Emerald Advisers, LLC
Small Cap Value

Q3 2018 | Economic & Portfolio Commentary

Once Again, Investors are Shunning Small Value, as Larger Growth Companies Surge in 3Q

Small cap value outperformance in 2Q was short lived, as growth companies, buoyed by momentum trading, had a strong showing in 3Q. Year to date though September 30th, the Russell 2000 Growth (R2G) is ahead of the Russell 2000 Value (R2V) by 862 bps, and since January 1, 2017 by almost 2600 bps. Investors flocked into Healthcare and Technology companies which represent 43% weight in R2G vs. under 15% in R2V, while avoiding Financial Services (mostly banks and thrifts) who make up ~40% of the R2V vs. only 10% of the R2G. It seems that investors are negative on domestic economic activity. Housing, autos, industrials, infrastructure construction, oil & gas, banks, and consumer staples are out of favor. We believe a meaningful shift in favor of value can occur in the near term, as value becomes cheaper relative to growth, valuation factors will start to matter, value companies should exhibit greater improvement in earnings and sales, and a strong domestic economy throughout next year.

Portfolio Review

Within small cap, valuation factors have lagged again, and the free cash flow yield metric has continued to be weak. Larger companies (over $1B in market cap) did well, and so did growth and momentum factors. ETF in-flow headwinds to active managers somewhat subsided in 3Q, mostly in the month of September. The Russell 2000 Value index total return in the first quarter was 1.60% vs. -1.72% for the Emerald small cap value portfolio gross of fees. The portfolio's underperformance was mostly due to stock selection.

Within the Russell 2000 Value benchmark, once again, the Healthcare sector was meaningfully up, over 7% in the quarter. Utilities and Producer Durables also had strong performance. Consumer Staples and Energy where the only sectors in the red, however, Financial Services just barely had a positive gain

Steven E. Russell, Esq.
Portfolio Manager

Ori Elan
Portfolio Manager

Key Points:

- We believe a meaningful shift in favor of value can occur in the near term, as value becomes cheaper relative to growth, valuation factors will start to matter, value companies should exhibit greater improvement in earnings and sales, and a strong domestic economy throughout next year.
- At the portfolio holdings level, negative stock selection in the Healthcare, Energy, and Financial Services detracted from performance. However, positive stock selection in Technology provided positive alpha.
- We remain committed in our pursuit of finding attractive investment opportunities for our clients by focusing on high-quality companies identified and evaluated by our fundamental research and active portfolio management.

EMERALD
DRIVEN BY RESEARCH

(banks and thrifts were negative).

At the portfolio holdings level, negative stock selection in the Healthcare, Energy, and Financial Services detracted from performance. However, positive stock selection in Technology provided positive alpha.

Our belief that a strong domestic economy supported by less regulation, lower taxes, and eventual sizable infrastructure investments, led us to invest in companies that are leveraged to that thesis. While we still hold the view that these companies should do well given the current economic environment and our expectation that it would continue to improve, they have underperformed mostly due to exogeneous circumstances that are short term in nature.

Engineering and construction companies were challenged by permitting delays, large customers pushing out project start dates (causing under-absorption issues), higher labor costs, and adverse weather. With that said, bulging backlogs at higher margins, pushouts not cancellations, a strong economy, and need for infrastructure spending, keep us positive on this group. In addition, public infrastructure projects are secured by long term funding and demand is starting to inflect and poise for a multi-year recovery.

Materials companies exposed to homebuilding have been lagging due to bearish sentiment on this industry. Some of the concerns are decelerating housing starts, higher interest rates, and weakening affordability. However, favorable trends in household formation, low inventory levels for new and existing homes, high demand for low-priced "starter" homes, and strong consumer confidence, lead us to believe that the housing market will rebound and show mid single digit growth in the next several years. Current valuations discount a near recession scenario with multiples last seen during the most recent financial crisis (i.e. peak housing cycle). However, today's fundamentals are much stronger and less risky than a decade ago. According to Raymond James, in 2019, homebuilders are projected to grow earnings and ROEs double digits, generate positive cash flow from operations, while maintaining de-risked balance sheets (1).

