Emerald Advisers, LLC
Diversified Small Cap Growth

Q2 2020 | Economic & Portfolio Commentary

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Key Points:

- From a style perspective growth stocks, which outperformed on the downside during the first quarter, outperformed on the upside in the second quarter.
- The Emerald Diversified Small Cap Growth portfolio outpaced the benchmark for the quarter driven by stock selection.
- At the sector level, the portfolio realized relative outperformance within the technology, consumer discretionary and consumer staples sectors, which offset relative underperformance within the healthcare, producer durables and energy sectors.
- As of quarter-end the portfolio held the largest relative overweight positions in the consumer staples, financial services, and consumer discretionary sectors. The portfolio had the most significant underweight positions within the healthcare, utilities, materials and producer durables sectors.

Market Rebounds

Market Update

The domestic discovery of the COVID-19 virus and its rapid spread across the U.S. was the catalyst for one of the most vicious market declines and subsequent rebounds in the history of the U.S. stock market. The second quarter picked up where the first quarter left off. Aggressive actions from the Federal Reserve to add the necessary liquidity to keep the funding markets functioning appropriately, and visibility to a meaningful fiscal policy response helped to alleviate the market's perception of the tail risk from the crisis as we exited the first quarter. Sentiment then continued to improve throughout the second quarter as the U.S. monetary and fiscal response proved larger and more extensive than originally anticipated, the market began to see meaningful medical progress in addressing the virus, the domestic economy began to reopen, key economic statistics (jobs, retail sales, home sales, auto sales, ISM manufacturing and non-manufacturing survey results) rebounded more aggressively than anticipated and economic forecasts began to be revised materially higher on a growing belief that the domestic economy was in the midst of a V-shaped recovery.

U.S. stock performance outpaced all other asset classes, with the S&P 500 gaining 20.5%, its best quarter since the fourth quarter of 1998. The rebound in the Russell 2000 was even starker. After falling by (30%) during the first quarter of 2020, the index surged, gaining +25.42% during the second quarter, representing the best quarterly performance since the first quarter of 1991. According to Jim Furey of Furey Research, this was the first time that the Russell 2000 has experienced that steep of a decline and that magnitude of a rebound. While the second quarter strength enabled the Russell 2000 index to exit the second quarter 49% off its March low, the Russell 2000 remains well in negative territory for the year with a total return of (12.98%).

From a style perspective growth stocks, which outperformed on the downside during the first quarter, also outperformed on the upside in the second quarter. Within the Russell 2000 universe, the Russell 2000 Growth Index advanced +30.58% meaningfully outpacing the Russell 2000 Value Index which appreciated by +18.91%.

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At the sector level, first quarter's laggards energy and consumer discretionary led to the upside gaining +63.67% and +52.21%, respectively. Utilities, after leading from a return perspective during the first quarter, not surprisingly lagged gaining a much more modest +5.44% for the quarter. For the first half of 2020, the healthcare (+7.34%), technology (+3.62%) and energy (+3.14%) sectors were the only sectors with positive returns.

Decomposing the Russell 2000 Growth Index performance further, given the relative outperformance of small capitalization stocks for the quarter, it is not surprising to see the smallest of the small capitalization stocks post the strongest performance. In this regard and according to a recent report from Steve DeSanctis, Equity Strategist at Jeffries, those companies that were smaller than $500 million market capitalization gained +40.18%, substantially outpacing the +29.2% gain achieved by those companies that are greater than $1 billion in market capitalization. What was somewhat surprising however, given the spread of growth outperformance to value, was the more muted performance of the more growth oriented names within the index when viewing performance by sales growth and P/E quintile. Whereas typically when growth as a style has outperformed value, the fastest growing companies and highest P/E companies will demonstrate relative outperformance that was not the case this quarter. In the case of performance by sales growth, the top quintile of sales growth (+36.48%) and the non-revenue generating companies (+32.39%) lagged the slowest growing quintile (+37.37%). A similar bifurcation in performance was witnessed when looking at performance by P/E. Performance by P/E quintile, with both the lowest P/E quintile (+40.12%) and the non-earners (+39.78%) leading returns, while the highest P/E quintile (+27.27%), lagged the aforementioned and the index overall.

