

# Emerald Advisers, LLC

## Small Cap Value

Q1 2019 | Economic & Portfolio Commentary

### A Very Nice Rebound for Small Caps in the First Quarter of the Year

After a miserable 4Q18 performance, small caps staged an impressive rally in 1Q19. The Russell 2000 had the best start to the New Year since 1991. However, once again it was small cap growth that bested small cap value. Investors shrugged off continued political discourse post mid-term election, the longest government shut-down on record, as well as weaker than expected economic data from both domestic and abroad, as the Fed sent a strong signal to the market that it is effectively putting any rate hikes throughout 2019 on hold.

#### Portfolio Review

For small caps, in 1Q19, growth sectors such as Technology and Healthcare did very well while Financials were at the back of the pack. This dynamic created a headwind for value managers compared to growth managers due to the weight representation of these sectors within each corresponding benchmark. In addition, while tax loss selling was over and the pace of redemptions slowed, active managers who focused on higher quality companies were disappointed again as loss-making, low ROE, smallest size quintile, highest leverage companies had strongest performance. The Russell 2000 Value index total return in the first quarter was 11.93% vs. 12.00% for the Emerald small cap value portfolio gross of fees. Emerald's outperformance was mostly due to stock selection and our discipline that seeks out undervalued quality companies.

Within the Russell 2000 Value (R2V) benchmark, Energy sector was up meaningfully, rising over 20% in the quarter. Technology and Materials & Processing sectors also had strong performance. Energy and Materials & Processing sectors fared well within the benchmark as commodity prices rebounded from December lows, and 4Q18 earnings results (reported in



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#### Key Points:

- Emerald's outperformance was mostly due to stock selection and our discipline that seeks out undervalued quality companies.
- At the portfolio holdings level, negative stock selection in Banks, Technology, and Energy detracted from performance. However, stock selection in REITs, Materials & Processing, Consumer Discretionary, and Healthcare contributed positively to the portfolio.
- We believe that the small cap value portfolio is well positioned to benefit from a slowing, yet growing, domestic economy and the eventual turnaround in domestically focused industries (such as Banks).



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1Q19) for the most part beat lowered expectations. Technology also was a big winner in the R2V as semiconductor companies rebounded strongly after 4Q18 inventory/China trade war/mobile growth concerns abated, and investors anticipate a trough in activity sometime in 1H19 followed by meaningful pick-up in 2H19. Financials (+7.8%) and Consumer Staples (+9%) while positive, lagged all other sectors.

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We have reduced our overweight in banks, but still believe that the underlying fundamentals of small cap community bank stocks remain attractive. In recent weeks, parts of the Treasury yield curve have inverted, presenting a potential barrier to increased earnings power for the bank sector. Therefore, investors have soured on the sector given uncertainty in the market based on the yield curve, global growth concerns and select calls for rate cuts. We believe that if banks can deliver a solid first quarter, which has been the case for the majority of banks reporting so far, there could be a rally in stock prices considering the recent selloff.

While lower rates will dampen loan yields, banks could see some benefit from a slower rise in deposit costs, and higher yields on repriced loans. Additionally, the sharp decrease in long term rates over the last six months should bolster growth in tangible book values (TBV) for many community banks during the first quarter earnings season as a result of increase in value of their available for sale (AFS) securities

portfolios. The vast majority of banks' AFS portfolios comprise of fixed income securities, which benefit when the 10 year Treasury yield declines. We continue to expect relative outperformance from community banks with: 1) solid core deposit basis that have net interest margin defensible characteristics in the form of lower cost commercial deposits; 2) loan growth outlooks that are better than average but achievable; 3) good credit quality; and 4) reasonable ability to offset top line revenue weakness through expense pruning all while still investing in the franchise. We believe that 2019 will also see a robust M&A activity in the banking sector. The recent large merger of equals should spur additional consolidation, as banks are looking to grow and provide more services to customers in a cost efficient manner. Valuations remain attractive with many community banks trading below historical levels despite the rebound in 1Q19.