Materials companies in our portfolio that supply to large infrastructure projects, also been adversely impacted by higher labor costs, rising raw materials prices, and abnormally wet weather. Again, our assessment is that demand is deferred not cancelled, and these companies are trading at near trough multiples and are extremely attractive investments based on our long term view.

Our Semiconductor stock investments declined in 3Q due to fears that capital spending by OEMs will be cut significantly as they push-out or cancel next node investments, and by worries about declining memory prices due to high inventory. Current market sentiment is that the industry will go through a multi-quarter downturn rather than a short correction period. We don't think that will be the case. We believe that the semiconductor market is more resilient than in the past, and the industry landscape has also vastly changed (largely through consolidation) where cyclical trends have become minimized. Underlying demand for semiconductors remains robust, driven by the data economy (5G, AI, Big Data, IoT, autonomous cars, etc.). Capital intensity and equipment spending levels need to rise just to support stable industry growth. Memory market fundamentals are still strong as equipment makers are much more efficient tool producers, and manufacturers can respond quickly to market softness. We expect strong growth in the memory market (both DRAM and NAND) in the next several years, which will drive a very robust wafer fab equipment capital spending environment.

Bank and thrift stock performance was mixed in the third quarter of 2018 as the SNL Large Cap Bank and Thrift Index was up 1.98% and the SNL Small Cap Bank and Thrift Index was down 3.50%. Logic would lead us to believe that rising rates are a tailwind for bank earnings but that is not always the case. We believe that the "rising rate tailwind" will play out for banks with good core deposit franchises and good core deposit costs. For many years since the financial crisis, deposits were not a concern as banks were awash in low cost deposits. In fact, as the Fed began raising interest rates into 2016, deposit costs and deposit betas remained anemic. In the first quarter of 2018 all that changed as we saw a significant uptick in deposit betas that has continued throughout the first nine months of 2018. As a result of increased deposit costs and competition amongst banks for commercial loans and a LIBOR rate that did not move much in the first two months of the third quarter, our expectation for the third quarter earnings season is for net interest margins to be at best "flat" if not down one or two basis points for the group. We believe that the remainder of 2018 will continue to see the smaller community banks continue to post good loan growth and indeed return to increased net interest margins in the fourth quarter of 2018. Longer term, we feel that the macro background is still strong, and current Street estimates do not incorporate meaningful net interest margin expansion or strong loan growth for small and community banks. Our theory is that banks with higher loan to deposit ratios will be less aggressive on pricing when competing for loans and typically, increases in deposit costs when there are rate increases lag the increase by about six months. We also remain encouraged by our long term belief that community banks are in the midst of an industry consolidation. Even though trends slowed in the third quarter, this year is set for the most active year since at least 1991. In fact, the third quarter was the fourth strongest quarter since 1991, with 59 deals announced, after 2Q 2018 with 84 deals, and 64 deals announced in 3Q 2017.

We are disappointed with the performance thus far this year, but we have strong conviction in our portfolio holdings. We believe that the small cap value portfolio is well positioned to benefit from an improving domestic economy and the eventual turnaround in some of the industries discussed above. We still maintain an overweight to banks within the Financial Services sector, and we continue to search for and invest in high quality companies that generate prodigious amounts of free cash flow.

Market Outlook

We still view the current domestic economic environment as very positive for companies focused on generating revenues and growing their operations in the U.S.. We acknowledge investors concerns with rising interest rates, trade tensions, upcoming mid-term elections, and margin headwinds due to higher labor/materials/transportation costs. However, we think there are many more positive dynamics that would create tailwinds to the economy and prevent it from slowing meaningfully in the next year or two. As such, we believe the recent downturn in small caps is a correction within the current bull market rather than a beginning of a bear market, as we are not seeing the tell-tale signs of a looming recession.

