Emerald Advisers, LLC
Growth Opportunities

Q4 2021 | Economic & Portfolio Commentary

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"Challenges in the Face of an Extremely Concentrated Market and Risk-Off Environment"

Quarterly Summary

Although Emerald Growth Opportunity portfolios experienced strong absolute 4th quarter and annual 2021 performance, it trailed the Russell 3000 Growth benchmark for the quarter and the year, as investors shunned risk assets – especially smaller caps – and gravitated for the perceived safety of "bond-proxy" mega-cap names, which make up a large portion of the Russell Index. Market returns became extremely concentrated through year end, with Jefferies strategist Steven DeSanctis noting that the top 10 names in the Russell 1000 Growth index accounted for an astonishing +71% and +62% respectively of that indexes Q4 and 2021 return. This type of concentration affords little room for alpha generation through active management. Fortunately, while we are benchmark aware, we are not beholden to it, and expect to generate benchmark beating returns over time by being different than the benchmark. Our barbell approach of pairing large/small cap, cyclical/secular, bond proxies/momentum and international/ domestically-oriented names – to name just a few of our "barbells" – has served investors well over the years and we believe should lead to outperformance when the market broadens and investors refocus on fundamentals.

Despite some Omicron related impact late in the quarter, economic conditions remained solid with employment continuing to grow as evidenced by the civilian unemployment rate dropping to 3.9% in December and initial unemployment claims holding steady at around 200,000. Housing Starts, Consumer Confidence, ISM Manufacturing and Non-Manufacturing indicators all showed continued strength, as did Leading Economic Indicators, GDP, Corporate Profits and Average Hourly Earnings. The money supply continued to expand at a rapid pace, despite Fed tapering announcements, and Capacity Utilization remained at a post-pandemic high. On the negative side, inflation continued to increase at a torrid and worrisome

Key Points:

- Although Emerald Growth Opportunity portfolios experienced strong absolute 4th quarter and annual 2021 performance, it trailed the Russell 3000 Growth benchmark for the quarter and the year, as investors shunned risk assets – especially smaller caps – and gravitated for the perceived safety of "bond-proxy" mega-cap names, which make up a large portion of the Russell Index.
- Emerald Growth Opportunities portfolios experienced strong absolute Q4 and annual returns in 2021, but trailed our Russell 3000 Growth benchmark; as while we had almost 50% exposure to large and mega-caps in portfolios (a recent high), the extreme concentration of returns in the largest names in the benchmark meant that even this level of exposure limited our ability to match total index returns.
- We are proud of the returns we generated in the quarter and full year as we think they prove our enduring fundamental research based growth Barbell approach works even in the face of historically high concentration of returns and an environment of increased equity correlations.

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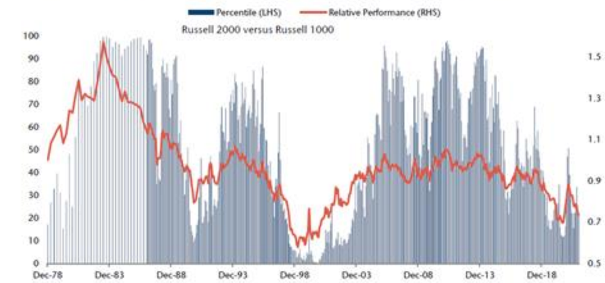
pace with q/q CPI reaching +8.2% in Q4, with both Industrial Production and Retail Sales figures sputtering at quarter end in an Omicron and likely supply chain induced slowdown.

Large cap growth stocks were the stars of the quarter and the year, with the Russell Top 200 Growth index returning +13.7% during Q4 vs. flat performance for the Russell 2000 Growth index, a difference of almost 1400 bps. According to JP Morgan, S&P 500 companies achieved stellar earnings growth of +34.5% for the full year on near record profit margins. The top 10 stocks in the S&P 500 grew to a record 30.5% benchmark weight at year end, yet the earnings contribution from these same names dropped to +25.8% vs. a record +33% at the beginning of the year. Small caps were at a disadvantage for the quarter and the year, according to Credit Suisse, while large cap growth stocks, as measured by the S&P 500 Growth index, had 2021 earnings growth of +32% trailing S&P 600 earnings growth of +57%. Small caps grew earnings at a much faster pace that large caps in 2021- 57% for small vs. 32% for large, yet small caps saw their PE multiples compress/decline by 20% in the face of this strong earnings growth vs. only a 1% decline for large caps despite their less robust fundamental earnings growth. In effect small cap stocks underperformed large despite the better fundamentals.

