Emerald Advisers, LLC
Mid Cap Growth

Q4 2020 | Economic & Portfolio Commentary

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"It was the best of times, it was the worst of times…..it was the season of light, it was the season of darkness, it was the spring of hope, it was the winter of despair." ***Charles Dickens***

Quarterly Summary

Never have we had a more opportune time to use the above passage to describe the state of the world, economy, and markets. 2020 truly was a year of contradictions and ironies. The year started out with fears of an unknown virus; fears which turned out to be completely justified, as economy after economy across the globe shut down and Covid-19-related hospitalizations and deaths skyrocketed. Governments, however, came to the rescue with unprecedented stimulus – by some estimates $8 trillion dollars – that first served to stabilize economies from a precipitous -31.4% Q12020 US GDP drop and then provide liquidity-inspired jet fuel to propel economies higher, as evidenced by +33.4% Q32020 GDP growth, with GDP estimates as high at +9% for Q1 2021. In concert with this stimulus, scientific ingenuity delivered vaccines in record time, fostering optimism about a return to economic and social normalcy by mid-2021. Despite economic devastation in certain sectors and unemployment skyrocketing to over 13% in Q2, markets responded to the unprecedented liquidity infusion with glee, propelling the Nasdaq higher by an astonishing +43.64% in 2020, leading major indices for the year. Small Caps had their best quarter ever ending Q4 up +31.37%.

From an economic perspective, the 4th quarter saw a stabilization, and in some cases modest retrenchment of economic activity after the torrid bounce back experienced in Q3 2020. Employment gains subsided, as governments re-closed in response to the dramatic virus reemergence. Durable goods orders,

Key Points:

- Emerald Mid Cap Growth portfolios slightly underperformed our Russell Mid Cap Growth benchmark for the quarter and materially bested the benchmark for the full year.
- For the year in particular, portfolios benefited from our "Flexible Barbell" approach to portfolio construction, which entailed a dynamic balancing of cyclical vs. secular, stay at home vs. reopening and smaller vs. larger benchmark names.
- While we are hesitant to make any bold predictions regarding the market in 2021 given the turmoil of the past 12 months, we believe Emerald's approach to stock selection and portfolio positioning is well suited to dynamically respond to whatever 2021 may bring.

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consumer confidence, industrial production, retail sales and Leading Economic Indicators all saw moderate declines. However, money supply growth and existing homes sales continued to grow at a breakneck pace, as the Fed made it clear that rates would stay low for the foreseeable future and continued its bond buying programs. Investment grade and high-yield spreads compressed to near record levels providing a fertile ground for investment in risk assets.

Value stocks beat growth stocks for the quarter after a long period of underperformance, as earnings and sales estimates accelerated faster for value stocks than for growth. Domestic stocks outperformed international and small stocks beat large, as like value stocks, smaller equity earnings and sales estimates are still moving higher, while large have stalled. For the year, the reverse was true with growth dominating value and large Tech outpacing other groups. Higher ROE and lower debt names outperformed, and the IPO market, accompanied by massive SPAC issuance, essentially doubled for the year.

Portfolio Review

Emerald Mid Cap Growth portfolios slightly underperformed our Russell Mid Cap Growth benchmark for the quarter and materially bested the benchmark for the full year. For the year in particular, portfolios benefited from our "Flexible Barbell" approach to portfolio construction, which entailed a dynamic balancing of cyclical vs. secular, stay at home vs. reopening and smaller vs. larger benchmark names. We utilized this active construction methodology for the better part of the last year, and, when factoring our proclivity to hold some of the best mid cap growth stocks in the domestic equity universe, the result was positive performance throughout the year.

Portfolios benefited from being slightly smaller than the benchmark with a weighted average market capitalization of $22.3bn. Portfolios also continued to be significantly growthier than the index with a projected 3-5 year growth rate of 19.5% vs. 18.25% for the benchmark. Portfolio holdings also maintained their valuation discount to the index on all measures we track including Price/Earnings, Price/Sales, Price/Book and Price /Cashflow. During the 4th quarter, our overweight Materials and Energy contributed the most to performance; while our exposure to selected REITs and under exposure to selected technology industries caused us to slightly trail the benchmark.

Market Outlook

It's tough to provide a 2021 equity outlook after 2020, a year no one could have accurately predicted. We certainly didn't expect the market to be down -34% from its highs at one point only to rally and be up over +18% for the year. We were fortunate that our dynamic, fundamental research and portfolio construction approach allowed us to nimbly rebalance amongst sectors and individual names in 2020, and that our conclusions about large vs. small, cyclical vs. secular and re-opening vs. stay at home names generally proved correct. But some years don't have trends that are quickly identifiable and investable. 2021 looks to have a generally positive set-up for stocks, but there are a number of cross currents, most notably valuations for selected names, the speed of the vaccine roll-out, the rate in change in inflation and the policy initiatives of the new Biden Administration and Congress.

