Emerald Advisers, LLC
Diversified Small Cap Growth

Q3 2020 | Economic & Portfolio Commentary

Rally Continues

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Market Update

The broad market equity indices continued to push higher during the third quarter, despite a difficult month of September and continued COVID concerns. Strong upward revisions to economic growth underpinned the advance, as the economy, much like the market, is staging a record setting recovery. Key economic statistics (jobs, retail sales, consumer confidence, home sales, auto sales, ISM manufacturing and non-manufacturing survey results) have been demonstrating strong upward momentum, with the third quarter Atlanta Fed GDPNow forecast now projected at +35.3% as of the October 6, 2020 forecast update. The current forecast stands at nearly 3x the Atlanta Fed's initial third quarter GDPNow forecast estimate of +11.9% issued July 31, 2020. The magnitude of the positive revisions, in conjunction with historically supportive monetary policy, further added fuel to the market's rebound. The S&P 500 advanced +8.9% for the quarter, which was the best third quarter return for that index since 2010. Equities remain the asset class of choice, as gains across nearly all of the broad market equity indices (Russell 1000 +9.47%, Russell 3000 +9.21%, Russell 2000 + 4.93%) substantially outpaced other asset classes with Long-Term treasury bonds (+0.2%), and Investment Grade corporate bonds (+1.7%), lagging on a total return basis.

From a style perspective, growth stocks maintained their relative dominance, with the Russell 1000 Growth, Russell Midcap Growth and Russell 2000 Growth gaining +13.22%, +9.37%, and +7.16% respectively for the third quarter, each outpacing their value counterpart. This strong streak of relative outperformance on a year-to-date basis through September has pushed the performance dispersion between growth and value to near record levels. While the gap tightened from the August peak, the Russell 1000 Value (-11.58%) is trailing the Russell 1000 Growth (+24.34%) by nearly 3600 basis points. While growth outperformance has transcended market capitalization, the spread of growth to value performance is much narrower within the Russell 2000 (+2500 bps), with the Russell 2000 Growth advancing by +3.88% on a year-to-date basis through September, as compared to the Russell 2000 Value which declined by (-21.54%).

While there has been much discussion about the relative outperformance of growth as a style, we believe equally notable is the similarly wide dispersion of

Key Points:

- From a style perspective, growth stocks maintained their relative dominance, with the Russell 1000 Growth, Russell Midcap Growth and Russell 2000 Growth gaining +13.22%, +9.37%, and +7.16% respectively for the third quarter, each outpacing their value counterpart.

- At the sector level within the Russell 2000 Growth, the rapidly improving economic backdrop helped propel relative outperformance within the cyclical sectors of the index, with the Energy, Consumer Discretionary and Materials sectors returning +119.49%, +16.33% and +15.39% respectively and substantially outpacing the Technology and Healthcare sectors which returned a more modest +3.59% and +4.07% respectively.

- At the close of September the portfolio held the largest relative overweight positions in the consumer discretionary, consumer staples and technology sectors. The portfolio had the most significant underweight positions within the healthcare and utilities sectors.

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performance between large capitalization and small capitalization stocks. The delta on a year-to-date basis stands at approximately 2046 basis points, with the Russell 1000 Growth advancing by +24.34% for the period versus the much more modest +3.88% gain recorded by Russell 2000 Growth.

At the sector level within the Russell 2000 Growth, the rapidly improving economic backdrop helped propel relative outperformance within the cyclical sectors of the index, with the Energy, Consumer Discretionary and Materials sectors returning +119.49%, +16.33% and +15.39% respectively and substantially outpacing the Technology and Healthcare sectors which returned a more modest +3.59% and +4.07% respectively. While growth continued to outperform value at the index level, the shift in sector leadership is altering the pattern of performance underlying the index. For example, according to an October 1, 2020 report from Steven DeSanctis, Equity Strategist at Jefferies, when viewing performance of the index constituents by sales growth, the fastest growing companies in quartile 1 (+7.23%) actually underperformed the slowest growing companies in both quartile 5 (+9.03%) and quartile 4 (+9.73%). Further, according to the same report, while performance by P/E quintile was more typical of a market with growth outperformance as the non-earners (+10.30%) and the highest P/E (+8.02%) companies outperformed, the gap of outperformance to the lowest P/E quintile (+7.33%) was relatively narrow which is notable. The sizable outperformance of high beta stocks (+17%) to low beta (-0.88%) was also noteworthy, as was the relative outperformance of high leverage (+10.22%) to low leverage (+3.33%). Each of which appear to be reflective of improving relative performance of cyclical versus secular growth companies.

