greenhouse gas reduction model is based on both the potential to abate non-carbon dioxide greenhouse gases from crop and rice lands as well as the maximum abatement potential for changes to intensive grazing and various feed practices by 2050.

Forest policies — The forest policy model assumes reforestation and restoration of 330 million acres of forest by 2040; reforestation of 40 to 50 million acres of federal and nonfederal land by 2030; and enrollment of 1 million acres of private forestland in the U.S. Forest Service’s Forest Legacy Program and the Community Forest and Open Space Program by 2030.

Building retrofits — The building retrofit model is based on the HOMES Act, as included in the Moving Forward Act (H.R. 2, Sections 33201 - 33207), which includes \$1 billion per year from 2021 through 2025. The model assumes \$4,000 per retrofit for 250,000 homes each year, factors in an estimated cost per British thermal unit (BTU) energy saved to calculate the energy savings, and extends the program through 2050.

Building efficiency incentives — Building efficiency-related models include rebates, tax credits, and incentives covering partial costs of residential heat pumps, improvements to commercial buildings, new homes designed to use less energy, as well as future efficiency improvements to save energy in federal buildings.

Building electrification — The building electrification model assumes there will be enough point-of-sale rebates to achieve 100% all-electric new buildings and appliances by 2035, and that local governments, states, and the federal government adopt building codes aimed at net-zero building emissions by 2035.

Green hydrogen production for transportation — The green hydrogen production for transportation model assumes that 5% of new trucks sold by 2030 will be powered by hydrogen – a smaller percentage than electric trucks due to the expectation that hydrogen technologies are likely to take more time to commercialize. The model assumes a conversion from using steam to separate water into oxygen and hydrogen to using electricity for the separation, a process known as electrolysis.

Low carbon fuel standard — The low carbon fuel standard model is based on the California low carbon fuel standard, which applies to all vehicles except for aviation, because jet fuel is excluded, and requires a 20% reduction in in the carbon intensity of transportation fuels by 2030.

Zero-emission vehicle (ZEV) sales standard — The zero-emission vehicle (ZEV) sales standard model assumes that sales of zero-emission vehicles ramp up for both light-duty and heavy-duty vehicles, reaching 50% of light-duty vehicles by 2030 and 30% of heavy-duty sales by 2030. It also assumes 100% of sales will involve zero-emission vehicles (either electric or hydrogen-fueled) starting in 2035 for light duty vehicles and 2040 for heavy-duty vehicles, resulting in net-zero emissions in both categories by 2050.

Industrial waste heat to power (WHP) and combined heat and power (CHP) incentives — The policy model assesses the potential impact of incentives included in the Renewable Energy Extension Act of 2019 and the Waste Heat to Power Investment Tax Credit Act of 2019 to expand the use of technologies that capture and use waste heat produced by existing industrial processes to produce electricity as well as cogeneration technologies to produce electricity and thermal energy at high efficiencies using a range of technologies and fuels.

Materials efficiency and reuse — The policy model considers a 10% demand reduction in iron, steel, and chemicals by 2050 as well as a 5% demand reduction in cement resulting from expanded product efficiency, recyclability, and reuse to cut product demand across a range of industries.

Methane measures — The methane policy model considers the maximum potential for abatement of methane from the oil and gas sector, as projected by the U.S. Environmental Protection Agency (EPA), by 2030 and continues the maximum abatement through 2050. Decreased natural gas use due to other policies would be expected to lead to additional emissions reductions totaling an estimated annual reduction of nearly 360 million metric tons in 2050.

Industrial performance standards — The model considers the potential impact of full fuel switching from fossil fuels to the use of electrification and hydrogen in industry by 2050; switching hydrogen production to electrolysis to extract hydrogen from water; and industrial energy efficiency improvements projected to vary in their impacts across a range of industries.

Hydrofluorocarbon (HFC) phasedown — The hydrofluorocarbon (HFC) phasedown model considers the potential impact of a schedule to phase down the use of HFCs by more than 80% over a 30-year period, resulting in a projected avoidance of more than 80 billion metric tons of carbon dioxide-equivalent emissions by 2050 – avoiding up to 0.5° Celsius of global warming by the end of the century, according to the EPA.

Green hydrogen production for industry — The model assesses the potential impacts of fully shifting hydrogen production to use electrolysis to separate hydrogen from water by using electricity to produce zero-carbon “green” hydrogen. In contrast, in the United States today and projected through 2050, roughly 95% of hydrogen is produced using natural gas and only 5% is produced via electrolysis.

Clean energy and carbon capture storage (CCS) incentives — The model assumes the Clean Energy Standard Act of 2019 taking effect in 2022, with the growth of the use of clean energy reaching 100% in 2040. A separate model looks at the full potential of the use of carbon capture and storage (CCS) tax credits authorized under the GREEN Act of 2020 to reduce releases of carbon dioxide.

Energy efficiency resource standard — The American Energy Efficiency Act of 2019 specifies targets for electricity and natural gas savings through 2035, then requires successive standards to be set according to “the maximum achievable level of cost-effective energy efficiency potential.” The policy model used a U.S. Department of Energy analysis of state-level electric energy efficiency potential to implement the cost-effective electric energy efficiency potential in 2035 through the improvement in the energy efficiency of new building components. The Energy Policy Simulator assumes the same percentage improvement in efficiency across components of all fuel types, principally electricity and natural gas.

Clean electricity standard and increased transmission — In addition to the growth of clean electricity under the clean energy standard, the model assumes better utilization of the existing transmission system and the addition of new transmission as a 30% growth of transmission capacity.

The S&P 500® Index measures change in stock market conditions based on the average performance of 500 widely held common stocks. It is a market-weighted index calculated on a total return basis with dividend reinvested. The S&P 500® represents approximately 75% of the investable U.S. equity market.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 10% of the total market capitalization of the Russell 3000® Index.

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Raymond James Investment Management is a global asset management company that combines the exceptional insight and agility of individual investment teams with the strength and stability of a full-service firm. Together with our partner affiliates – Chartwell Investment Partners, ClariVest Asset Management, Cougar Global Investments, Eagle Asset Management, Reams Asset Management (a division of Scout Investments), and Scout Investments – we offer a range of investment strategies and asset classes, each with a focus on risk-adjusted returns and alpha generation. Raymond James Investment Management believes providing a lineup of seasoned, committed portfolio managers, spanning a wide range of disciplines and investing vehicles, is the best way to help investors seek their long-term financial goals.

Learn more about Eagle's small-cap strategies

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