

Emerald Advisers, LLC

Growth Opportunities

Q3 2020 | Economic & Portfolio Commentary



“Stock Picking Making a Comeback Aided by Disruption, Dispersion and a Dovish Fed”

Quarterly Summary

During the third quarter the Emerald Growth Opportunities portfolios outperformed our Russell 3000 Growth benchmark, as our overweight to selected Energy, Materials and Industrial names powered strong absolute and relative returns, as we look for innovators and disruptors in the U.S. equity markets. Equity markets and Emerald portfolios experienced robust performance in the first two months of the quarter based on improving economic activity, continued positive virus trends, as well as repeated dovish statements from various Fed officials. A host of economic indicators registered impressively strong reports during the quarter such as: U.S. money supply growth (M2), motor vehicle production, retail sales, new and existing home sales and composite PMI prices, just to name a few. Internationally, it was much of the same, with Chinese manufacturing and service measures showing significant bounces off the spring lows and European retail sales experiencing similar gains.

Economic indicators weakened a bit in the later part of August as lack of Federal stimulus checks impacted economic growth, as shown in weaker personal income, retail sales and consumer confidence data, but overall employment, manufacturing and non-manufacturing data continued to be better than generally expected. The following illustration showing the Jefferies JefData US Economic Activity Index (an index representation of a broad collection of economic movement, employment activity and consumer behavior measures) provides a clear visual of this year’s tumultuous COVID-borne economic activity. Notice the dip late in the quarter, likely fueled by the elimination of stimulus related payments, and election and virus uncertainty.

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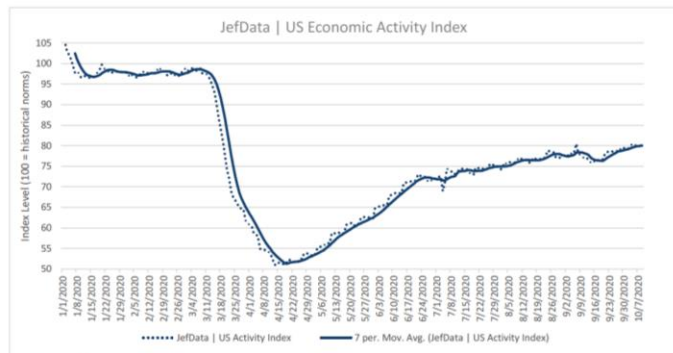
Associate Portfolio Manager

Key Points:

- Emerald portfolios bested our benchmark for the quarter, as strong stock selection, particularly in Energy, Producer Durables and Consumer Staples drove outperformance.
- Portfolios benefited from our flexible “barbell” approach to portfolio construction, wherein we maintained modestly underweight positions in the FAANGM names (less Netflix) and at the same time had significant exposure to some of our favorite small- and mid-cap names, composed of a mixture of cyclical and secular growers, companies benefitting from COVID-related dynamics and firms benefitting from reopening activity.
- We believe that Emerald’s early identification of companies involved in emerging trends, therapies, applications, systems and technologies has resulted in strong investment results since our inception.



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Source: Jefferies

While COVID-related case counts, deaths, vaccine and therapy news filled the airwaves during the quarter, the pace of retail and commercial re-opening activity was relatively positive with more and more restaurants, sports, and entertainment venues opening up to at least partial capacity. GDP, earnings and sales growth remained in improvement mode, with analysts continuing to boost estimates after slashing numbers in the spring. S&P 500 third quarter earnings estimates are still expected to decline 21%, but this is a marked improvement from the 25% drop expected on June 30. Analysts now estimate 2021 earnings and revenue growth of almost 26% and 8.0% respectively (Factset).

Growth equities beat value in the quarter continuing a trend of larger market cap stocks outperforming mid and small stocks. A mixture of non-earners and high ROE equities led, with the Energy, Consumer Discretionary, Technology and Materials sectors advancing the most during the quarter. The top five weighted index names accounted for over a third of the index return, as markets remained narrow at the top contributing to the largest three-year difference in performance between small and large caps since 1999.

Portfolio Review

As noted above, Emerald portfolios bested our benchmark for the quarter, as strong stock selection, particularly in Energy, Producer Durables and Consumer Staples drove

outperformance. Portfolios were overweight the Consumer Discretionary, Energy and Materials sectors, equal weight Healthcare and underweight Technology, Consumer Staples and Financials.

Portfolios benefited from our flexible “barbell” approach to portfolio construction, wherein we maintained modestly underweight positions in the FAANGM names (less Netflix) and at the same time had significant exposure to some of our favorite small- and mid-cap names, composed of a mixture of cyclical and secular growers, companies benefitting from COVID-related dynamics and firms benefitting from reopening activity. Similar to last quarter, large benchmark holdings Apple Inc. and Amazon.com Inc. contributed significantly to performance even though, as noted, we were modestly underweight these ultra-mega cap names.

Portfolios were decidedly large cap with a weighted average market cap of \$514bn vs \$625bn for the index. As in past quarters, portfolios were materially growthier than the benchmark, with an estimated 3-5 year EPS growth rate of 20.08% vs. 17.45% for the index. Portfolios continue to trade at or below the benchmark on every valuation metric that we track including Price/Earnings, Price/Sales, Price/Book and Price/Sales, have less debt and have literally twice the historical earnings growth.

