Emerald Advisers, LLC
Diversified Small Cap Growth

Q4 2018 | Economic & Portfolio Commentary

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Small Caps Suffer Correction

Market Update

The S&P 500 returned (4.4%) for the full year 2018, marking the first negative return year since the financial crisis, and ending the market's nine year streak of positive returns. After a record start to 2018 and a strong 9-month market advance driven by accelerating U.S. GDP and domestic earnings growth the market ended the year with a thud. The S&P 500 returned (13.5%) in the fourth quarter, memorializing its place as the worst fourth quarter in recent memory, with only the fourth quarters of 1987 and 2008 posting worse returns. The month of December was particularly weak, with the S&P posting a (9%) return, representing the index's worst monthly return since 2002. Small capitalization stocks experienced a similar retrenchment although much greater in magnitude with the Russell 2000 returning (11.0%) for the year, (20.20%) for the quarter, and (11.88%) in the month of December. December was the worst month for the Russell 2000 since the financial crisis, with the fourth quarter representing the worst quarterly return since the third quarter of 2011, and the worst absolute return calendar year since 2015.

This massive market reversal that began in the middle of September was catalyzed by escalating concerns regarding decelerating global growth, trade wars, rising domestic recession fears (flattening yield curve and widening credit spreads) and fears of monetary policy missteps. Volatility surged as the market climbed the wall of worry through the quarter. The CBOE Volatility index started the year at 11 and ended the year at 25, peaking at north of 35 on December 24, 2018 at the height of uncertainty and what in retrospect marked the market bottom. Directional moves in the market were similarly magnified. In the fourth quarter of 2018 alone there were 12 trading days where the market staged a greater than 2% directional move. To put this in context, the fourth quarter of 2018 by itself tallied more 2% or greater market moves than any year in the last five years according to a January 2, 2019 report from Jonathon Golub of Credit Suisse. The rapid rise in volatility and concerns regarding forward earnings growth weighed heavily on market multiples. According to Mr. Golub, the nearly 400 bps decline in P/E multiples (from 18.2x at the end of 2017 to approximately 14.4x today) was the third largest decline in P/E multiples in over 40 years, with only 2000 and 2002 showing more substantial declines.

Key Points:

- On a relative basis, Emerald underperformed the benchmark for the quarter as the negative contribution from stock selection offset the positive contribution from allocation effect. At the sector level, relative underperformance within the financial services, technology and utilities sectors offset relative outperformance within the healthcare, consumer discretionary, producer durables, materials, and energy sectors.

- The financial services sector was the largest detractor to return for the period, resulting largely from the portfolio's relative overweight position and challenging stock selection within the banking industry.

- Small capitalization domestic growth stocks should be particularly well positioned in this environment given the recent retrenchment in valuations and stronger rate of earnings growth relative to their large capitalization peers. A combination we believe will prove attractive as growth becomes increasingly scarce.

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From a style perspective, value outpaced growth during the fourth quarter, although it was hard to call that a meaningful victory given the broad market retrenchment. Within the small capitalization universe the Russell 2000 Value returned (18.67%) relative to the Russell 2000 Growth which retraced by a more substantial (21.65%). Notably, despite the fourth quarter retrenchment, growth as a style outperformed its value counterpart across the capitalization spectrum for the full year of 2018.

Within the Russell 2000 Growth, risk aversion was particularly evident as every sector posted double-digit negative returns for the quarter, with the energy (40.58%), healthcare (25.32%) and materials (24.99%) sectors posting the greatest declines. Decomposing the index further, risk aversion was similarly apparent at the factor level with the fastest growing companies as measured by sales growth, the smallest market capitalization, the non-earners and the highest beta companies each lagging the index.

Portfolio Review

On a relative basis, Emerald underperformed the benchmark for the quarter as the negative contribution from stock selection offset the positive contribution from allocation effect. At the sector level, relative underperformance within the financial services, technology and utilities sectors offset relative outperformance within the healthcare, consumer discretionary, producer durables, materials, and energy sectors.