Portfolio Review

The Emerald Diversified Small Cap Growth portfolio outpaced the benchmark for the quarter driven by a combination of stock selection and allocation effect. At the sector level, the portfolio realized relative outperformance within the consumer staples, producer durables and materials sectors, which more than offset relative underperformance within the healthcare sector.

The consumer staples sector was the largest relative contributor to performance for the period driven largely by stock selection within the food and beverage industries.

The positive contribution from stock selection also drove the portfolio's relative outperformance within the producer durables and materials sectors. At the industry level, the portfolio experienced the most notable contribution from holdings within the engineering & contracting, aerospace, industrial machinery and building materials industries.

Partially offsetting the positive contributors to return outlined above, was the relative underperformance within the healthcare sector. Within the sector, performance was most challenged within the healthcare services and medical equipment industries where both the portfolio's relative underweight position and stock selection proved challenging.

As we enter the fourth quarter of 2020, the portfolio held the largest active exposures in the consumer discretionary, consumer staples, and technology 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 primarily 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 and personal care products.

- The consumer discretionary sector was also overweight at quarter-end. Emerald continued to build on the portfolio's relative overweight within the consumer discretionary sector over the course of the third quarter through a combination of new and existing positions within the auto parts, consumer services, home building, specialty retail, leisure, restaurants, and recreational vehicle industries. While the consumer backdrop in aggregate remains uncertain given the level of unemployment, we believe there remain meaningful opportunities for share gains for those companies offering differentiated products/services with strong value propositions amidst a consolidating retail, restaurant and leisure backdrop.

- The portfolio exited the quarter with an overweight position to the technology sector. 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 more recent shift 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 the semiconductor industry in those companies poised to benefit from network infrastructure spending/upgrades, the rebound in industrial and automotive production, and the growing penetration of 5G and industrial IoT (internet of things).

- 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 15 drugs approved during the quarter, bringing the YTD total to 40. On average, there have been 13 new drugs approved per quarter dating back to 2017.

Market Outlook

The U.S. economy is recovering at an extraordinary pace, with third quarter GDP currently tracking up +35.3% according to the October 6, 2020 Atlanta Fed GDPNow update. Contributing to the strength has been a faster than anticipated recovery in employment, with the unemployment rate again dropping sequentially to 7.9% in September. Improving employment appears to be helping confidence. Consumer confidence as measured by the University of Michigan consumer sentiment survey also improved sequentially in September, to the highest level witnessed in the last six months. This improvement is particularly encouraging as it was achieved despite the lapse in unemployment benefits and no agreement on the size and scope of a Phase 4 stimulus plan. Corporate earnings have similarly shown a rapid rate of improvement, with earnings revisions now well into positive territory. The Federal Reserve for its part, is maintaining its dovish posture, and with the removal of target employment and increased flexibility regarding the level of inflation, appears to be in no hurry to normalize interest rates. While all of these factors have added fuel to the market's advance, risks to the pace and magnitude of the economic recovery remain ever present. In the near-term, the outcome of the upcoming U.S. Presidential election and the implications to fiscal policy and inflation expectations, the potential for a contested election outcome, the potential for a fall virus resurgence, and any delays in bringing a vaccine to market are likely to be most impactful to the trajectory of the economic recovery, the direction of forward earnings and subsequently the broad market.

While all of the aforementioned factors remain a near-term risk, assuming the election outcome is certain, the framework for fiscal policy is defined, stimulus is forthcoming, and there is a visible path of virus containment that will enable a full and unencumbered reopening of the both the domestic and global economies, we believe there remains a path to improved economic performance in 2021. Within that construct, Emerald believes that small capitalization stocks will be particularly well positioned for mean reverting outperformance. 2021 earnings growth is set to improve meaningfully for the Russell 2000, expanding by +21% year over year versus the +12.7% earnings growth currently expected for the S&P 500, according to an October 7, 2020 report from Furey Research Partners. Valuations are also looking increasingly attractive based on historic precedent with the Russell 2000, now trading at the cheapest level relative to the Russell 1000 since 2003, according to an October 5, 2020 report from Steven DeSanctis. Further, according to the same report from Steven DeSanctis referenced above, when valuations have reached this level, small capitalization stocks have demonstrated strong relative outperformance in the forward six month and 12 month periods, with a batting average of 65.9 and 78.0 for the respective periods.

Emerald, as always, remains vigilant and focused on utilizing our fundamental bottom up research process to identify the most attractive growth opportunities within the small capitalization universe. At the close of September the portfolio held the largest relative overweight positions in the consumer discretionary, consumer staples and technology sectors. The portfolio had the most significant underweight positions within the healthcare and utilities 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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