Emerald Advisers, LLC
Diversified Small Cap Growth

Q2 2021 | Economic & Portfolio Commentary

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Large Capitalization Growth Stocks Recover

Market Update

Large capitalization stocks, after lagging during the first quarter, took the lead as the equity market built on first quarter gains. The S&P gained +8.5% for the quarter, finishing at a record high, and closing out the first half of 2021 with the second best first half gain (+15.2%) since 1998, according to Savita Subramanian of B of A Securities. Gains for the quarter were broad based across equities with the Dow Jones, Nasdaq Composite and Russell 2000 advancing by 5.07%, 9.67% and 4.29% respectively, as the market continued to ride the wave of better than expected first quarter financial results and positive commentary on forward growth. Economic surprises similarly continued to trend positively, highlighted by a better than expected consumer confidence and continued gains in employment.

Inflation expectations, however, were also percolating with management teams across sectors and industries referencing wage and supply chain pressures as part of their quarterly communication. While the market has largely been tolerant of rising inflation given the Federal Reserve's verbal commitment to let inflation run hot short-term as part of its average inflation targeting framework, the Fed's messaging post the June Federal Open Market Committee Meeting struck on a more hawkish tone than anticipated. The Committee's summary of economic projections for economic growth and inflation were revised meaningfully higher for 2021, while at the same time the median dot plot projection for interest rate hikes was pulled forward with two rate hikes now projected in 2023, with seven of the eighteen participants looking for a liftoff by the end of 2022. While commentary on tapering remained largely consistent, the Federal Reserve's more hawkish shift in messaging drove a recalibration in market expectations for growth and long-term inflation which resulted in a meaningful flattening in the yield curve and a rotation away from the cyclical sectors of the economy.

Within the Russell 2000, this rotation away from cyclicals reverberated through style performance, driving a significant rebound in growth during the month of June, with the Russell 2000 Growth gaining 4.69%, outpacing the Russell 2000 Value which fell by 0.61%. Despite the late quarter growth surge, the total return for the Russell 2000 Value (+4.56%) outpaced that of the Russell 2000 Growth Index (+3.92%) for the second quarter.

Key Points:

- Despite the late quarter growth surge, the total return for the Russell 2000 Value (+4.56%) outpaced that of the Russell 2000 Growth Index (+3.92%) for the second quarter.
- The Emerald Diversified Small Cap growth portfolio performed essentially in-line with the benchmark for the quarter as the positive contribution from allocation effect, offset the negative contribution from both selection and interaction effect.
- On the economic growth front, Emerald remains optimistic regarding the durability of above trend economic growth. The consumer backdrop continues to strengthen with consumer net worth surging, savings abundant, confidence rising, wages increasing and unemployment on the decline.
- 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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From a style perspective, within the Russell 2000 Growth, despite the late quarter strength in growth as a style, the headwinds to growth remained prevalent with the fastest growing companies within the benchmark, measured by sales and earnings growth, continuing to post lackluster performance. According to a July 2, 2021 report from Steve DeSanctis, Equity Strategist at Jefferies, while the top quintile of companies measured by sales growth returned +3.99%, performing essentially in-line with the benchmark overall, the cohort still lagged the performance of the slower growing quintile 2 and quintile 3. Similarly according to a recent report from Savita Subramanian from B of A Securities, when viewing performance by earnings growth, the cohort of companies with a long-term earnings growth rate above 20% was the worst performing cohort for the quarter, gaining 1.3% and meaningfully underperforming the companies with long-term earnings growth less than 10% which gained 6.9% for the quarter.

Portfolio Review

The Emerald Diversified Small Cap growth portfolio performed essentially in-line with the benchmark for the quarter as the positive contribution from allocation effect, offset the negative contribution from both selection and interaction effect. After a strong start to the quarter, with the portfolio outperforming for the quarter to date period through May, driven by relative outperformance within the healthcare, technology, consumer discretionary and consumer staples sectors, the month of June proved more challenging. The turn of the calendar to June, several idiosyncratic events within the biotechnology industry and a Federal Reserve induced rotation from the cyclical sectors of the economy (consumer discretionary, industrials and financials) where the portfolio was overweight, resulted in the portfolio surrendering the relative outperformance achieved during the quarter-to-date period through May. Specifically, within the healthcare sector, which was the greatest source of underperformance for the month of June, the portfolio's relative underweight position and stock selection within the biotechnology industry weighed heavily on relative performance.

The portfolio's relative underperformance during June substantially changed the complexion of the portfolio's performance, resulting in performance that was generally in-line with the Russell 2000 Growth benchmark for the second quarter of 2021. For the full quarter, at the sector level, stock selection driven relative outperformance within the consumer discretionary, consumer staples, technology and energy sectors was largely offset by stock selection driven relative underperformance within the healthcare and financials sectors.

The healthcare sector was the largest detractor to performance for the quarter, as relative outperformance within the sector during April and May, shifted to meaningful underperformance during the month of June and, subsequently the quarter. While the healthcare sector certainly benefitted from the rotation discussed above, there were several other idiosyncratic factors that contributed to the Russell 2000 Growth biotechnology industry's return of nearly 12% for month of June.

Performance within the financial sector also proved to be a headwind to relative performance largely as a result of the portfolio's overweight position and challenging stock selection within the banking industry. The pullback in yields, and flattening of the yield curve, pressured financials and specifically, holdings within the banking industry.

Offsetting the aforementioned headwinds to performance was the positive contribution to return achieved within the consumer discretionary, consumer staples and technology sectors. Within the consumer discretionary sector, performance was driven by relative outperformance within the specialty retail, casinos and gambling and recreational products industries.

The consumer staples sector was also a source of relative outperformance in the second 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. Our outperformance in the prior fourth quarter was led by our holdings in the nutritional snacking and active nutrition industries.

