# Emerald Advisers, LLC
# Diversified Small Cap Growth

Q1 2021 | Economic & Portfolio Commentary

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## Bifurcated Market

### Market Update

The market rally continued through the first quarter of 2021, with equities posting gains across all of the broad market indices. The S&P rose +6.2% and exited the quarter at a record high. Vaccination progress, a more visible path to reopening, the finalization of a new stimulus bill, an infrastructure bill in-waiting, building economic momentum, and strong equity inflows (+78 Billion in 1Q21) collectively supported the advance. While equities advanced, bonds retraced as the growth implications from these same factors stoked inflation expectations, driving bond yields higher. The 10-year yield posted its largest quarterly increase since the fourth quarter of 2016, rising 83 bps for the period and driving a (13.29%) contraction in long-term Treasury bond returns.

The Russell 2000 gained +12.70%, furthering the small cap relative outperformance that began in earnest in November of 2020. Within the Russell 2000, the smallest of the small capitalization stocks continue to post the strongest performance. According to an April 4, 2021 strategy update report from Steven DeSanctis Equity Strategies at Jeffries, those companies with market capitalizations < $1 billion gained more than +22% while those companies with market capitalizations > $1 billion gained a much more modest +10.94%. The performance variation, when decomposing the index by size quintile, was starker as the smallest size quintile gained +22.67%, whereas the largest size quintile gained +6.08%. Further, in our review of the factors that impacted index performance during the first quarter we would be remiss if we did not mention the implications from the Reddit craze and the ensuing upward pressure on the most heavily shorted stocks. Within the Russell 2000, the most shorted stocks quintile, according to a recent report from Jim Furey of Furey Research, was the second best performing group by short-interest, rising +14.0% and meaningfully outperforming the Russell 2000 index overall. This cohort because it comprised some of the larger market capitalization companies inside of the benchmark, actually contributed approximately +27% to the Russell 2000's total return.

From a style perspective, the strengthening economic backdrop and rising interest rates shifted the value rotation into high gear with cyclicals surging and long duration secular growth equities lagging. This rotation was magnified by the fund flows into value equities which surged (+$31 billion) while growth equities experienced outflows (-$14.5 billion). These factors resulted in a meaningful bifurcation in performance

### Key Points:

- The Russell 2000 gained +12.70%, furthering the small cap relative outperformance that began in earnest in November of 2020. Within the Russell 2000, the smallest of the small capitalization stocks continue to post the strongest performance.
- From a style perspective, the strengthening economic backdrop and rising interest rates shifted the value rotation into high gear with cyclicals surging and long duration secular growth equities lagging.
- As we move through the balance of the year, we believe the market will begin to focus on the outlook for 2022 and the sustainability of above trend GDP growth. Key considerations include the direction of Federal Reserve Policy, extreme deficit spending, the ultimate structure of the Biden administration's tax proposal and to a lesser degree foreign policy initiatives, specifically as it relates to China and Iran, and the amount of new primary and secondary stock sales including IPO's and SPAC's.

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amongst the style indices, with the Russell 2000 Value advancing 21.17%, while the Russell 2000 Growth gained +4.88%. The +16.3% performance gap to Growth, was the largest outperformance by Value since the fourth quarter of 2000, according to the same report cited above. This performance gap was noticeably narrower in Russell Midcap and Russell 1000 at +13.6% and +10.3% respectively.

The value factor rotation can also be observed within the performance of the constituents of the Russell 2000 Growth index. For example, according the same report from Steven DeSanctis cited above, when decomposing the performance of the Russell 2000 Growth Index by sales growth, we find that the fastest growing companies gained +0.79% for the quarter materially underperforming the performance of the slowest growing companies which gained +9.49%. The underperformance of the fastest growing companies can also be witnessed when viewing performance by long-term earnings growth. In an April 1, 2021 report from Savita Subramanian of B of A Securities, those companies within the Russell 2000 Growth with earnings growth of 10% or less gained +11.6% in the quarter while those companies with earnings growth of 20% or greater advanced by a more modest +4.0%. Headwinds to growth were just as pronounced when viewing performance by P/E quintile. The highest P/E quintile and non-earners (typically associated with higher growth) returned (1.17%) and (3.23%) respectively for the quarter whereas the lowest P/E quintile returned a whopping +29.86%.

