Emerald Advisers, LLC
Mid Cap Growth

Q2 2021 | Economic & Portfolio Commentary

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"Topsy-Turvy But Upwardly Biased Markets"

Quarterly Summary

While the Emerald Mid Cap Growth strategy delivered robust absolute quarterly returns, portfolios gave some of our 2021 outperformance vs. our benchmark back in the 2nd quarter, as it was a very difficult June and quarter for active managers. Our bias towards selected growth cyclical names helped early in the quarter, then turned into a hindrance, as secular growth reasserted its leadership later in the quarter on a significant drop in rates and inflation expectations. Our overweight in the Materials and Consumer Discretionary sectors hurt performance, as did underperformance of a few Healthcare names. Technology sector stock selection was particularly strong.

Market performance varied markedly from the beginning to the end of the quarter. In April and May, cyclical and value stocks continued to outperform based on expectations of above-trend economic growth, higher inflation and optimism about COVID restrictions being lifted. In June, sentiment abruptly shifted with the 10-year Treasury yield and inflation break-evens dropping materially in the face of economic and monetary uncertainty, driven by weakness in some economic statistics and renewed COVID lockdowns in selected geographies. The decline in inflation expectations, drop in the yield curve, as well as concerns about reaching peak GDP and earnings growth caused investor sentiment to shift back to larger, secular growth names, which dramatically outperformed their smaller value counterparts. The Russell Mid Cap Growth benchmark returned +6.80% in June, vs. a loss of -1.2% for the Russell Mid Cap Value index that month. This huge growth outperformance allowed the Mid Cap Growth index to easily outpace the Value benchmark +11.1% to +5.7% for the quarter. But, Value is still easily outpacing Growth YTD at +19.5% vs. +10.4% for the Russell Mid Cap Growth index. Beyond sales

Key Points:

- While the Emerald Mid Cap Growth strategy experienced robust absolute quarterly returns, portfolios gave some of our 2021 outperformance vs. our benchmark back in the 2nd quarter, as it was a very difficult June and quarter for active managers.
- Our overweight in the Materials and Consumer Discretionary sectors hurt performance, as did underperformance of a few Healthcare names. Technology sector stock selection was particularly strong.
- Our portfolios are constructed to take advantage of the many inefficiencies markets present us with on a regular basis: growth, valuation, trading, etc. Over time, it is by profiting from these inefficiencies that we believe we are able to outperform.

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growth and size, companies with higher foreign sales, higher Price/Earnings and lower leverage outperformed for the quarter.

From an economic perspective, civilian employment growth stabilized on worker availability concerns and selected indicators such as Retail Sales, New and Existing Home Sales, and ISM Manufacturing and Non-Manufacturing all cooled later in the quarter on supply chain and worker availability issues and moderation of Federal stimulus payments. The cooling of selected economic indicators was a prime factor in driving 10-year Treasury yields down from 1.77% near the beginning of the quarter to a recent low of 1.25%. Positive indicators we think under-appreciated by the market include: that energy prices remained at yearly highs, capacity utilization and consumer confidence both posted year-to-date highs and both the Dodge Momentum Index and the Cass North American freight index showed continued strength.

Portfolio Review

Portfolios experienced strong performance in the Consumer Staples, Energy and Technology sectors. Performance lagged in the Materials, Consumer Discretionary, Financials, Industrials, Healthcare and Telecommunications sectors. Portfolios have a similar estimated long-term growth rate as the Russell Mid Cap Growth benchmark at 19.5% vs. 19.6% for the index, with our internal estimates pointing higher. Selected characteristics such as Price/Earnings, Price/Cashflow, Price/Book and Price to Sales are all more attractive in our portfolios vs. the benchmark, pointing to market and analyst estimate inefficiencies and giving us some comfort at over time the valuation disparities should dissipate assuming the earnings materialize. In addition to attractive valuations, Emerald's portfolios had a slightly smaller market capitalization vs. the index, which hurt performance late in the quarter.

Market Outlook

It's never fun to be an active equity manager in the summer - vacations at the beach can only last so long. Summer oftentimes brings a change from a micro, stock-based focus (wonderful for us), to a macro, technical and sentiment-based focus (take us back to the beach!). Taper tantrums, indiscernible trends, irrational stock action, limited-liquidity, information vacuums, and general market indigestion seems to always happen in the summer, just when we need a break.