Portfolio Review

The Emerald Diversified Small Cap Growth portfolio outpaced the benchmark for the quarter driven by stock selection. At the sector level, the portfolio realized relative outperformance within the technology, consumer discretionary and consumer staples sectors, which offset relative underperformance within the healthcare, producer durables and energy sectors.

The technology sector was the portfolio's largest positive contributor to return due largely to relative outperformance within the software, electronic entertainment and communications technology industries.

Stock selection similarly drove the portfolio's relative outperformance within the consumer discretionary sector. At the industry level, holdings within the education services and home building industries led returns.

Partially offsetting the aforementioned was relative underperformance within the healthcare, producer durables and energy sectors. Of these, the healthcare sector was the largest detractor to relative performance. Despite being the largest contributor to performance on an absolute basis and a positive sector level contribution from stock selection, the healthcare sector lagged largely as a result of the portfolio's underweight position. At the industry level, relative outperformance within pharmaceuticals was offset by relative underperformance within the biotechnology, medical & dental instrument, medical equipment and health care services industries.

Performance within producer durables sector also proved challenging on a relative basis as solid stock selection was unable to offset the impact of the portfolio's relative underweight to the sector. Also detracting from performance for the quarter was performance within the energy sector as the portfolio's holdings, which were more skewed toward natural gas production and transport, lagged relative to oil related crude producers and energy equipment companies which rallied in tandem with oil prices.

As we enter the third quarter of 2020, the portfolio held the largest active exposures in the consumer staples, financial services and consumer discretionary sectors. Thoughts on those sectors and other notable areas of exposure are highlighted below.

- The portfolio exited the quarter with an overweight position to the consumer staples sector. The overweight consists of select niche opportunities in disruptive category leaders with innovative product offerings and above average growth prospects that are aligned with emerging consumer trends in the food and beverage industries. Specific areas include pet food, nutritional snacking, active nutrition products, and adult beverages. Our portfolio holdings largely benefitted from the pantry-loading phase in the early days of the COVID-19 crisis and have seen a resumption of long-term growth trends as consumption trends have returned to more normalized levels. Overall, we believe that our positions in the Consumer Staples sector will benefit from multi-year opportunities to grow through product category growth and market share gains, along with expanding profit margins.

- The consumer discretionary sector was also overweight at quarter-end. After reducing exposure during the first quarter, Emerald added exposure to the sector over the course of the second quarter to a combination of new and existing positions within the home building, specialty retail, leisure, restaurants, and recreational vehicle and boat industries. While the consumer backdrop in aggregate remains uncertain given the level of unemployment we believe the housing and recreational vehicle markets have emerged as an area of noteworthy strength and believe there remain meaningful opportunities for share gains for those companies offering differentiated products/services with a strong value proposition amidst a consolidating retail, restaurant and leisure backdrop.

- The relative positioning within the financial services sector also moved to an overweight position during the second quarter. This shift in positioning however was due largely to the rebalance of the Russell index, which lowered the index weighting for financial services from 10.75% at the end of the first quarter to 8.80% at the end of the second quarter. The portfolio's absolute positioning over the time frame remained relatively consistent.

