Emerald Advisers, LLC
Mid Cap Growth

Q4 2018 | Economic & Portfolio Commentary

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"Perseverance is Stubbornness with a Purpose"

-Author and Speaker Josh Shipp

Quarterly Summary

There is no reason to pull any punches: Emerald Mid Cap Growth portfolios had an ugly 4th quarter and the full year wasn't much better. Our overweight to Energy and other cyclical industries and our continued holding of higher growth Healthcare, Financial and Industrial names detracted from stock selection and caused considerable pain for both time periods. According to Canaccord strategist Tony Dwyer, last year began with a global synchronized recovery, low volatility, extreme bullishness and the potential for >20% S&P 500 earnings growth. It ended with a global synchronized slowdown, high volatility, extreme bearishness, concerns of a sharply slowing U.S. economy and potential for flat earnings growth. Our view is that, as has been the case for the past three years, company valuations did not matter and balance sheet strength, real or perceptual, was paramount regardless of the company's' ability to service debt. Lower growth "stable" earnings names and bond proxies did well for the quarter and the year, with all cyclical and high growth sectors lagging for both periods. As we have noted in past commentaries, high frequency, program, ETF, index and derivative strategies and trading ruled the markets during the quarter and year accounting for as much as 85% of trading volumes according to JP Morgan. This development has dramatically limited price discovery in equity markets and contributed to recent volatility and equity dislocation.

Economic data was generally positive during the quarter, as well as for the year, with calendar year GDP growing at 2.9%, the civilian unemployment rate trending below 4%, retail sales showing strength, housing starts and auto sales both performing at reasonable levels; and industrial production and

Key Points:

- Emerald Mid Cap Growth portfolios struggled in most sectors with particular weakness in Energy, Technology, Producer Durables and Financials. Our aforementioned focus on the highest earnings growth names in the highest growth sectors meaningfully detracted from performance in a quarter and year where we think valuations really didn't matter.

- In most cases our winners were names that had unrewarded strong quarters and our losers had reasonable or even strong quarters, but unfortunately were in sectors or industries with factors labeled as cyclical or at risk of earnings revision in the event of a substantial earnings slow down or recession. A risk we see as overblown.

- Beyond the upward expected trend in equity markets, we think strongly that there will be a reversion to the mean away from overvalued sectors and industries like Consumer Staples, Utilities and Healthcare (areas we are underweight) and into beaten up areas like Energy, Materials Consumer Discretionary and Financials, (areas we are materially overweight).

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consumer confidence registering robust readings. Yet, as shown by the recent large drop in ISM new orders for December, the economic data is not uniformly bullish. Financial and monetary indicators have been pointing to slower demand growth in the future, with monetary growth weakening, credit spreads widening and parts of the yield curve close to inverting. These factors along with tariff and international economic concerns all contributed to the market's retreat. Sadly, the Fed's seeming ignorance to many of these weakening forward looking factors just added to investor anxiety and compounded the substantial downdraft.

We cannot overstate the impact of the changes in the market structure we touched on in the first paragraph: changes that we feel caused distortions and extreme dislocations in the performance of many of our names for the better part of the last two years, regardless of fundamentals (more on our positioning later). Strategist Jim Furey highlighted market structure changes in a recent client note. He lists a number of market developments that contributed to what he sees are unjustified swings in equity markets:

- Elimination of uptick rule preventing short sales on downtick
- The Volcker mandated closure of stock stabilizing proprietary trading desks
- The prevalence of high frequency trading
- The seeming first ever wave of passive net selling, with havoc being created as passives are now the dominant force in the market

And we will add:

- Hedge Fund closings, and liquidations
- Record mutual fund redemptions of over $100 bn in the last two weeks of the year
- And, unprecedented tax loss selling

All these factors compounded the dramatic equity sell-off with December registering the worst equity performance for that month since 1931.

Portfolio Review

In a quarter when your best performing stock contributes 13 basis points to performance and your worst five stocks detract by an average of 68 basis points each, you know performance is not going to look good on an absolute or relative basis. This lack of upside volatility and dispersion was troublesome for an active manager that depends on the fruits of our labors conducting deep fundamental research and for all active mid cap growth managers, with just 26% beating the benchmark for the quarter according to Jefferies. In most cases our winners were names that had unrewarded strong quarters and our losers had reasonable or even strong quarters, but unfortunately were in sectors or industries with factors labeled as cyclical or at risk of earnings revision in the event of a substantial earnings slow down or recession. A risk we see as overblown.