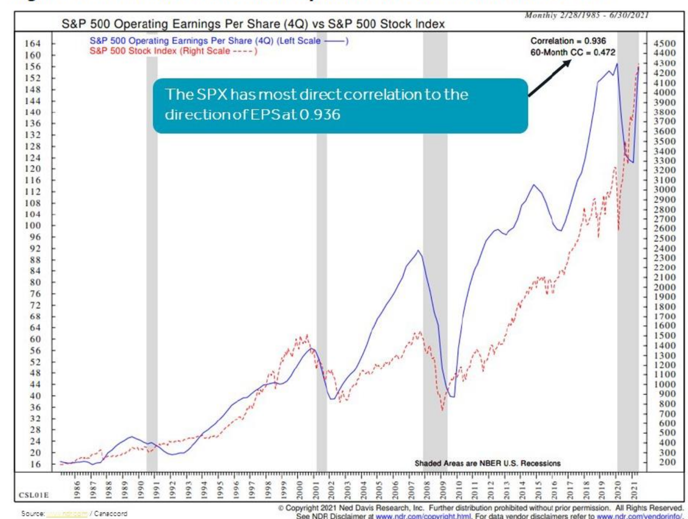
This summer is proving no different. Equity markets have hit successive new highs, yet the equal-weighted S&P500 and the small cap Russell 20000 have been in correction/consolidation territory since earlier in the spring, marking a difficult period for active managers. The two major themes equity markets are dealing with are the Fed policy transition from extreme stimulus to just accommodative, as well as fears that the economy and earnings growth are peaking. Add in consternation and uncertainty about the durability of inflation and the rise of the COVID-related Delta variant and investors are left with limited data to make cogent investment decisions.

Following are some of our thoughts on some of the major market forces that we are taking into consideration in our portfolio construction process – recognizing that we are a bottom-up manager building our portfolios one stock at a time:

Inflation – The inflation numbers are clearly running hot with this quarter's q/q CPI running at 6.3% and short term inflation expectations surging. Given the recent decline in the 10-year inflation breakeven rate and the failure of long-term inflation expectation to accelerate, the market clearly does not believe inflation will be permanent, but transitory, as the Fed is postulating. We think a certain amount of inflation – particularly in wages and housing - will be sticky and less transitory that the market is pricing in, as companies clearly have pricing power at this time. This less transitory inflation will move the Fed to taper its asset purchases faster than the market expects, as will robust economic growth. This leads us to a more cyclical bias at this point focusing on names with pricing power and benefiting from economic growth that we do not think has been fully priced in.

GDP and Earnings Growth – We agree with Canaccord Strategist Tony Dwyer who states that "easy monetary and strong credit conditions should allow the domestic economy to remain at or above average growth trajectory and enhance the synchronized global expansion well into 2021." Dwyer further posits that the market direction is most closely correlated to the direction of EPS – not the rate of change. Clearly absent a credit based recession, S&P 500 earnings are projected to grow strongly into 2022, with most estimates forecasting 10% 2022 earnings growth in the range of $215/share. This could be impacted a bit by any tax changes, but clearly the direction of earnings growth remains strongly positive.

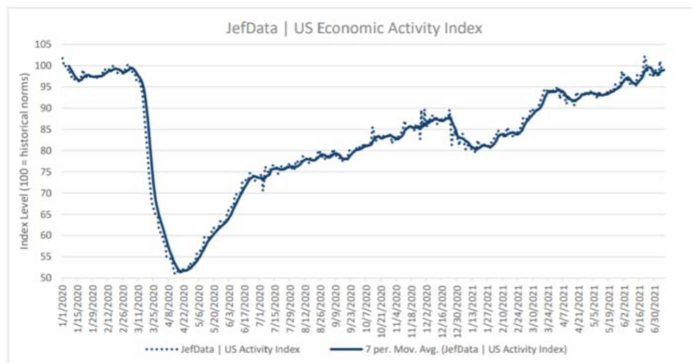
Figure 1:The market is most closely correlated to the direction of EPS



The 10-year Treasury – We agree with strategists Jim Furey and Tony Dwyer that 10-year Treasury rates have seen their lows and the time to fade the economic recovery theme has passed and that Treasury yields are set to rise as yields have discounted any slowing in the rate of change of economic activity. We also think rates are set to rise as the U.S. Treasury has to actually issue new debt and not rely on the Fed to draw down its balance sheet.

