Emerald Advisers, LLC
Growth Opportunities

Q3 2021 | Economic & Portfolio Commentary

"Two Steps Forward One Step Back"

Quarterly Summary

Emerald Growth Opportunities All Cap Growth portfolios trailed the Russell 3000 Growth index for the quarter giving back a modest amount of our 2021 year-to-date outperformance. During the quarter, our overweight to a number of fast growing small cap holdings detracted from performance, as small cap growth stocks were the quarter's worst performing asset class. Domestic equity markets were flat to modestly down for the quarter in what Canaccord Genuity strategist Tony Dwyer coined "The Summer of Indigestion." We think this is a very apt description of equity market volatility given the explosion of the Covid-19 Delta variant; the Fed discussing a taper; supply chain and inflationary pressures; declining Federal stimulus payments; and concerns about decelerating corporate earnings and margins.

From an economics perspective, the quarter started out with some weakness with Manufacturing, Retail Sales, Consumer Expenditures, Personal Income and Corporate Profit measures all registering weakness in July, while at the same time inflation, in the form of the CPI and PCE, continuing to run hotter than the Fed predicted. As the quarter progressed, these same measures reversed, with virtually all of the above economic measures registering substantial gains in August and ISM Manufacturing and Non-Manufacturing showing strength in September. Employment growth did slow in August, with nonfarm payroll growth adding just 235,000 new jobs, down from close to one million in June and July. Inflation measures on the other hand continued to show signs of durability**,** much to the Fed's consternation.

While the Delta variant dominated the headlines, another issue likely had a greater economic impact: ongoing supply problems showed little signs of improvement. Evidence of this issue was widespread: the Beige Book reported a record number of firm-referenced shortages, the NFIB survey showed a new high for firms indicating below-desired inventory levels, and both shipping rates and port congestion

David A. Volpe, CFA
Portfolio Manager

Stephen L. Amsterdam
Associate Portfolio Manager

Joseph Hovorka
Associate Portfolio Manager

Key Points:

- Emerald Growth Opportunities All Cap Growth portfolios trailed the Russell 3000 Growth index for the quarter giving back a modest amount of our 2021 year-to-date outperformance.
- Emerald Growth Opportunities portfolios achieved outperformance in the Financial Services and Industrials sectors, but underperformed in Energy, Materials, Consumer, Healthcare and Technology.
- We For over the past decade we have employed what we believe is a simple, yet effective strategy: Invest in innovative companies with strong management teams that are number one or two in their respective industries, with disruptive business models, significant competitive moats and durable, often under-appreciated expected growth rates.
- We continue to manage risks with a consistent view toward fundamental growth and remind ourselves that successful investing is a marathon, not a sprint.

EMERALD
DRIVEN BY RESEARCH

measures hit new highs. These constraints drove upward pricing pressure during third quarter with the producer price index (PPI) rising +0.7% over the month of August and up +8.3% from a year prior, the fastest annual growth pace on record.

Large caps, particularly large cap growth stocks, were positive in the quarter – no surprise given the market's volatility and investor's desire for more predictable returns. IPO issuance was at record-breaking levels and M&A was very strong. From a sector perspective, Financials and Technology were the winners, with Energy, Materials and Industrials lagging, reversing some of the year's earlier outperformance. Equity pair-wise correlations fell for the quarter, while equity valuation dispersions remained high – both factors creating a good environment for active managers.

Portfolio Review

Emerald Growth Opportunities portfolios achieved outperformance in the Financial Services and Industrials sectors, but underperformed in Energy, Materials, Consumer, Healthcare and Technology. As noted, our overweight to selected high growth smaller cap names in these sectors detracted from performance, as did our overweight to some cyclical sectors like Energy and Materials, which gave back some of their year-to-date outperformance. Portfolios continue to utilize our "Flexible Barbell Approach" and maintain higher estimated long-term growth rates than the benchmark at 21.94% vs. 20.45% for the index with, we believe, an upward bias. Selected characteristics such as Price/Earnings, Price/Cashflow, Price/Book and Price/Sales are all more attractive in our portfolios vs. the benchmark, pointing to market and analyst estimate inefficiencies and giving us some comfort that assuming earnings materialize, these valuation disparities should continue to dissipate in our favor.

Market Outlook

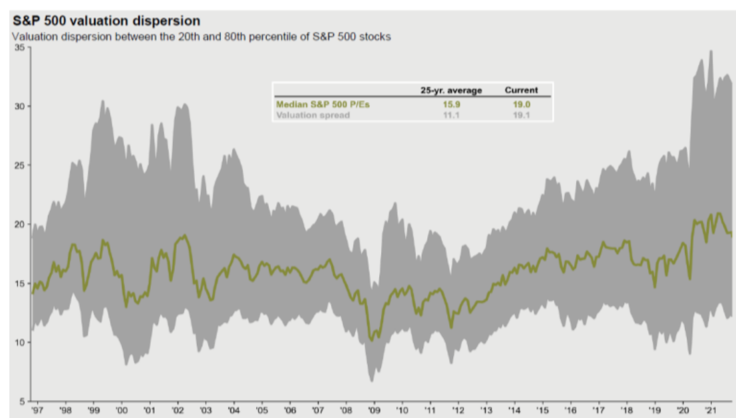
Not to sound like a broken record, but the benefit of our Growth Opportunity Strategy's "Flexible Barbell Approach" is our ability to flex our portfolios to/from sectors/industries/companies impacted from various economic conditions such as higher rates or inflation, strength or weakness in the dollar, risk-off, or risk-on behavior, increased IPO and M&A activity, more stay-at-home or reopening activity, or labor and capital shortages or excesses, just to name a few of the factors we consider. We take full advantage of the flexibility this strategy affords us by balancing allocations to small vs. large caps, cyclicals vs. secular growers, stay-at-home vs. reopeners, bond proxies vs. future growers, lower debt vs. higher debt companies, international, vs. domestic exposure and other equity classifications.

