Emerald Advisers, LLC
Small Cap Value

Q4 2019 | Economic & Portfolio Commentary

A Strong 4th Quarter Caps off a Banner Year for All US Equity Asset Classes

Small cap companies delivered a strong performance in 4Q19. However, it was not enough to come close to large cap companies stellar returns. The Russell 1000 beat the Russell 2000, for a 3rd straight calendar year, by almost 600 bps. Small cap earnings growth substantially lagged large caps in 2019, which mostly explains small caps relative underperformance since late 2018, and as the economy slowed down. It is no surprise that large caps have been consistently posting new highs, while small caps are yet to reach their past peak. Within small caps, value's outperformance in the 3rd quarter was short lived, as growth leadership returned. Once again (3 years running and 8 out of the past 10 years), the Russell 2000 Growth (R2G) was well ahead of the Russell 2000 Value, up 28.48% vs. 22.39% for calendar year 2019. In 4Q19 growth benchmarks were aided by strong performance in Health Care, and more specifically biotechnology, thanks to record-breaking M&A, higher drug approval rate, and positive trial data/results.

While the year was a challenging one for small cap value managers, the return for Emerald Small Cap Value portfolio outperformed the Russell 2000 Value's Index. At the risk of sounding like a broken record, we still believe conditions are favorable for value to outperform growth, but our confidence level is not as high as it was in prior years.

Portfolio Review

For small caps in 4Q19, Technology and Healthcare outperformed. The strong performance in biotechnology represented a headwind for managers, as they are traditionally underweight this industry. In addition, lower quality companies defined by smallest size, lowest ROE, and non-earners had the strongest performance. The Russell 2000 Value Index total return in the third quarter was

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Key Points:

- For small caps in 4Q19, Technology and Healthcare outperformed. The strong performance in biotechnology represented a headwind for managers, as they are traditionally underweight this industry.
- At the portfolio holdings level, negative stock selection in Utilities and Technology detracted from performance. However, positive stock selection in Healthcare, Consumer Discretionary, and Materials & Processing contributed positively to the portfolio.
- 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.

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below the Emerald Small Cap Value's portfolio. Emerald's outperformance was mostly due to stock selection.

Within the Russell 2000 Value benchmark, Technology, Healthcare, and Materials & Processing sectors had strong performance. Conversely, Utilities and Energy sectors had the weakest performance during the quarter.

At the portfolio holdings level, negative stock selection in Utilities and Technology detracted from performance. However, positive stock selection in Healthcare, Consumer Discretionary, and Materials & Processing contributed positively to the portfolio.

We anticipate headwinds for community banks as we move into earnings season. The Federal Reserve cut rates three times in 2019, creating a headwind for banks trying to bolster net interest margins. These headwinds will be driven by 4Q19 margin pressure resulting from the recent movement in LIBOR rates and the most recent rate cuts, as well as, stubbornly competitive deposit pricing. On a more positive note, the yield curve has steepened, credit quality remains pristine, deposit pricing is moving in the right direction (albeit slowly), banks continue to reduce expenses via branch closures and the implementation of technology in the back office, and the U.S. economy continues to expand leading to continued loan growth. We expect loan growth and earnings growth to slow in 2020, but we still believe that 8-10% loan growth rate and low double-digit earnings growth rate is significant and should lead to positive sentiment for community banks. Fundamentally, we believe 2020 will mark another year of moderating loan growth for community banks from 9-11% in 2019 to 8-10% in 2020. Our lower loan growth expectation reflects a combination of economic and macro uncertainty, likely additional elevated payoff activity, and some further hesitation by commercial and industrial borrowers. While 8-10% loan growth seems fine on the surface, it would represent the third consecutive year of slowing growth and the group's weakest performance since 2013. While the consumer loan growth has held in well, commercial and industrial loan growth has slowed considerably in the past several months, based on the Fed's H.8 data. We continue to believe that the community bank industry is in a long-term consolidation "wave" that will benefit community bank valuations. In fact, the number of banks fell 33% or 2,240 from the end of 2009. However, smaller deals continued to constitute most activity as the industry's years long consolidation trend persists. Despite 20%+ returns for community banks as an industry in 2019, we think they remain inexpensive with the industry trading at 11.8x their 2020 EPS estimates versus the historical multiple of 14x and at a 20% relative discount to the S&P 500, 72% versus 90%. As a result, we remain positive on the community bank industry in 2020.

