Emerald Advisers, LLC
Mid Cap Growth

Q3 2018 | Economic & Portfolio Commentary

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Growth/Valuation Mismatch at Extremes – Our Confidence Level Higher than Ever

Quarterly Summary

For the past year and a half we have been expressing confidence that, sooner rather than later, our mid cap growth portfolios, which are comprised of faster growing equities vs. the benchmark, yet trade at significant discounts on virtually every valuation metric, must be rewarded for the growing growth/valuation mismatch. Unfortunately, that valuation mismatch has only worsened in 2018 with our portfolio holdings trading even cheaper vs. long-term growth rates, as investors are unwilling to pay up for real or perceived cyclical growth on concerns of a pending economic slowdown – a slowdown we just don't see in the U.S. in the near term. Our confidence in a reversal in sentiment regarding our portfolio holdings has never been stronger and we are convinced we are on the cusp of being rewarded for our patience.

For the past two years valuations really have not mattered, with slower growing names with supposed stable earnings characteristics garnering almost unlimited fund flows, despite lack of growth. According to Jefferies' Steven DeSanctis (US Equity Strategy, 9/30/18) the gap between the highest P/E stocks and the lowest in the small cap universe is the widest since 1999, with momentum being the leading contributor for most of the quarter and year-to-date. Our portfolios have had a decidedly cyclical bent with an overweight position in Energy and Materials, as these sectors have experienced far higher earnings growth rates than other areas of the market, along with strong forecasted earnings based on robust domestic economic activity.

Most economic statistics were positive for the quarter with employment and

Key Points:

- Emerald Mid Cap Growth portfolios underperformed our Russell Mid Cap Growth benchmark for the quarter, as strong Consumer Discretionary and Financial Services performance failed to offset weakness in Energy, Materials, Producers Durables, Technology and Healthcare.

- While we cannot be sure about the timing, we are quite confident that after two years of trying to compete unsuccessfully against a benchmark stacked with lower, or suspect growth, higher valuation names, our portfolios should get a chance to shine, as investors start to pay up for growth and reward high quality, beaten up, lower valued, growth companies.

- Given the international weakness, we have positioned portfolios with a domestic revenue bent with over weights in Energy and Materials, Biotech and Pharmaceuticals, and underweights to Software, Producer Durables and selected Consumer Discretionary industries.

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average hourly earnings continuing to improve, industrial production expanding and capacity utilization also remaining robust; and inflation, while increasing, still remaining relatively benign.

In the third quarter real U.S.GDP is forecast to grow 3.1% q/q, with July and August Manufacturing ISM averaging a strong 60 and Consumer Confidence of 138.4 registering a post recovery high. Second quarter S&P 500 earnings grew at a new record 27%, with net profit margins coming in at 11.8% - the highest since 2008 (FactSet). The only areas of concern during the quarter related to housing starts, and new and existing home sales, as mortgage rates continued to rise and affordability was tested. Additionally, trade tensions impacted selected company earnings and forecasts by creating a drag in export opportunities while a casting negative pall over companies with significant China exposure.

Portfolio Review

Emerald Mid Cap Growth portfolios underperformed our Russell Mid Cap Growth benchmark for the quarter, as strong Consumer Discretionary and Financial Services performance failed to offset weakness in Energy, Materials, Producers Durables, Technology and Healthcare. As noted above, most names with real or perceived cyclical economic exposure lagged for the quarter, regardless of actual results and guidance. Momentum carried the day as valuations were increasingly irrelevant, as were earnings growth rates, particularly in some of the aforementioned underperforming sectors.

Portfolios were slightly smaller than the benchmark with an average market capitalization of $15.8bn and a significantly higher expected earnings growth rate. As noted above, portfolios were significantly less expensive than the index on current and future Price/Earnings, as well as Price/Cashflow, Price/Book and Price/Sales ratios. Contributions to quarterly returns came from a mixture of high growth momentum names, as well as core, and cyclical growth securities as Emerald's research team continued to identify some of the market's hidden mid cap gems.

While our portfolios contained a majority of the quarter's best mid cap growth performers we also had some of the worst performing stocks.