The financial services sector was the largest detractor to return for the period, resulting largely from the portfolio's relative overweight position and challenging stock selection within the banking industry. Emerald has taken a more selective approach to its holdings within the banking industry, and while we continue to remain overweight relative to the benchmark, absolute exposure to the banking industry has declined, which has contributed to a shift in the portfolio's aggregate exposure to the financial services sector from an overweight position to an underweight position.

Performance within the technology sector also weighed on relative performance, driven largely by the portfolio's sizeable overweight position to the sector, specifically the software industry, and underperformance within the computer technology industry. Stock selection in aggregate was neutral to performance. Within the software industry, relative performance was negatively impacted by the portfolio's meaningful relative overweight position. While the underlying secular growth drivers of the software industry remain intact, the market retrenchment weighed heavily on valuations penalizing these fast growing businesses.

The relative underperformance of holdings within the utilities sector also detracted from performance for the period.

Partially offsetting the aforementioned underperformance was relative outperformance within the healthcare, consumer discretionary, producer durables, materials and energy sectors. Amongst these, the healthcare sector was the largest positive contributor to return for the fourth quarter, driven largely by the portfolio's relative underweight position to the benchmark. While stock selection at the sector level was a negative contributor in aggregate, at the industry level the portfolio experienced a positive contribution from stock selection within the medical equipment and medical & dental instruments industries.

Stock selection within the consumer discretionary sector also contributed positively to return reflecting outperformance within the consumer services, casinos & gambling and education services industries.

Also contributing positively to performance was positioning within the producer durables, materials and energy sectors which benefitted from a combination of allocation and interaction effect.

As we enter 2019, the portfolio held the largest active exposures in the technology, consumer discretionary, and utilities sectors. Thoughts on those sectors and other notable areas of exposure are highlighted below.

- The technology sector was the portfolio's largest relative overweight position exiting the fourth quarter of 2018. Within the sector, the computer software and services industry continues to represent the portfolio's largest exposure. Emerald continues to see a strong secular growth opportunity in enterprise security and vertical software as we believe that large corporations are behind in their efforts to digitally transform their businesses. Within software we remain overweight the security end market given increased vigilance of corporate boards and ongoing upward pressure on security budgets as the threat landscape continues to broaden. We also continue to be optimistic regarding network infrastructure spending as consumer demand for bandwidth continues to drive network upgrades, and at this point, multiple segments are in the early stages of network expansion/evolution. Datacenters are upgrading speeds from 25G to 100G as well as laying the foundation for 200G/400G. Telecom and cable companies are driving fiber deeper into their networks to provide customers with faster speeds, which has the potential to change the fundamental architecture of the entire system, and the emergence of 5G/IoT/autonomous vehicles creates another potentially dramatic growth catalyst for network infrastructure.

- The portfolio also exited the quarter with an overweight position in the consumer discretionary sector. The overweight is comprised of a diverse subset of companies within the casino & gambling, specialty retail, education services, leisure time, diversified retail, consumer services, apparel & shoes, and restaurant industries. Emerald believes that, amidst an expansionary consumer backdrop each of these companies is positioned to benefit from company specific initiatives and opportunities.

- The portfolio also maintains a modestly overweight position to the utilities sector. Within the utilities sector, we continue to see attractive opportunities related to the increasing adoption of cloud-based unified communications, growing demand for bandwidth among businesses and consumers, and the preparations for the rollout of 5G networks.

- The healthcare sector, while underweight relative to the benchmark, remains an area of meaningful exposure within the portfolio. At the industry level, the biotechnology industry remains the largest aggregate exposure. We continue to look for innovative therapeutics that can command premium pricing, though we note that competition for small niche patient populations is becoming a challenge. That being said there continues to be a high-level of successful innovation in the marketplace as there were 18 drugs approved by FDA during Q4-18, bringing the total to 59 on the year. Further we also believe there is a developing opportunity in companies that have launched drugs in the past 2-3 years, as it often takes small companies several quarters to get their commercial organization running efficiently. Rounding out the portfolio's healthcare sector exposure are niche opportunities within the healthcare services, medical equipment, medical & dental instruments and pharmaceutical industries.