September unemployment rate came in at 3.68%, lowest unemployment rate since December 1969! Meanwhile the U6 rose slightly to 7.5% from 7.4%, as more people are encouraged to re-join the labor force. Also, average hourly earnings grew 0.3% month over month, and 2.8% year over year. There is less slack as the labor market continues to tighten. This has been positive for consumers. With stronger prospects for employment and wage growth, consumer confidence is close to decade highs at 99 (October).

The Fed is on a path to continue raising rates, three times so far this year and another hike is expected in December. These actions are fanning fears of a potential policy misstep that would cause the economy to slow down and eventually enter into a recession. Our take is that the Fed tightening policy is not a response to inflationary concerns, but rather an attempt to gradually get back to normalized levels for both interest rates and the Fed's balance sheet. As such, with a stronger economy, the yield curve should actually steepen rather than invert. In that scenario, smaller banks with relative lower loan to deposit ratios will do very well, and see their net interest margins expand.

As mentioned above, there are mounting headwinds affecting construction, such as rising interest rates higher input costs, and bad weather. However, the data tells us that there is still lots of activity throughout the country, which we believe, should continue for several more years. Domestic industrial metrics strengthened sequentially in 3Q18 with the ISM PMI averaging 59.7 for the quarter and up slightly from 58.7 in 2Q18, and in-line with a strong 59.7 in 1Q18, tying the best calendar quarter of industrial activity since 1Q11. September was the 25th consecutive month of growth in manufacturing. The sector remains in expansionary mode with activity at a high level. The Dodge Momentum Index, which tracks initial reports of construction projects in planning, was at its highest reading in history, 169.8, in July 2018. The April – August 2018 period was the only time since the index's inception (in 2012) that the index exceeded 160. The August 2018 Architectural Billings Index (ABI) was 54.2. The ABI offers an approximately 9- to 12-month glimpse into the future of nonresidential construction spending activity. A reading above 50 tends to coincide with rising demand. In addition, construction and remodel activity remains at a high level. If only weather would normalize (less wet in prime construction regions), this group would benefit from both top line growth and improving margins, as they become more efficient in managing logistics and labor.

The extent of the damage that trade wars can inflict on the U.S. economy ($19 trillion) should be manageable, as we see progress and eventual resolution on several fronts. The U.S. economy is being stimulated by tax cuts, deregulation and improved sentiment, and tariffs are potentially bullish to domestic companies that are able to raise prices which lead to higher profits, assuming they can keep their costs down. The major disagreement with China had little impact on the growth rate of our domestic economy, and so far only a handful of industries have been targeted. While we do not have any unique insights to the trade negotiations, we believe a deal, or even cessation of tit-for-tat tariffs, can send the markets higher again. However, as we have seen with the announcement of the new trade agreement between the U.S. – Canada – Mexico, investors favor buying larger companies over small ones.

Banks have been out of favor due to investors concerns over diminishing earnings power related to increasing deposit betas, eventual normalization of credit costs, and a flattening yield curve. However, we feel that the macro background is still strong, and current Street estimates do not incorporate meaningful net interest margin expansion or strong loan growth for small and community banks.

We strongly believe that companies that are generating prodigious amount of free cash flow are higher quality companies, and will outperform over a market cycle. In the past few quarters, companies that have low return on equity or "non-earners", which we consider lower quality companies, have done very well. We expect this trend to reverse as investors will start to focus on earnings growth and balance sheet strength, as valuation gap between growth and value widens, and concerns over an eventual economic slowdown increase.

We remain committed in our pursuit of finding attractive investment opportunities for our clients by focusing on high-quality companies identified and evaluated by our fundamental research and active portfolio management.

(1) *Raymond James, Housing: History Is On Homebuilders' Side Heading Into "Hope Trade 2019", 15 October, 2018*

DRIVEN BY RESEARCH

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

To learn more about Emerald Advisers, please visit us at teamemerald.com.

Contact Us

Phone: 1-800-722-4123
info@teamemerald.com
3175 Oregon Pike
Leola, PA 17540

King of Prussia, PA
Pittsburgh, PA
Cleveland, OH

EMERALD