From a market cap perspective portfolios had an average market capitalization of $12.9bn compared to $14.5bn for the Russell Mid Cap Growth benchmark. As has been the case for the past two years portfolios were composed of securities with expected earnings growth rates of 18.91%, substantially higher than the benchmark's 17.14%; while at the same time trading at a discount to the benchmark on virtually every valuation metric including current and forward P/E, P/B, P/S and P/CF. ROE was lower than the index as we were overweight the highest growth sectors of Materials and Energy which tend to have lower return on equity, and underweight selected higher ROE Technology and Industrial names. This lower ROE posture put us at a disadvantage as stocks perceived as lower quality materially lagged for the quarter and year regardless of benchmark leading earnings growth. Interestingly, Emerald's portfolios actually traded at a lower long-term debt/capital level than the benchmark. **Given the aforementioned valuation dislocations and substantial valuation discounts of some of our names – Energy stocks trading lower than in early 2016 when WTI crude hit $26 – we added to selected Energy, Materials, Financial and Industrial names in December as we had been sitting on higher than average amounts of cash during much of the quarter. These additions compounded our under performance but we feel set us up beautifully for 2019 – as we have witnessed in early January, with portfolios strongly outperforming the benchmark thru the date of this commentary (1/11/19).**

Emerald Mid Cap Growth portfolios struggled in most sectors with particular weakness in Energy, Technology, Producer Durables and Financials. Our aforementioned focus on the highest earnings growth names in the highest growth sectors meaningfully detracted from performance in a quarter and year where we think valuations really didn't matter. All that mattered were concerns about a future economic slowdown and dire predictions of negative earnings revisions. In terms of contributors and detractors to Mid Cap Growth portfolios for the quarter, there is not much to talk about on the contribution side.

For the full year 2018 the story was similar with underperformance in the same areas: Energy, Materials, Producer Durables and Financial Services. Technology was the bright spot with strong software and services performance.

Market Outlook

To say 2018 was a macro, momentum and earnings slowdown/recession fear driven market would be an extreme understatement. According to many strategists such as Lori Calvasina from RBC Capital Markets, stock prices declined to a level where investors were pricing in a mild recession for 2019, and certainly more than a growth scare – neither scenario we think is very likely to occur given the present strength of the U.S. economy. Will earnings growth be revised downward as it has for the past several months? Certainly, but Calvasina notes that most negative earnings revisions will be completed by January and therefore based on the dislocated valuations in the market, equity markets should be near their nadir and are set for a rebound in 2019. Valuations for mid cap growth stocks in general are very attractive with current mid cap growth P/Es trading at just 87.5% of their 20 year average).

Current P/E as % of 20-year avg. P/E

	Value	Blend	Growth
Large	90.0%	90.9%	89.8%
Mid	86.8%	88.1%	87.5%
Small	78.8%	88.6%	99.9%

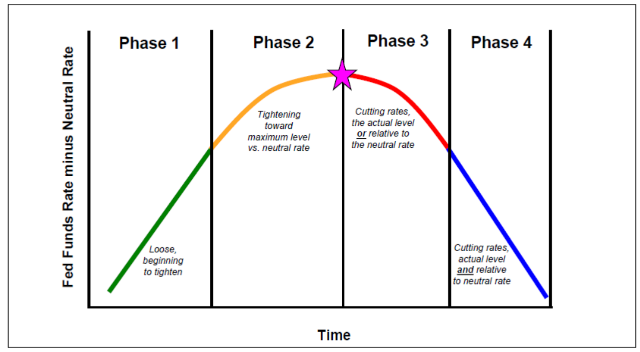
Source: FactSet, Russell Investment Group, Standard & Poor's, J.P. Morgan Asset Management.

(Source: JP Morgan Asset Management Guide to Markets, 12/31/18)

Trade wars, monetary policy, and Fed and other central bank behavior all caused the precipitous market decline and jump in investor risk aversion in the second half of 2018. By our reckoning trade wars and a potential China led global economic slowdown have been the most important factors driving down stock multiples to levels not seen since 2011. Trade wars can have a contractionary impact on global growth and can cause companies to put the skids on new orders and purchasing activity, as we have seen since the inception of President Trump's announced tariffs on various Chinese products. The Chinese economy – which some now argue is the world's largest – is still slowing but with the Fed having tightened to the point of choking off domestic growth, both sides have an incentive to do a trade deal. In addition, China's authorities have started taking actions such as changing bank reserve requirements to stimulate their massive economy. That said we still have to watch the direction of the Chinese Manufacturing PMI before we truly see a bottom in developing and U.S. stock market indices.