Market Outlook

After a less than desirable conclusion to 2018, 2019 has gotten off to a better start thanks to an impressively strong December employment report, dovish commentary from Federal Reserve Chairman Powell which implied data dependence and balance sheet run-off flexibility, and easing credit spreads which have collectively helped to alleviate recession fears. That being said, while clouds may be starting to part, it is difficult to say that the storm has passed as global economic growth continues to decelerate, trade policy remains in flux, and there remains a significant gap between the market's assumption regarding the trajectory of Federal Reserve Rate hikes in 2019 (10% probability of an increase according the Fed Funds Futures) and the Federal Reserve's current dot plot which continues to imply two more rate increases.

The anticipation of slowing global economic growth has been a large contributor to the negative earnings revision cycle that is currently underway. After meaningfully positive earnings revisions throughout 2018, the outlook for 2019 earnings growth has been contracting. At this point forward consensus implies approximately 6-7% operating earnings growth for the S&P 500 in 2019 and approximately 15% for small cap stocks, which represents a marked deceleration from the 9-10% and 18-19% growth that was projected, respectively for large and small caps exiting September. Although estimates have trended lower in recent weeks, given the late December commentary from Apple and FedEx regarding the sudden deceleration in China as well as the significant deceleration in the recently reported December ISM and weakening data points in Europe, we believe the market is bracing for further negative revisions as earnings season progresses. Although the market retrenchment has somewhat priced in this deceleration, we believe that the negative revision cycle for earnings and economic growth for 2019 needs to be exhausted before the market is positioned to meaningfully advance.

Emerald does not believe that the U.S. is on the verge of either an economic or earnings recession. While current forecasts are still calling for U.S. economic growth to remain in expansionary territory, gaining 2.0-2.5% year over year, uncertainty regarding the forward outlook has been growing as recent data points regarding the domestic manufacturing landscape and capex outlook have shown signs of weakening. We believe this recent weakness is in part reflective of the deceleration of growth within both the Chinese and European economies. While these international influences certainly present risks, counterbalancing that weakness however is the resiliency of the U.S. Non-Manufacturing ISM, and the strength of the U.S. consumer. The December employment report reflected remarkable strength as have the early looks on holiday retail sales which are currently forecasted to be the strongest in recent history. Encouragingly, in the event that economic growth was to decelerate to a level below 2%, earnings can still expand. According to Ed Hyman of Evercore ISI there have been other environments where sub-2% domestic GDP growth has resulted in mid-single digit EPS growth, which would prove to be a much better outcome than the flat growth to earnings contraction commentary that has been discussed as the potential bear case for 2019.

We believe this backdrop of slowing but positive domestic growth continues to position the U.S. domestic markets as the strongest house on the international stage. Given that the compression in price/earnings multiples has already been historic, if there is a resolution to the trade/tariff situation in China and the market can get comfortable that the U.S. economy and corporate profitability remains on a growth trajectory, albeit at a slower pace, we could see the recent market rebound continue. While commentary from the Federal Reserve Chairman Powell leaned dovish, in order for the market to advance on a more durable basis, "Fed Speak" needs to evolve into "Fed Action" with an official pause and a removal of the 2019 dot plot increases.

Small capitalization domestic growth stocks should be particularly well positioned in this environment given the recent retrenchment in valuations and stronger rate of earnings growth relative to their large capitalization peers: a combination we believe will prove attractive as growth becomes increasingly scarce. In the interim, however, uncertainty breeds volatility and as a result, volatility is likely to remain elevated over the coming weeks as we progress through the corporate earnings reporting season and get the first true look into 2019 revenue and earnings expectations. That being said, market dislocations create opportunities and Emerald remains focused on capitalizing on those opportunities.

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