COVID-19 – There is no question there will be a lot of scary headiness, but it's important to keep in mind that vaccinations have been shown to date to be highly effective against severe cases – and even contagious variants like the Delta variant. According to Dennis DeBusschere from EvercoreISI, there will continue to be hotspots of growth, especially in countries lacking the infrastructure to vaccinate their residents, but over 40 million doses of COVID vaccine are administered daily and even in areas with higher rates of transmission, rates, hospitalizations and deaths are significantly off their highs. All these factors leave us comfortable with our cyclical

growth bias at this time, but we are watching the Delta variant and other variants and their impact on non-U.S. economic growth. See the following Jefferies JefData Activity Index thru July 11, 2021 which at 99 is just one point under the pre-COVID levels in March 2020.



Source: Jefferies

Margins and Cost Pressures – It is clear companies are facing cost pressures, most particularly from wages, supplies and freight among many other pressure areas. This is something we pay close attention to, but what is also clear is that companies in most industries have a substantial amount of pricing power. Be it restaurants, retailers, semi-conductor manufacturers, or industrials, most of our holdings are clearly benefiting from a good amount of pricing power. This should enable companies to maintain margins in the face of increasing input costs.

The Fed – The Fed is clearly trying to thread the needle related to inflation, employment, economic growth and the virus. The Fed runs the risk of being too late to act should inflation be less transitory than expected, or if economic activity surprises to the upside. We are in the camp that the Fed is normally too late to react to events and has to play catch-up. We think the same will hold true this cycle.

The Reopening/Active Theme – In last quarter's commentary we noted that we still think market is under-appreciating the operating and financial leverage many of consumer discretionary reopening names possess. We have witnessed a dramatic surge in consumer spending on travel, entertainment and experiences and we think we are still in the early stages of this trend regardless of COVID flare-ups. We see substantially scaled down cost structures at many firms that should result in consensus beating revenues and materially improved margins.

Valuations – We discussed above our portfolio's attractive valuation position vs. the benchmark. Emerald Mid Cap Growth strategy holdings trade at a significant discount to the index constituents on forward Price/Earnings, as well as on Price/Sales, Price/Cash flow and Price /Book measures. Large caps in general are materially more highly valued than small and mid-cap stocks, with small-caps according to Jefferies strategist Steven DeSanctis, trading at the 22nd percentile relative to large caps and mid-caps at the 47th percentile relative historical percentile. Small caps are expected to grow earnings 30% for 2021 over 2019 levels vs. 24% for mid and 20% for large. The good news also is that earnings estimates for 2021 continue to move higher.

The Dollar – As we noted last quarter, one issue that worries us is potential strength in the U.S. Dollar, as this could impact names with overseas exposure and cyclical names exposed to commodity prices.

Equity markets' chaotic, disorderly price action the past few weeks has already highlighted some of the volatility we predicted might occur this summer given the current

uncertainties related to inflation, the Fed, rates, COVID-19 and growth, among others. Fortunately, we believe Emerald Mid Cap Growth portfolios are well situated to weather and ultimately profit from this "normal" summertime volatility – volatility which seldom lasts longer than a month or two. We have built a portfolio with a good amount of cyclical growth exposure (based on our relatively optimistic predictions of out-year earnings growth) complimented by market-share leading secular growers, a slightly smaller-mid cap bias, a growth rate similar to the index, yet trading at a meaningful valuation discount on virtually every valuation metric. Our portfolios are constructed to take advantage of the many inefficiencies markets present us with on a regular basis: growth, valuation, trading, etc. Over time, it is by profiting from these inefficiencies that we believe we are able to outperform. We will also benefit from meaningful stock valuation dispersion allowing us to identify market inefficiencies- see the following JP Morgan Asset Management chart showing the high amount of valuation dispersion over the past two years, dispersion that allows for active manager outperformance. We feel confident we will get through the volatile, sentiment-driven summer period in one piece and get to an environment, most likely in the fall, when our active research-based approach can shine.

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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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