Market Outlook

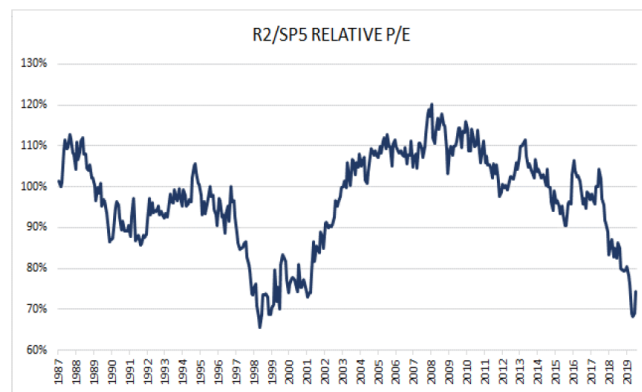
The resilience of the US economy and the rapid rise in equity markets since the March lows has left most investors in shock and disbelief. No one would have guessed that a scant six months after equity markets suffered one of their sharpest and quickest declines ever, indices would be back whole with strategists predicting substantial gains ahead. Nor would they have guessed that the prospects of a contentious election, that

could bring massive increases in Federal spending and taxes, would barley put a crimp in the equity market advance. Valuations have not really mattered, nor has market structure and breadth, nor the plethora of IPOs, led by SPACs of every size and color. The only thing that has really mattered, beyond positive virus vaccine and treatment headlines, is the Fed’s actions and statements surrounding inflation and interest rates and the trillions of dollars of stimulus that have and will likely be pumped into the economy.

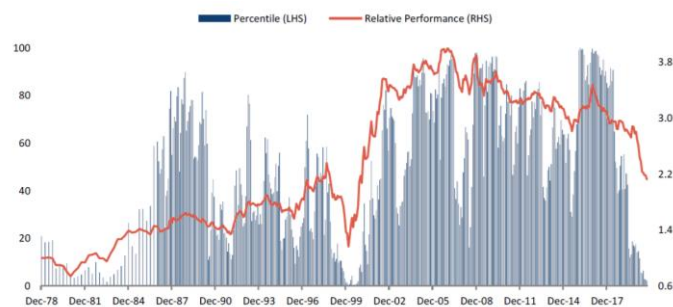
Going forward our job as portfolios managers will be very challenging. To date, we have outperformed based on our bottom-up, “Flexible Barbell” portfolio construction approach that has balanced mega and large cap holdings against small; reopener vs. COVID beneficiaries; and shorter duration cyclicals vs. longer duration secular growers. Our practice of holding the best houses (stocks) in their respective neighborhoods (sectors and industries) regardless of interest rates, inflation, economic growth rates and valuation has served us well. Going forward we suspect it will be more of the same portfolio decision making and construction. The virus will pass, although many of the COVID-expedited trends in work, entertainment, information and health may be here to stay.

To be clear, we do try to bias the portfolios based on our expectations for economic growth, interest rates, inflation, credit conditions and valuations. But these biases are certainly secondary to good old fashioned research-based, bottom up portfolio construction – as our firm has engaged in since 1992. At this point it would be easy to say the massive move in larger cap growth stocks has run its course. Growth has outperformed value in virtually every month this year, and value is very cheap historically, as are small caps. See the following Furey Research and Jefferies slides showing the

valuation disparity.



Source: Furey Research Partners and FactSet. Data as of 9/30/20. Represents median P/E using latest available trailing 12-month earnings. Profitable companies only



Source: FactSet; FTSE Russell; Jefferies

But these charts don’t tell the full picture. For small and value to post superior earnings growth and thus outperform – other than in reversion to the mean trades – nominal GDP has to be moving higher, inflation rising and the Fed pursuing a positive real rate policy – something it has not committed to do. Until that time larger, longer duration growth names with superior margin and competitive profiles will likely continue to outperform.

That is not to say small caps, particularly small- and mid-cap growth stocks and cyclicals, cannot contribute to portfolio performance. In Emerald’s case we should continue to benefit from owning Industrial and Energy names that are at the forefront of introducing new environmentally friendly means of powering our vehicles and homes; healthcare names that bring new and innovative therapies to difficult to treat populations; and reopening beneficiaries whose stocks still

trade at large discounts to their normalized growth rates. We should also continue to benefit from increased M&A activity, as many of our small cap holdings are platform growers that offer acquirers tremendous diversity and growth. Portfolios contain selected financial, consumer and material names that will continue to benefit from strength in housing and infrastructure, as well as a number of defense industry holdings that we believe – while underperforming recently – should rebound with some certainty around the election and the realization that their slice of the defense pie should see minimal cuts. These defense names as well as a precious metals holding provide some risk mitigation should the U.S. relationship with China continue to deteriorate.

After half a decade of fighting a very difficult battle against our benchmark indices, we can finally say that we are in a stock pickers market! A precondition for active management outperformance is wide dispersion of earnings estimates and results. This condition is a good proxy highlighting under-researched, under-followed companies. Dispersion of estimates and actual results have been increasing with COVID uncertainty, thus allowing a research intensive manager like Emerald the opportunity to take advantage of growth and valuation disparities. We think this trend continues with sell side firms reallocating resources and less research being completed on smaller capitalization stocks. We also can benefit from our ability to overweight selected sectors, industries and names that we see benefitting and triggering some of the disruption and innovation accompanying the COVID-related societal changes that have become so apparent. Whether it be work from home, entertainment, information, healthcare, energy or transportation, we are seeing more disruption over the past six months than we saw in past half decade.

For nearly three decades, Emerald's doctors, PhDs, industry specialists and finance veterans have invested in many facets of technological advancement and innovation. We believe that Emerald's early identification of companies involved in emerging trends, therapies, applications, systems and technologies has resulted in strong investment results since our inception. This commitment to understanding, identifying, researching and profiting from innovation and technological disruption is part of our research DNA and hopefully will be apparent as stock selection becomes more paramount as indices become more concentrated and research dollars even more scarce. Portfolios continue to have substantially more expected earnings growth than our index, yet trade at a discount on almost every measure – a situation that we think bodes well for future returns assuming a rational market and reasonable execution.

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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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