Stock selection within the technology and energy sectors also contributed positively to performance. Contributing to the relative outperformance were holdings within the semiconductors, computer services, software and renewable energy industries.

Exiting the second 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 a resumption in 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 now open, vaccines widely distributed, the labor market recovering and consumer net worth continuing to rise, we believe the outlook for consumer spending in 2021 remains attractive and believe there remains meaningful opportunity for share gains for those companies offering differentiated products/services with strong value propositions.

- 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. While software remains the largest absolute exposure, holdings within the technology sector are diversified among the semiconductor, production technology, computer hardware, consumer digital services and computer services industries. Within the semiconductor industry, we also continue to be optimistic regarding select opportunities within 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. Emerald also remains optimistic regarding the outlook for the production technology/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. That being said, with demand still significantly outstripping supply, we continue to monitor the nuanced supply side dynamics. Lastly, we believe a new risk factor is emerging, which is the oversupply of tech IPOs that are continuing to come to market. We are actively monitoring this situation as well.

- 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 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 nominal exposure within the portfolio. The portfolio's underweight to the healthcare sector is driven largely by the portfolio's relative underweight position to the biotechnology industry. Emerald believes performance within the biotech industry has been challenged on a year-to-date basis for a number of reasons including: rare disease niches getting crowded with competition, risks around governments recognizing intellectual property, record setting IPO and secondary offerings, fear of rising interest rates, lack of leadership at the FDA, 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, less M&A activity possibly driven by a tougher FTC, and the seemingly never ending discussion of drug pricing. While all of these factors have been gating factors to the portfolio's relative positioning, the biotechnology industry remains an area of considerable nominal exposure within the portfolio. We continue to look for innovative therapeutics that can command premium pricing, driven by their unequivocal clinical data, and we are seeing opportunities in innovative therapeutic areas including: cell therapy and gene editing. 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.

Market Outlook

The flattening of the yield curve and retrenchment in treasury yields accelerated into July. While it is difficult to truly pinpoint the exact cause of the dramatic decline of the 10-year yield, which bottomed near 1.25% in the early days of July, we believe there was a confluence of factors likely weighing on yields including institution flows from pension funds, and shifting of exposure within some asset managers, which was magnified by lower liquidity during the holiday weeks. Outside of the technical /trading related aspects there has been growing market chatter regarding the durability of growth, as the second quarter likely represents the peak rate of change for both year-over-year GDP and earnings growth, as the economy laps the weakest growth quarters of 2020.

The recent June ISM Manufacturing and ISM Services mild disappointments relative to consensus could have contributed to those concerns, although we believe supply constraints are likely gating demand to some degree. That being said while there are growth concerns, the concerns don't appear to be prevalent as inflation expectations and high yield credit spreads remained relatively unchanged. We should also note the emergence of the Delta Variant of the COVID-19 virus. While cases have been rising, there is no evidence at that this juncture there will be measurable economic disruption as a result. Progress of the variant both domestically and abroad is something we will continue to monitor. Looking forward we continue to believe volatility in bond yields is set to continue in the near-term as the market assesses and adjusts to incoming data points on growth and inflation.

On the economic growth front, Emerald remains optimistic regarding the durability of above trend economic growth. The consumer backdrop continues to strengthen with consumer net worth surging, savings abundant, confidence rising, wages increasing and unemployment on the decline. In addition to the aforementioned the direct child tax credit payments begin hitting bank accounts in July. All of these factors we believe are supportive of an elevated level of consumer spending as excess saving currently residing in savings accounts gets redeployed. We are similarly optimistic regarding the trajectory of business investment which we anticipate will accelerate as 2021 progresses. Confidence in the corporate suite is on the rise which we believe will remain supportive of capital spending. According to the recently released Deloitte's North American CFO Signals™ survey for the second quarter of 2021, Chief Financial Officers have grown much more optimistic about the current economy, including business conditions in North America, the financial prospects for their own companies, and their expectations for key operating metrics. Specific to capital expenditures, expectations for capital spending growth increased to 12.4% from 10.2% in the first quarter. The regional Federal Reserve surveys are corroborating this increasingly positive outlook for capex through rebounds in their respective capex expenditure outlook results. Similarly we are seeing a rebound in technology spending intentions. In Citigroup's Chief Information Officer spending intention survey, published July 7, 2021 by Tyler Radke, forward spending intentions in the U.S. continue to reaccelerate with year-over-year budget growth now estimated at 4.2%, the highest survey result since the third quarter of 2018. Further given the resurgent strength in the new orders components of the ISM surveys, which typically lead capex spend by a year, according to Lori Calvasina of RBC, trends are likely to continue to demonstrate improvement. For all of these reasons Emerald remains optimistic regarding the outlook for domestic GDP growth.

A strong domestic economic backdrop, in our view, remains particularly favorable for the trajectory of small capitalization earnings growth. As of early July, Russell 2000 earnings growth was estimated to grow by +29.7% over the 2019 earnings level, representing a more than 900 bps delta to its large capitalization counterpart, according to a July 6, 2021 report from Steve DeSanctis of Jefferies. The small capitalization earnings recovery has meaningfully outpaced that of their large capitalization peers. From April of this year to July the projected 2021 earnings growth rate relative to 2019 has expanded from 17.8% excluding energy to 29.7%% excluding energy. The gap to large capitalization earnings growth grew meaningfully over this period expanding from more than 500 bps to more than 900 bps. At the same time the relative valuation has improved, according to the same report, the Russell 2000 is now trading in the 22nd percentile relative to the Russell 1000 as compared to the historical valuation range and at a discount on four of the seven metrics.

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.

** Intel was not held in the portfolio and is mentioned for general economic and market discussion purposes only.*

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