These shifting preferences for growth had a meaningful impact on sector leadership within the Russell 2000 Growth benchmark, with the consumer discretionary (+19.41%), Energy (+11.25%) and Telecommunications (+10.33%) leading, while the Utilities (-3.71%), Healthcare (-2.43%) and Technology (+1.34%) lagged.

## Portfolio Review

Given Emerald's strategy to invest in the fastest growing companies in the sectors and industries within the Russell 2000, the market's aversion to growth as discussed in detail above created a notable headwind to the portfolio's relative performance. While headwinds were particularly noteworthy within the traditionally longer duration sectors of healthcare and technology which succumbed to multiple compression during the quarter, the impact was felt across the portfolio, with the Emerald Diversified Small Cap growth portfolio trailing the benchmark for the quarter as a result of challenging stock selection. At the sector level, stock selection headwinds were most notable within the healthcare, technology, energy and industrial sectors which more than offset relative outperformance within the financial and consumer staples sectors.

The healthcare sector was the largest detractor to performance largely resulting from challenging stock selection within the biotechnology industry. With value rotation in full swing, growth factors out of favor, and the non-earners lagging, the Russell 2000 biotechnology industry return of (-7.4%) meaningfully lagged that of the healthcare sector (-2.4%) and benchmark overall. While the portfolio was underweight the biotechnology industry by an average of more than 500 bps, at an average absolute weight of approximately 13-14% the biotechnology industry still represented the portfolio's largest industry weighting. Together the combination of this sizeable absolute weighting and challenging stock selection weighed on relative performance. We believe a confluence of the market factors discussed above as well as some uncertainty regarding the FDA's willingness to approve new drugs given the agency's recent issuance of several high profile complete response letters or delayed regulatory actions. Emerald continues to monitor the actions of the FDA but we do not believe at this point that there has been a meaningful change in posture of the FDA.

Performance within the technology sector also proved to be a headwind to relative performance driven largely by challenging stock selection within the software and consumer digital services industries.

Performance within the energy and industrial sectors also proved challenging. Within the energy sector, portfolio performance lagged as a result of both the portfolio's relative underweight position and stock selection within the renewable energy industry. Within the industrial sector, while stock selection was a modest headwind to performance there were no meaningful detractors to return at the industry or stock level.

Partially offsetting the aforementioned headwinds to performance was the positive contribution to return achieved within the financial and consumer staples sectors.

The financial services sector was the largest positive contributor to return driven by both the portfolio's relative overweight position and stock selection. At the industry level, the portfolio experienced the most noteworthy outperformance within the bank and investment services industries. Of these, holdings within the banking industry were the largest positive contributor to return. Banking was one of the better performing industries in the benchmark gaining nearly 23%, as rising yields, a steepening of the yield curve and fading credit concerns drove upward revisions to earnings expectations. Within the Emerald portfolio, the portfolio benefitted as a result of both the portfolio's more than 300 bps average overweight to the bank industry and solid stock selection.

The consumer staples sector was also a notable source of relative outperformance for the quarter. Emerald continues to focus on 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. The portfolio's outperformance in the fourth quarter was led by holdings in the soft drinks and pet food industries.

Exiting the first quarter of 2021, the portfolio held the largest active exposures in the financial services, consumer discretionary, technology, industrial and consumer staples sectors. Thoughts on those sectors and other notable areas of exposure are highlighted below.

- The financial services sector, comprised of holdings within the bank, full line insurance, investment services, property and casualty insurance and life industries, was the portfolio's largest relative overweight position at quarter-end. Emerald has been adding to its exposure to holdings within the banking industry as we anticipate the steepening of the yield curve and a better credit backdrop with the aid of stimulus should be beneficial to earnings growth. In addition, Emerald has placed specific emphasis on those banks that are positioned to drive a meaningful improvement in their efficiency ratios.