We think that the Fed has been the next largest factor in causing downside market turbulence. The Fed's tightening which began over four years ago has become overly aggressive and is now risking credit deterioration and contraction and a potential U.S. economic recession. According to Stifels' Barry Bannister, the Fed under Chairman Powell has now reached the area of maximum monetary tightness and should actually look to start cutting rates relative to the neutral rate.

There are four phases in a Fed rate cycle, and the Powell Fed has reached *maximum* tightness (★now)



Source: Stifel

(Source: Stifel - Macro & Portfolio Strategy, 01/02/19)

MKM's Mike Darda, one of our favorite strategists, argues the same thing saying "We believe the Fed should take the side of *forward looking indicators* (as opposed to strong coincident trends) all of which are saying the Fed has already hit neutral and may even be a bit beyond it." **The good news is it seems Chairman Powell and the rest of the Fed seem to be waking up to what the market has been signaling for two months and have significantly toned down the rhetoric about future rate increases and the timing of shrinking the Fed balance sheet, noting current conditions afford material flexibility for both actions.**

The big question for us and other investors is will the Fed's dovish tone continue in the face of reasonably strong U.S. economic indicators? If the Fed maintains its present "flexible" stance equity markets should continue the rebound that began at the beginning of the new year, the U.S. Dollar should depreciate, emerging markets should perk up and beaten up growth cyclicals should very nicely outperform defensive and higher valued growth sectors. Also stock selection and valuations should begin to matter, as, for example, investors realize that Utilities are trading at a huge premium to Banks yet have dividend yields very similar with little or no growth. We are banking on the Fed waking up to the reality of the global slowdown, credit contraction and implications of the trade war and putting the brakes on future rate increases until all of the data can support future U.S. economic growth.

Assuming some resolution of the trade wars, a continued more dovish Fed stance and a recognition by other central banks of the risks of tightening too far, it is likely stock multiples will begin to expand as risk aversion dissipates and market returns should improve. Following is a MKM Partners slide showing the market normally rebounds strongly after a large fall in forward multiples as has recently occurred.

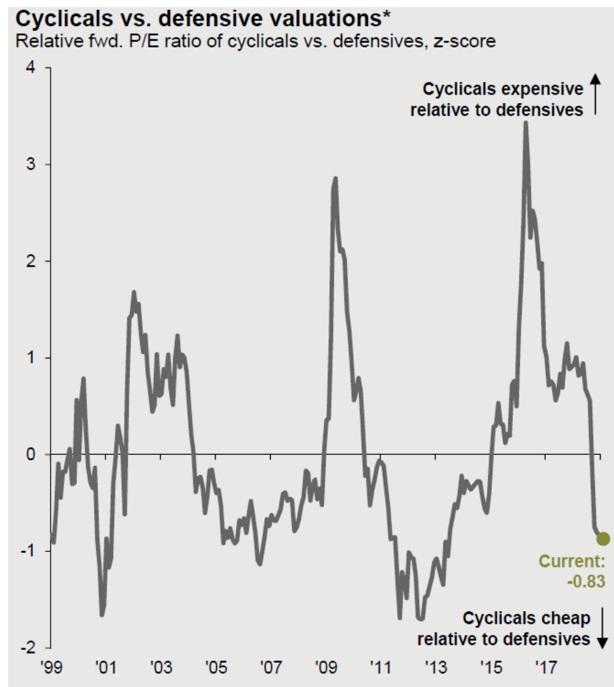
Multiple Declines of Recent Magnitudes *Usually* Followed By Strong Market Returns...