Also, during the quarter we reduced our exposure to construction and materials companies that are affected by wet and cold weather. We believe these companies will probably miss consensus estimates due to adverse weather conditions across the country, and therefore, see their share prices decline after releasing 1Q19 earnings results.

We believe that the small cap value portfolio is well positioned to benefit from a slowing, yet growing, domestic economy and the eventual turnaround in domestically focused industries (such as Banks). We continue to search for and invest in high quality companies that generate prodigious amounts of free cash flow, as well as financial services enterprises that trade significantly below their terminal value.

## Market Outlook

The strong rebound in the stock market was a welcomed relief for investors after being shell-shocked during 4Q18. The markets rallied despite a change in Capitol Hill that guarantees political gridlock, so-so economic data, a lackluster housing market, continued negotiations with China on trade, and risks overseas (BREXIT, EU economic slowdown, China economic slowdown).

It seems that optimism is abound, as investors feel that the dark clouds are still far out on the horizon. The Fed definitely gave a big boost to the market by waiving the white flag on future 2019 rate hikes. Also, employment data has been very strong with U.S. Job openings rising to 7.58 million in January, almost reaching back to the 20-year highest record of 7.63 million in November 2018 according to the Bureau of Labor Statistics (BLS). Currently, job openings are exceeding the unemployed by more than 1 million and this type of discrepancy has been present for 11 consecutive months. All the while, new claims for unemployment insurance broke below the 200,000 threshold in early April to hit the lowest level since October 1969. Indications from government officials suggest that a trade deal with China is expected soon. The consumer is healthy and not stressed, given that credit card loan delinquencies are steady and have not deteriorated in almost two years. As for inflation, it seems that is right about where the Fed's target is (~2%).

While we still believe that the US business cycle is maturing, current market conditions are supportive of further growth and margin expansion in domestic companies. ISM Manufacturing and Non-Manufacturing PMIs have been down sequentially year to date, but still well above 50 and

signaling continued economic growth. NFIB Small Business Optimism Index has been above 100 despite the government shut down earlier in the year, indicating that small businesses continue to power the economy. Also, it seems that labor slack is diminishing and wages continue to rise. The latest reading of the unemployment rate was 3.8%, and the U6 underemployment rate fell to 7.3%, which indicative of full employment (BLS).

Growth beat Value again in 1Q19, and it seems to be a recurring theme in since the end of 2016. "Lower for longer" interest rates and a flattening yield curve (at some points on the curve even inverting), are becoming headwinds for financial services companies (banks, insurance), which are a significant portion of the R2V. "Lower for longer boosts longer duration assets like growth stocks, and lower rates tend to mean weaker GDP growth and that's not great for the cyclicals. The small cap value index has nearly 30% of its weight in the Financials versus less than 7% for growth. In addition, valuations not mattering also helps growth more than value" (1). With falling sales and earnings growth expectations for 2019, investors are willing to pay up for perceived scarcity of growth and gravitate towards secular themes in Healthcare and Technology, which represent a large chunk of the Russell 2000 Growth (R2G) benchmark. In other words, Since 2005, slow growth, low inflation, and low interest rates have placed a premium on growth and held back valuation's power to produce positive relative returns. This dynamic eventually will change.

Value is cheaper relative to growth, and we believe that valuation factors, which haven't really mattered to investors thus far, will start to work, and value companies will exhibit

greater improvement in earnings and sales as the domestic economy is expected to grow ~2.5% in 2019. We believe that companies that are generating prodigious amount of free cash flow are higher quality companies, and will outperform over a market cycle. We are confident in our ability to identify small banks that can outperform in challenging environments, by following our robust 10-step investment process and utilizing our long term relationships with executive management teams.

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 the valuation gap between growth and value widens, and concerns over an eventual economic slowdown increase.

As always, we will continue to seek attractive investment opportunities for our clients by focusing on high-quality companies identified and evaluated by our fundamental research and active portfolio management.

*(1) Jefferies, JEF's SMID-Cap Strategy—Lower for Longer Hurts Fin'ls, Downgrading to UW, 22 March, 2019*

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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](http://teamemerald.com).

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