- The technology sector, while only modestly overweight relative to the benchmark exiting the second quarter, remains the portfolio's second largest absolute exposure. Within the sector, the computer software and services industry remains the portfolio's largest total and active exposure as we continue to believe that secular themes such as digital transformation, cybersecurity, the shift to cloud-based architecture and the move to a work-from-home/remote environment should continue to garner an ever increasing share of enterprise technology spend. Outside of software, we also continue to be optimistic regarding select opportunities within network infrastructure spending, as demand for bandwidth continues to drive network upgrades, and at this point, multiple segments (datacenter, telecom and cable companies) are in the early stages of network expansion/evolution. Secular trends such as 5G and industrial IoT (internet of things) continue to build momentum. Lastly, we remain overweight electronic entertainment as we expect the video gaming backdrop to remain very strong for the foreseeable future.

- The healthcare sector, while underweight relative to the benchmark, also 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, with an emphasis on drugs that patients can take from their homes or are for diseases so severe that missing doses of medication is higher risk than SARS-CoV-2 infection. In med-tech we are looking for companies who could benefit from increased testing or safety equipment associated with SARS-CoV-2. Rounding out the portfolio's healthcare sector exposure are niche opportunities within the healthcare services, medical equipment, medical & dental instruments and pharmaceutical industries. There were 14 drugs approved during the quarter, bringing the YTD total to 25. On average, there have been 13 new drugs approved per quarter dating back to 2017.

Market Outlook

As we look forward, while the trajectory of the economic recovery to date has been encouraging it remains unclear as to whether the pace of the recovery (V-recovery) currently being witnessed can be sustained at the same rate given ongoing government mandated business activity restrictions, virus flare ups, business re-closures, and the implications of all of the aforementioned on the pace of reemployment and consumer behavior (spending/confidence). Additionally, we believe domestic social unrest, the upcoming U.S. Presidential election and surrounding rhetoric, and volatile relations with China have the potential to further muddy the path to economic normalization. That being said, and while we acknowledge the risks related to all of the aforementioned, the aggressive monetary and fiscal initiatives implement by the Federal Reserve and the U.S. Government have provided the fuel for the recovery to date and additional stimulus is likely on way - the breadth and magnitude of which will likely be dictated by the forward path of the recovery. Further, the reality is that the economy is reopening, and while the rate of change within the economic statistics may decelerate as the recovery progresses and in response to the puts and takes outlined above, domestic economic growth should continue to demonstrate sequential improvement as we move through the balance of the year and into 2021.

Within this backdrop, and assuming volatility remains muted, we see an emerging opportunity for small capitalization stocks to claw back some of their year-to-date and trailing multi-year relative underperformance. Forward earnings and sales revisions have inflected positively and while still negative, the second quarter should represent the trough negative rate of change. Domestic earnings revisions have outpaced the rest of the world, which we believe should bode particularly well for small capitalization stocks. Further, while on an absolute basis it is difficult to argue that the market is inexpensive (depending on where you fall out on earnings recovery, equity risk premium and appropriate forward multiple), on a relative basis small capitalization stocks have become increasingly attractive relative to large. According to a recent report from Steve DeSanctis, Equity Strategist at Jefferies, the valuation of the Russell 2000 relative to the Russell 1000 now stands in the 16th percentile and cheapest relative valuation quintile, a level that hasn't been seen the early 2000's, and low-end of the trading range since December 1978. Historically when relative valuations have fallen into this range, according to Mr. DeSanctis, small capitalization stocks have outperformed large capitalization stocks by over 600 basis points over the next year.

Further, we cannot lose sight that the presence of the virus remains the greatest impediment to forward growth. A change for the better in the trajectory of the virus or a meaningful therapeutic advance or positive vaccine news that opens the door for the economy to embark on a full and unrestricted opening remains a prospect that can't be ignored.

Emerald, as always, remains focused on utilizing our fundamental bottom-up research process to identify the most attractive growth opportunities within the small capitalization universe. As of quarter-end the portfolio held the largest relative overweight positions in the consumer staples, financial services, and consumer discretionary sectors. The portfolio had the most significant underweight positions within the healthcare, utilities, materials and producer durables sectors. Please note that as a fundamental bottom-up manager the aforementioned sector weights are a fall-out of the stock selection process.

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