Year	Fall in Forward Multiple*	S&P 500 Return Following Year, %	*Notes*
1907	-5.1	52.2	Curve Inverts in 1905 (leads stock market peak in 1906)
1917	-4.4	13.3	Curve Inverts in 1918 (lags stock market peak in 1916)
1930	-7.2	-35.3	Curve inverts in 1928 (leads stock market peak in 1929)
1937	-11.3	17.9	No Curve Inversion (ZLB)
1966	-4.3	4.8	Curve inverts in 1965-66, short bear market decline follows, no recession
1970	-4.5	27.6	Curve Inverts in 1967-68 (leads stocks)
1974	-5.8	30.8	Curve inverts in 1973, but lags stock market peak by two months
1988	-5	26.3	Bear market w/no curve inversion or recession
2003	-5.8	38.5	Curve inverts in March 2000, coincident with stock market peak
2008	-5	-11.3	Curve inverts in 2006, leads stock market peak by nearly two years
2018	-4.9	n/a	???
Mean	*-5.8*	*16.5*	
Median	*-5.0*	*22.1*	

Source: Bloomberg; Datastream; MKM Partners

(Source: MKM Partners - MacroStrategy, 01/03/19)

Beyond the upward expected trend in equity markets, we think strongly that there will be a reversion to the mean away from overvalued sectors and industries like Consumer Staples, Utilities and Healthcare (areas we are underweight) and into beaten up areas like Energy, Materials Consumer Discretionary and Financials, (areas we are materially overweight). These latter sectors are trading at levels in some cases not seen since 2011 and have certainly priced in a sizable global recession, a recession we just don't see migrating to the all-important U.S. or Chinese economies. Demand has been strong for most energy and industrial commodities and thus just don't support the multiple contraction seen in these sectors. JP Morgan notes that cyclicals are currently very cheap vs. defensive sectors.



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.

(Source: JP Morgan Asset Management Guide to Markets, 12/31/18)

We at Emerald have long espoused that earnings growth drives stock prices and we have put our money where our mouth is for the past two years but have seen literally no reward as the highest earnings growth sectors have tended to be the worst performers regardless of valuation. We think that trend is going to change, and change materially, as investor risk appetite improves and as strategists start to highlight the magnitude of the growth/valuation disparity that has developed between selected sectors. We feel strongly that monies will move into beaten up names in the Energy, Materials, Consumer Discretionary and Financial sectors. We also think that the deep and unusual valuation discount for our portfolios vs. the benchmark will reverse and result in strong returns for our portfolios.

Emerald Portfolios have Higher Expected Earnings Growth, Yet Trade at a Discount

	Emerald Mid Cap Growth (weighted harmonic avg.)	Russell Midcap Growth (weighted harmonic avg.)
P/E using FY2 est.	14.87	17.13
Price/Cashflow	11.67	15.57
Price/Book	2.90	5.06
Price/Sales	1.97	2.29
Estimated 3-5 yr Growth	18.91	17.14

Source: Factset

Despite challenging performance over the past two years nothing has changed at Emerald regarding our philosophy, process or people. We continue to dig deep to find under-researched, undervalued mid cap growth stocks. This past quarter we were able to add another moniker to the types of names we search for: "Dislocated" as price discovery in the market eroded for the reasons listed above and afforded us what we think is a once in a decade opportunity to pick up growth names pricing in a significant recession, something we just don't see occurring. FactSet, as of January 11 in their Earnings Insight, still has CY 2019 earnings projected to growth at 6.9% with revenue growth of 5.5%, and while there can be some variation in these estimates we, like Lori Calavasina from RBC, think most of the worst will be behind us in the next month, affording smoother sailing to those worrying about negative earnings revisions. We actually think selected sectors like Energy, Materials and Consumer Discretionary could see positive earnings revisions as we get past the first quarter of 2019 thus driving even higher multiple expansion. As always fundamental, bottom-up research is at the core of what we do at Emerald. It has been an essential differentiator for over 26 years of managing portfolios. We can think of few better investors to buttress our point than legendary Fidelity Magellan Fund portfolio manager Jeff Vinik who in announcing the relaunch of his hedge fund recently made the following comments related to active management opportunities:

"While markets have become more competitive over time, I believe the broad industry switch from active to passive management is creating excellent opportunities for fundamental stock pickers like me," said the 59-year-old Vinik. "I am confident that the style I have employed for more than three decades — fundamental bottom-up company analysis (growth at a reasonable price) guided by a top-down blueprint of the economy and markets — can achieve strong long-term returns."

Like Vinik we feel more strongly than ever that, given the rise of passive and quantitative price agnostic strategies, our research insights and actively constructed portfolios will become more dear and in demand to investors craving alpha generating returns.

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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.

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

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