We continue to believe that the Small Cap Value portfolio is well positioned to benefit from a slowing, yet growing, domestic economy, the eventual turnaround in domestically focused industries, and a steepening yield curve. 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

In our 4Q18 newsletter we referenced Citigroup's CEO, Michael Corbat, comment that the next recession would be brought about sentiment rather than economic fundamentals. That was in relation to the abysmal stock market returns and investors' mood at the end of last year.

What a difference one year makes! Investors are no longer in "fear mode", but rather quite bullish, lifting the S&P up over 31% in 2019. A shift in the Federal Reserve's interest rate policy prompted investors to believe in the sustainability of the current economic cycle. Despite slowing economic data, muted earnings growth, an industrial recession here in the U.S., and concerns over trade war with China, investors pushed valuation multiples ever higher. To be clear, we do not anticipate a recession in 2020. Through the current long expansionary period, the private sector continues to run a healthy financial surplus, there are no signs of meaningful pick-up in inflation nor of any financial imbalances, and job creation remains strong. However, there are several major factors that can affect this year's economic growth rate.

The Phase 1 deal with China includes some commitments on IP protection, stopping forced technology transfers, currency manipulation, elimination of trade barriers, and increasing purchases of US goods by more than $200bn over the next 2 years. While it represents a milestone and provides a de-escalation mechanism of trade tensions, still several key structural issues remain unresolved. These sticking points include: industrial subsidies, how to deal with broader technology issues, and managing the geopolitical strategic competition between the two countries. However, as Phase 1 is implemented we should experience less of a growth drag from the trade war that should put the economy on a solid footing in 2020.

Business investment has been weak in 2019. Several management teams we have met this year blamed uncertain economic conditions due to the trade policy and the cloud of recession fears as the main drivers for lower capital expenditures. While this might be true, we do expect a pick-up in investments in 2020, as confidence in the economy improves and corporations respond to strong demand growth while looking to improve margins through automation, modernization (technology upgrades), and capacity expansion.

The elections later this year will be top of mind for investors as we get clarity about the Democratic Party's candidate. A lot has been written and discussed in the media about how the markets and certain sectors/industries would be impacted by each of the candidates. We believe that for now it is just noise, and while markets might gyrate with the electability odds of any particular candidate, as fundamental investors we would take advantage of dislocations in the market, as the overall economy should not be affected.

Fed policy is always in focus for investors. As we entered 2019, we were looking for the Federal Reserve to take no action on rates for the year. However, the Fed lowered the federal funds rate three times in the second half of 2019. Once again, we do not expect the Fed to take any action in 2020 in regards to rates, a signal it conveyed in its last meeting in December. Unless there will be a significant deterioration in the economy throughout the year, a scenario we do not foresee, than the Fed might choose to act and lower rates. Our outlook puts very low probability on the opposite scenario too, where the Fed will raise rates. The bar for a change in either direction over the next year appears high.

According to JP Morgan, the rotation out of momentum into value stocks late August to mid-September, only partially corrected the extreme dislocation among styles. Initially, this rotation has largely been technical (short covering) in nature due to historical valuation gap. Going forward, the rotation towards value should be driven by better macro-fundamental data and confirmation of cycle recovery.(1) In addition, value is still very cheap! Jefferies data shows that the R2G is most expensive since Dec 2001 at 26.7x earnings, 40% above the longer-term average. The R2V is trading at 15.6x earnings and only back to levels seen in 2018. We also expect better earnings growth in value vs. growth (propelled by profitability improvement in healthcare and energy sectors) in 2020. Better GDP, a steeper curve boosting Financials, a better backdrop for housing, and a pick-up in capital expenditures should be tailwinds for small cap value investors.

Lastly, also in our 4Q18 newsletter we highlighted a study done by Furey Research Partners showing that since 1940, in the ten other quarters that were worse than 4Q18, small-caps posted +25% average 12-month forward returns. Also, following the nine other years that were worse than 2018, the next year's return also averaged +25%.(2) Well, it was darn close as the S&P 500 was up 31.5% in 2019. Furey Research Partners did another study recently in which they found that since 1950, when small-caps post a 20%+ year (as the market did in 2019) the average next year's return was +12%, and 56% probability of the next year return being above 10%.(3)

Let us hope again that past is prologue.

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) JP Morgan, US Equity Markets 2020 Outlook, 09 December, 2019

(2) Furey Research Partners, Earnings Look Ahead, 11 January, 2019

(3) Furey Research, 4Q19 Quarter-End Letter, 06 January, 2020

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