On the positive side, S&P 500 earnings are expected to grow +23% in 2021, with small cap and cyclical equity estimates trending even higher. Real rates remain low, as while the 10-year yield has increased, so have inflation expectations. Monetary and fiscal stimulus will continue to occupy center stage as the recent $900bn stimulus package should add upwards pressure to 2021 GDP estimates, and it seems clear more stimulus and potentially infrastructure investment is on the way. Evercore's Ed Hyman is having a hard time constraining his 2021 GDP growth forecast below +5%, with upside likely with more stimulus. In fact, he recently upped his Q1 2021 GDP forecast to +10%. If GDP growth comes in this high, clearly small caps and cyclicals should outperform after lagging for the past few years despite a very strong end to 2021. Equities with international exposure should also continue to do well assuming a weaker dollar, higher rates and a positively sloping yield curve. Hyman also recently increased his 2021 S&P 500 earnings estimate to $200 for the year, which would represent an astounding +46% growth rate from depressed 2020 earning levels.

Beyond earnings and GDP growth, a strong tailwind for the market has been the extreme tightness in US corporate credit spreads, which as of the end of the year were at close to 20-year lows. These low spreads and the unprecedented liquidity in the market has led to an upturn in retail trading volumes which have approached a 12-year high according to Jefferies and account for 45% of all trading volumes. Astonishingly, according to RBC sub $5.00 names recently made up 43% of the trading volumes. Low spreads have also fostered a deluge of IPO and SPAC issuance with 535 issues raising $128 bn, the highest since the Tech Bubble according to Jefferies. We see no reason for this fervor to abate and also anticipate a robust M&A environment, especially when the virus is judged to be under control.

Other factors positive for specific sectors of the market include the recent surge in commodity prices, with Goldman's Jeff Currie positing that we are entering into another commodity super-cycle. We believe that Emerald portfolios are well set up for this to occur, as we are overweight Energy and Materials in our portfolios. Another clear positive for markets is the spectacular bounce back in China's economic conditions, with Evercore noting China bank loans increased +12.8% Y/Y and Eurozone industrial production ratcheting back to pre-pandemic levels.

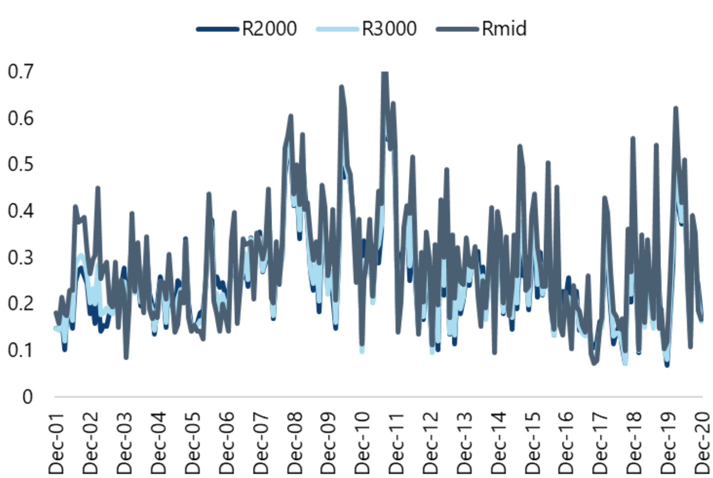
Much will depend on President-elect Biden's first few months in office and his relationship with the new Congress. If policy actions quickly serve to highlight significantly increased regulation and anti-business and high net worth individual tax policy, the markets may suffer. If, on the other hand, the liquidity gravy train is seen as continuing, accompanied by an infrastructure package and policy gridlock on tax and regulatory matters, markets will likely continue to climb.

Beyond policy risks, other potentially negative market factors include:

- Inflation and rates rising faster than market predictions of a very gradual incline
- China relations or other geopolitical turmoil, including cyber terrorism
- Vaccine distribution issues, or some new vaccine resistant virus mutation

- Valuations, which for some sectors of the market are reaching extremes.

A recent positive market development for active managers like Emerald has been the decline in stock correlations within major market indices. As shown in the following figure provided by Jefferies' Steven DeSanctis, monthly pairwise stock correlations have dropped over the past several quarters as the dispersion within individual equity performance has increased substantially, thus allowing active managers to benefit from stock selection as opposed to primarily macro driven stock movements. It is certainly our hope that equity correlations stay low, allowing for more stock picking to shine.



Source: FactSet; FTSE Russell; Jefferies

As noted above, we have attempted to apply a dynamic portfolio construction approach that, while remaining true to our fundamental growth style, allows us to quickly adjust portfolio market cap, industry and sector exposure, beta, and economic sensitivity. This approach lessens the impact of macro factors and allows us to be somewhat agnostic to economic conditions, as long as equity pairwise correlations stay at reasonable levels. The core of our process is, as always, our rigorous fundamental research effort to identify the fastest growing mid cap companies with the best management teams and competitive positions in the domestic equity universe. While we are hesitant to make any bold predictions regarding the market in 2021 given the turmoil of the past 12 months, we believe Emerald's approach to stock selection and portfolio positioning is well suited to dynamically respond to whatever 2021 may bring.

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