Market Outlook

While we cannot be sure about the timing, we are quite confident that after two years of trying to compete unsuccessfully against a benchmark stacked with lower, or suspect growth, higher valuation names, our portfolios should get a chance to shine, as investors start to pay up for growth and reward high quality, beaten up, lower valued, growth companies. Names that we gravitate towards as a high active share manager, building portfolios that truly do not look like the benchmark.

As noted above, the US economy is strong with 3% plus forecast GDP growth and solid consumer and business conditions, along with positive Leading Economic Indicators. Unfortunately, there is a true dichotomy between the economies of the U.S. and most other regions. European Union economies and those of most Asian nations, particularly in emerging markets, have seen their economic growth contract significantly, as the strength of the U.S. Dollar, tariffs, and lower commodity prices (except for oil) have all served to drive down many currencies and grind economic growth to a halt.

Given the international weakness, we have positioned portfolios with a domestic revenue bent with over weights in Energy and Materials, Biotech and Pharmaceuticals, and underweights to Software, Producer Durables and selected Consumer Discretionary industries. We are looking to add to domestically oriented Industrials exposure with a keen eye towards names less pressured by labor and energy cost inflation. A key to our future performance will be getting our Energy, Materials and Industrials calls right – something we have failed to do for the past two years as valuations did not matter and passive funds poured into large benchmark holdings. Portfolio market capitalizations are similar to the benchmark with an expected 3-5 year weighted average earnings growth rate of 19.06% vs. 17.89% for the benchmark.

Markets have narrowed considerably over the past quarter, despite many of the broader market averages registering all-time highs. At the same time many of the stocks constituting the indices are approaching bear market territory, especially those with exposure to housing, autos or Chinese markets; areas that seem to have bad news every day. At the same time U.S. economic reports remain healthy with fed funds still below 3%, bond yields below 4%, inflation still below 3% and corporate spreads still very tame with investment grade credit spreads beginning the year at 160 bps and ending the quarter at 174 bps. Our sense is that as long as employment remains strong, the risk of a near-term domestic economic slowdown is quite low. The larger risk is if this is as good as it gets. Risks increase as rates rise and P/E's fall and the Fed tightens too far until something breaks. If this "As good as it gets" scenario plays out and there is some mean reversion to underperforming growth areas, we think we can add value.

P/E rates for many of our portfolio holdings are approaching trough valuations last seen during the most recent industrial recession of 2015-2016. At that time WTI oil slipped to $26, job growth slowed, and a variety of production indices and sentiment indicators were very weak; almost the polar opposite of today's economic conditions with third- and fourth-quarter S&P 500 earnings expected to grow 19.1% and 17.0% respectively (FactSet). The one similarity is the economic weakness of the Chinese economy and the fears of an emerging market slowdown. We think the massive increase in passive and algorithmically traded portfolios is causing a growth/valuation imbalance and price discovery has been thrown out the window. We view this as an opportunity and will selectively add to names that we think become too far dislocated from long term fundamentals and intrinsic value.

In 2016 the lackluster economic conditions caused the Fed to postpone raising interest rates pending the direction of inflation, and improvement in the domestic and international economies. It will be interesting to see if the current international market & currency issues and the lack of inflation will serve as a catalyst for the Fed to take its foot off the gas as we move into 2019. That would be seen as a real positive by the market.

Risks are certainly abundant in the markets. Risk to earnings from U.S. Dollar appreciation; mid-term election uncertainty; the possible escalation of the trade war; and certainly international currency and market weakness, to name a few. We think to a large extent many of the aforementioned risks are priced into selected sectors and industries, particularly in the Materials, Energy and to a lesser extent the Industrials sectors. In Technology and Healthcare, risk aversion, increasing rates and sector rotation could likely cause a pullback and we are therefore significantly underweight Technology. As always we are keenly focused on the growth of earnings and company fundamentals and as noted in the title of this commentary, are very optimistic that our Mid cap Growth portfolios consisting of names in the aggregate that are cheaper than the benchmark, but growing more quickly will be rewarded as markets become more comfortable that earnings are not on track to decline precipitously and valuations for companies in sectors we are overweight are very reasonable.

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Emerald is an asset management firm providing research-based portfolio management. We provide growth-oriented and income-producing portfolios for institutions and individuals.

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