# Emerald Advisers, LLC
# Mid Cap Growth

Q3 2020 | Economic & Portfolio Commentary

## "Stock Picking Making a Comeback Aided by Disruption, Dispersion and a Dovish Fed"

### Quarterly Summary

During the third quarter Emerald Mid Cap Growth portfolios outperformed our Russell Mid Cap Growth benchmark, as our overweight to selected Energy, Materials and Healthcare names powered strong absolute and relative returns. 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 blowout 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 massive 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 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 striking visual of this year's tumultuous Covid-borne economic activity. See the dip late in the quarter likely fueled by the elimination of stimulus related payments, election and virus uncertainty.


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## Key Points:

- Emerald portfolios bested our benchmark for the quarter, as strong stock selection, particularly in Healthcare and Consumer Staples drove outperformance.
- Portfolios benefited from our flexible "barbell" approach to portfolio construction, wherein portfolios were composed of a mixture of cyclical and secular growers (in some cases aided by COVID) and reopening beneficiaries, as well as names that will benefit from a return to more normalized earnings.
- 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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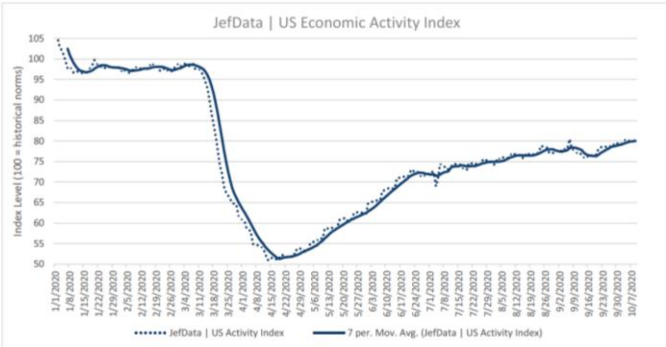



Source: Jefferies

While COVID-related case counts, deaths, vaccines 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, and larger mid cap stocks beat small, continuing a trend. A mixture of non-earners and low yielding growth equities led, with the Consumer Discretionary, Energy and Materials sectors advancing the most during the quarter.

## Portfolio Review

As noted above, Emerald portfolios bested our benchmark for the quarter, as strong stock selection, particularly in Healthcare and Consumer Staples drove outperformance. Portfolios were overweight the Consumer Discretionary, Energy and Materials sectors, equal weight Financial Services and underweight Technology, Consumer Staples and Healthcare.

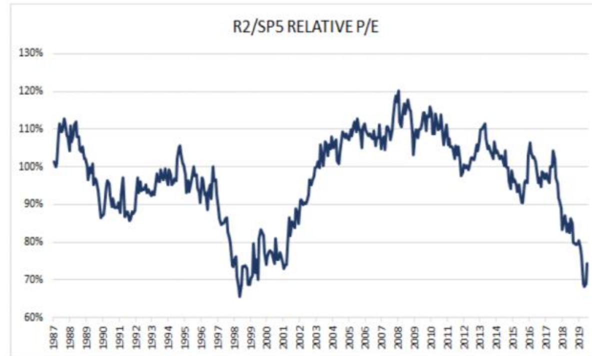
Portfolios benefited from our flexible "barbell" approach to portfolio construction, wherein portfolios were composed of a mixture of cyclical and secular growers (in some cases aided by COVID) and reopening beneficiaries, as well as names that will benefit from a return to more normalized earnings. Portfolio size was in line with the index with a weighted average market cap of $20.4bn. Portfolios are substantially growthier than the benchmark, with an estimated 3-5 year EPS growth rate of 17.75% vs. 16.45% 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.

## Market Outlook

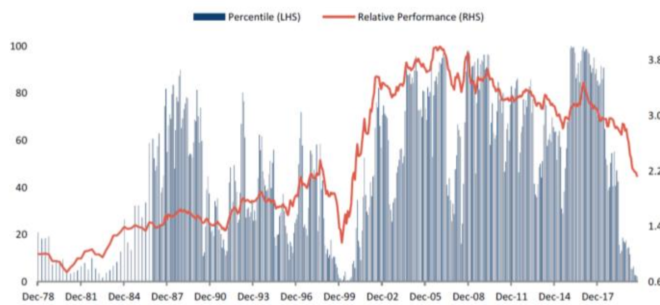
The resilience of the US economy and the rapid rise in equity markets since the March lows has left most investors in shock and disbelief. No one would have guessed that a scant six months after equity markets suffered one of their sharpest and quickest declines ever, indices would be back whole with strategists predicting substantial gains ahead. Nor would they have guessed that the prospects of a contentious election, that will almost certainly will 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, or 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 likely will 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 larger benchmark and market cap mid-caps against smaller; reopeners 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 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 means 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 smaller 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 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 – 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 to take advantage of growth and valuation disparities. We think this trend continues with sell side analyst firms reallocating resources and less research being completed on smaller capitalization stocks. We also 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 ore 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 almost every facet of technological advancement and innovation. 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 be 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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