Over the past one-and-one-half years, portfolios have benefited from increased exposure to reopening plays, energy, cyclicals, and a bias towards small caps. Our thesis has been first and foremost that the impact of Covid-19 would be transitory and that selected reopening plays with under-appreciated operating and financial leverage would outperform meaningfully – a thesis that has proven correct since the spring of 2020. We also surmised that inflation would be at a greater magnitude and of longer duration than the Fed bargained for, and thus positioned portfolios with a cyclical bias, with names that generate operating leverage from increased pricing such as Financials, Energy, and Industrials. We also theorized that rates, as exemplified by the 10-year Treasury, would be hard pressed to stay at the extreme low levels we saw during this quarter given reasonably robust economic growth, significant inflationary pressures and fiscal and monetary stimulus. Thus, again, we biased portfolios towards risk on with material small cap exposure as expressed through a cyclical bias, while at the same time staying close to the benchmark with some of our favorite secular growers and mega cap names. We also correctly recognized that the proliferation of IPOs in this generally strong GDP growth and excess liquidity environment would have an impact on lower quality, non-earnings securities such as smaller biotech names, and thus reduced our exposure to this industry. We will continue to bias towards companies with earnings and stronger balance sheets and away from extreme future cash flows given the yield curve steepening and inflation expectations ticking up.

Related to the reopening theme above, we continue to project that earnings, especially for small caps and cyclicals, will be at elevated levels coming out of the pandemic lows, with the earnings trend for 2021 vs. 2019 at 42% for small caps and 26% for large according to Jefferies' Steve DeSanctis. Earnings projections for 2022 also favor small caps and earnings revision trends for cyclicals continue to accelerate vs. secular growers.

Areas of concern for continued outsized earnings and GDP growth are stressed supply chains and labor force availability. Inventory levels for most durable goods are at record low levels and, as noted above, port and trucking bottlenecks are pervasive, with almost all companies being impacted. We have attempted to construct portfolios with names that have the scale to at least try to control some of their own supply chain, that have preferred relationships with suppliers and that actually have pricing power and potentially benefit from supply chain issues. But few companies are immune from this issue which could last well into 2022 and beyond. The availability of labor is also a critical issue affecting virtually all companies with a record number of job openings and worker departures – with the worker quit rate at record levels. Again, we have attempted to construct portfolios with companies that have access to qualified labor, but only time will tell the true impact on company growth and earnings.

While valuations tend to be a secondary concern for us when building portfolios – expected durable growth being the primary factor of focus – valuations do matter related to both positioning and dispersions. We have seen that active managers tend to do better when valuation dispersions between the top and bottom percentiles of the market universe are at higher levels and current valuation dispersions are at significantly higher levels than average - see the JP Morgan Asset Management S&P 500 valuation dispersion chart.



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of September 30, 2021.

On this criteria our friend strategist Jim Furey notes that "Small-cap relative P/E's have only been less expensive in 1999 which was followed by a strong small cap relative P/E expansion." We would highlight that our portfolios, as noted above, trade at valuation levels substantially lower than the benchmark on a forward P/E, P/S, P/B and P/CF level and we think valuation will continue to matter as it has over the past two years.

Inflation, and even stagflation are terms increasingly becoming part of the daily lexicon of investment professionals. Under any economic scenario, falling profit margins and rising rates can place real equity returns in jeopardy and household wealth can stagnate. While we don't expect significant stagflation, we believe our portfolios are positioned with exposure to stocks with a cyclical bias, and have some component of costs that are fixed, or actually declining, thus providing some pricing power to stabilize or increase operating margins.

For over the past decade we have employed what we believe is a simple, yet effective strategy: Invest in innovative companies with strong management teams that are number one or two in their respective industries, with disruptive business models, significant competitive moats and durable, often under-appreciated expected growth rates. At the same time, we seek industries and companies with wide valuation dispersions that are unfairly discounted by the market.

By using our "Flexible Barbell" approach to portfolio construction, coupled with Emerald's time-tested fundamental research focus, our portfolios should withstand short-term market volatility and we believe, over time, perform well vs. our Russell 3000 Growth benchmark. We remain optimistic that this tumultuous period of external-factor-influenced investor behavior will eventually subside and valuation disparities will persist. We continue to manage risks with a consistent view toward fundamental growth and remind ourselves that successful investing is a marathon, not a sprint.

DRIVEN BY RESEARCH

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.

Contact Us

Phone: 1-800-722-4123
info@teamemerald.com
3175 Oregon Pike
Leola, PA 17540

King of Prussia, PA
Pittsburgh, PA
Cleveland, OH

EMERALD