Emerald Advisers, LLC
Mid Cap Growth

Q2 2019 | Economic & Portfolio Commentary

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"Very Strong Absolute Performance Despite Slowing Economy"

Quarterly Summary

After a strong first quarter, Emerald Mid Cap Growth portfolios gave back some relative performance in the second quarter, as our benchmark Russell Mid Cap Growth Index registered torrid quarterly and year-to-date returns of 5.4% and 26.08% respectively - the best preforming domestic asset class for those periods. Trade and interest rate issues were front and center for the quarter, with names that had perceived exposure to China underperforming, along with those in economically sensitive sectors and industries. Larger names in the benchmark substantially outperformed smaller constituents and non-earners beat earners for both the quarter and year-to-date. Unfortunately, Emerald portfolios while having a similar average market capitalization as the benchmark, contained many smaller names which according to Jefferies Steven DeSanctis, were among the worst performers for the quarter and the year, trailing the largest names by approximately 300 bps for both periods. Additionally, Emerald portfolios contained a number of names that while fundamentally strong, are exposed to trade issues, particularly in the Consumer Discretionary sector and thus continue to trade at valuation levels substantially below the benchmark.

From an economic and monetary perspective, metrics such as Real GDP, ISM Manufacturing, Consumer Confidence, Leading Economic Indicators, Freight, Architectural Billings and Dodge Momentum all softened as the quarter progressed based on trade, interest rate and economic uncertainty. Productivity measures were strong keeping inflation in check. Corporate earnings, although weak, did exceed low expectations, but earnings revisions across the board were negative due to tariffs and uncertainty surrounding trade rhetoric. Despite reasonable, albeit slowing, employment and wage growth, the yield

Key Points:

- While growth substantially outperformed value for the quarter and year-to-date, Emerald Mid Cap Growth portfolios modestly trailed the benchmark for the 2nd quarter as stock selection in Consumer Discretionary, Technology, Financials and Energy failed to offset strong performance in other sectors.

- At Emerald we have long held the belief that earnings drive stock prices. While many were predicting an earnings recession in 2019, it seems we have narrowly skirted that market negative event as Q1 2019 earnings came in roughly flat after being revised upward throughout the last earnings season.

- Our expectation is that some of the beaten up cyclical growth sectors and industries like Energy, Financials and Materials begin to outperform with Fed rate cuts and reinvigoration of growth. We continue to focus on companies with great management teams, above benchmark growth and significant competitive differentiation.

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curve inverted during the quarter as investors gravitated towards risk-free assets.

Portfolio Review

While growth substantially outperformed value for the quarter and year-to-date, Emerald Mid Cap Growth portfolios modestly trailed the benchmark for the 2nd quarter as stock selection in Consumer Discretionary, Technology, Financials and Energy failed to offset strong performance in other sectors. One issue that has been a continuing challenge has been the relentless strong performance of the largest names in the Russell Mid Cap Growth benchmark. YTD there were 56 names over 50bps in the benchmark and those names were up an average of 33.25% for that period vs. 26% for the strong performing Russell Mid Cap Growth benchmark as a whole (Factset). Thus the vast preponderance of smaller index holdings not only trailed the performance of the largest benchmark constituents, they also trailed the benchmark itself, making outperformance difficult for an active manager focused on fundamental, growth-based stock selection. These large index names also had very substantial P/E expansion year-to-date, up an average of 18.6% vs. 16.7% for Emerald portfolio names.

Market Outlook

With the Russell Mid Cap Growth benchmark up 26% YTD some might question any optimism about equities in the near term. We take the other side of the argument as we think investors should focus on the old axiom: "Don't fight the Fed." By remaining tight in 2018, as well as sending mixed and confusing messages, the Fed almost drove the economy into recession by their disregard for the inversion of the yield curve and persistently low inflation. Even with encouraging employment numbers, it seems clear the Fed knows it needs to loosen monetary policy to battle historically low inflation and to spur growth to reinvigorate the yield curve. At this point we expect 25 basis point Federal Funds rate reductions at the July and September Fed meetings. Canaccord Genuity strategist Tony Dwyer likens current market and economic conditions to 1995 when the Fed reduced rates and started an economic reacceleration leading to extraordinary market gains.

At Emerald we have long held the belief that earnings drive stock prices. While many were predicting an earnings recession in 2019, it seems we have narrowly skirted that market negative event as Q1 2019 earnings came in roughly flat after being revised upward throughout the last earnings season. If Q2 S&P 500 earnings follow the same upward revision pattern, Evercore ISI strategist Ed Hyman posits Q2 2019 earnings will likely end with 3% year-over-year growth; certainly not strong, but not in recession territory. Certainly earnings weakness is the risk to the market as we enter the Q2 earnings season. Company balance sheets are in good shape and high yield credit spreads have remained relatively tame, with lower than normal default rates (JP Morgan Asset Management). We will continue to monitor corporate spreads and defaults, as well as employment and jobless claim data as early indicators of recessionary conditions, but at this time these factors are not pointing to an economic contraction.

As mentioned above, Emerald portfolios were impacted by holding a number of names that, while fundamentally strong, were negatively affected by trade issues. With the recent suspension of additional tariffs at the G20 summit, we think we are moving slowly towards some type of trade resolution with China that would provide a positive catalyst for selected portfolio companies. Our thought is once the trade fears start to wane, capital spending will begin to reaccelerate from current subdued levels.

In terms of portfolio positioning, portfolios are overweight Consumer Discretionary, Energy and Materials, equal weight Financial Services and Healthcare and underweight Consumer Staples, Producer Durables and Technology. We have added to the software and service area in Technology given the growth of the benchmark in that industry and are feeling more confident than we have in a long time that our overweight to Energy will begin to pay off. Portfolios are roughly equal to the benchmark in market cap, and have greater expected growth than the index (16.62% estimated 3-5 year EPS growth rate vs. 15.32% for the benchmark – a level consistent with past quarters). Portfolios also continue to trade cheaper than the benchmark on every valuation metric. A phenomenon we have seen for the past two years that we think will change through P/E expansion based on reinvigorated economic strength. While portfolio market caps are similar to the index in aggregate, they are underweight the largest benchmark constituents – the same names that have been the best performers year-to-date - given their lower growth vs. the benchmark and because many of these names trade at large valuation premiums despite low growth.

Even with underperformance year-to-date of smaller, growthier benchmark constituents, Emerald Mid Cap Growth portfolios have held their own and only modestly trail the index performance. Our expectation is that some of the beaten up cyclical growth sectors and industries like Energy, Financials and Materials begin to outperform with Fed rate cuts and reinvigoration of growth. We continue to focus on companies with great management teams, above benchmark growth and significant competitive differentiation. We added several new names that grew out of our small cap growth portfolios to become mid cap in the Consumer and Technology sectors and think that the virtuous cycle of transitioning small cap growth portfolio companies into mid cap growth portfolio companies will continue to be a source of strong returns. We feel very good about Emerald's ability to continue to grow and thrive in this difficult environment for active managers. Emerald's staff continuity and longevity is extremely strong, as is our commitment to fundamental bottom-up research. To that end, we think our deep dive, bottom-up research model is becoming more and more advantaged as trading dollars dry up, the sell side continues to shrink its research efforts, and regulations like MiFID II makes its way to the US shores. Firms like Emerald with large, proprietary research teams will be advantaged as less true fundamental research is conducted by the Street. The Emerald advantage will become more apparent as the Street's research cut-backs cause markets – particularly small and mid-cap markets – to become less efficient and price discovery gravitates to fewer and fewer equity players.

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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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