- Emerald also held an overweight position within the consumer discretionary sector at quarter-end. The overweight is comprised of a diverse subset of holdings within the educational services, specialty retail, recreational services, recreational products, restaurants, casinos and gambling, and auto parts industries among others. With the economy poised for a full reopening upon the successful distribution and uptake of COVID-19 vaccines, we believe the outlook for consumer spending in 2021 remains particularly attractive and believe there remains meaningful opportunity 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 industry remains the portfolio's largest total and active exposure. Emerald continues to believe that secular themes such as digital transformation and cybersecurity will remain spending priorities. Outside of software, we also continue to be optimistic regarding select opportunities within the semiconductor industry in those companies poised to benefit from the rebound in industrial and automotive production, and the growing penetration of 5G and industrial IoT (internet of things) applications. In addition, Emerald has become increasingly optimistic regarding the outlook for the semiconductor capital equipment industry which we believe will benefit from a broad acceleration in capacity investment, given the high-profile supply shortages and the shift toward advanced packaging, as well as on a long-term basis Intel's decision to re-focus its efforts on advanced node technology, which should lead to increasing capital intensity for the next several years.

- Emerald also exited the quarter with an overweight position to the industrial sector. The overweight was comprised of a diverse subset of holdings with the building materials, professional business support services, defense, industrial machinery, engineering and contracting services, freight transportation and transaction processing services industries, among others that at are poised to benefit from a combination of the cyclical recovery in the economy and company specific business initiatives that we believe will collectively translate to industry leading growth in revenue and earnings.

- 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, and active nutrition.

- The healthcare sector, while underweight relative to the benchmark, also remains an area of considerable exposure within the portfolio. At the industry level, the biotechnology industry remains an area of considerable nominal exposure. We continue to look for innovative therapeutics that can command premium pricing, driven by their unequivocal clinical data. Rounding out the portfolio's healthcare sector exposure are niche opportunities within the pharmaceutical, medical equipment, medical services, health care services and medical supplies industries. There were 14 new drugs approved during the quarter. On average the FDA has approved 13 drugs per quarter dating back to 2017.

## Market Outlook

2021 is shaping up to be one the strongest years for domestic economic growth in recent history. The ISM services survey for the month of March surged to a historic high, with new orders and business activity both demonstrating an acceleration. The ISM manufacturing survey was similarly strong, hitting the highest level for that survey since 2010. The March Nonfarm Payroll report also surprised to the upside with 916,000 jobs added. Consumer confidence is building and as the states further ease their COVID related restrictions we believe the unemployment rate will continue to decline, confidence will rise and spending should accelerate as excess savings currently residing in saving accounts gets redeployed into services and goods. We are similarly optimistic regarding the trajectory of business investment which we anticipate will accelerate as 2021 progresses. Given the aforementioned, Emerald believes that 2021 GDP growth estimates are biased to the upside from the current 5.9% Factset Consensus and expect economic growth will continue to gain momentum as the economy reopens.

A strong domestic economic backdrop, in our view, is particularly favorable for the trajectory of small capitalization earnings growth. As of early April, Russell 2000 earnings growth ex-energy was estimated to grow by more than 17.8% over the 2019 earnings level, representing a more than 500 bps delta to its large capitalization counterpart, according to an April report from Steve DeSanctis of Jeffries. Valuations of small caps also remain supportive, as the Russell 2000 continues to trade at a discount to the Russell 1000.

Although we remain enthusiastic regarding the prospect for upward revisions to economic growth, the prospect for a near-term inflation overshoot remains plausible as the economy reopens. Consumer confidence surveys are flashing warning signs with concerns rising regarding the prospect for price inflation and while Chairman Powell and the Federal Reserve continue to reiterate the committee's unified commitment to the lower for longer rates strategy, any meaningful uptick in inflation will likely fuel concerns of a Federal Reserve policy misstep. We believe the interplay between yields and inflation is likely to remain a source of equity market volatility as these dynamics continue to unfold. Additionally, while we do not yet know how strong 2021 domestic growth will ultimately be, the market has already baked above trend growth into expectations given the current consensus for 2021 domestic GDP growth standing at 5.9%. As we move through the balance of the year however, we believe the market will begin to focus on the outlook for 2022 and the sustainability of above trend GDP growth. Key considerations include the direction of Federal Reserve Policy, extreme deficit spending, the ultimate structure of the Biden administration's tax proposal and to a lesser degree foreign policy initiatives, specifically as it relates to China and Iran, and the amount of new primary and secondary stock sales including IPO's and SPAC's. Finally, we would note that while the roll-out and trajectory of vaccinations in the U.S. has been exemplary, we are keeping a watchful eye on the rest of the world and the potential for any short-term supply disruptions or any supplier-specific issues to surface.

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.

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