Technology, Real Estate and Materials were the sector return winners in Q4 with Telecommunications, Financials and Energy lagging. For the full year Energy, Financials and Real Estate were the sector winners. Equity correlations rose substantially during the 4th Quarter after falling each quarter since the beginning of 2020, making active stock picking difficult in the quarter.

Chart 8 - ...And relative model down to the 21st percentile



Source: FactSet; FTSE Russell; Jefferies

Portfolio Review

As noted above, correlations shot up in Q4 on virus and Fed tapering related fears and supply-chain related growth concerns – not a strong recipe for growth-oriented, diversified active management. Emerald Growth Opportunities portfolios experienced strong absolute Q4 and annual returns in 2021, but trailed our Russell 3000 Growth benchmark; as while we had almost 50% exposure to large and mega-caps in portfolios (a recent high), the extreme concentration of returns in the largest names in the benchmark meant that even this level of exposure limited our ability to match total index returns. In fact, despite our materially increased large cap exposure (see our largest portfolio contributor NVIDIA discussed below), failure to own all the indices largest cap names detracted almost 500 bps in Q4 performance - with failure to own Tesla alone detracting 100 bps. Besides being slightly smaller than the index, at a weighted average market cap of $799 BN, portfolios continued to be growthier than the benchmark with estimated 3-5 year EPS growth of +20.71% vs. +19.68%, yet trade a materially lower valuation levels than the index with FY1 and FY2 PE estimates of 28.27 and 22.7 vs. 29.84 and 26.94 for the Russell 3000 Growth index. Portfolios also traded at a significant discount to the index on Price/Sales, Price/Cashflow and Price/Book valuation metrics. But as noted, the quarterly and yearly returns were dominated by large cap growth despite significant and persistent valuation and earnings growth disparities.

Market Outlook

At Emerald we believe earnings growth drives stock prices and as such, we try to build portfolios around some of the strongest earnings growth companies, with the best management teams, advantaged competitive positions and pricing power. This portfolio construction process, along with our Barbell Strategy of pairing large/small cap, cyclical/secular, bond proxies/momentum and international/ domestically-oriented names, normally results in a portfolio with expected growth rates higher than the index with a slight small cap bias. While this small cap bias hurt in Q4 in particular, we continue to stick to our strategy of focusing on earnings growth which has us remaining overweight small caps due to their significantly better expected earnings growth than large in 2022, with small caps expected to generate +15.9% earnings growth vs. +8.5% for large caps according to Factset, Standard & Poor's and Jefferies. Beyond superior earnings growth, small caps should benefit from some reversion to the mean as their weight in the total US equity market has dropped to a multi-decade low of less than +5% - an unsustainable level in our opinion.

Small caps also only trade at the 21st percentile of relative valuation metrics vs. large according to Steven DeSanctis from Jefferies, a significant discount to historical data. Amplifying this, Strategist Jim Furey posits that small cap's forward valuation vs. large is sitting at its lowest level going back to 2002. Strategist Ed Yardeni notes the Mega-cap Price/Sales ratio of 6.6x is at a record high. The earnings growth discussed above is predicated on the economy growing at an above trend rate with steadily increasing interest rates along with steady improvement in COVID-19 case counts and hospitalizations and gradually receding inflationary and supply chain pressures - all factors that would be favorable to our current growth "Barbell" strategy, and especially favorable to the small cap asset class. Given our growth outlook and expectations of a steepening yield curve, portfolios continue to have a cyclical and reopening bias vs. secular growth and bond proxies, as Fed rate hikes should be beneficial to cyclicals, which are still relatively inexpensive with among the highest projected earnings growth rates. Portfolios also contain a significant number of reopening oriented names in the leisure/hospitability/lodging, casino/gambling and Fintech industries, and names that given relatively low valuations and significant potential 2022/2023 earnings growth, have material upside to our price targets.

We continue to overweight Energy, Materials, Industrials, Consumer Discretionary and Banks, with underweights in Technology, Healthcare and Consumer Staples. In particular we are underweight Software given that industries with higher valuations have, and may continue to be, challenged given above trend economic growth and expectations for higher rates. We actually used the pullback in this industry in the later part of 2021 to consolidate our positions in some of the highest growth, highest quality names in the software space.

Portfolios benefited from some M&A and IPO issuance during the year, particularly in the first half 2021. Given strong liquidity and low rates, we would expect M&A to be a positive portfolio influence this year and have already profited from M&A activity early in 2022. The level and quality of IPO issuance overwhelmed the market late in 2021 resulting in offering prices of many IPOs being reduced and many IPO companies breaking deal price. This should create a more discerning IPO market and result in a lower number of higher quality IPOs being brought to market in 2022.

Risks to our portfolio construction thesis include the failure of economic and earnings growth to materialize as supply chain issues and higher inflation persist in the face of Fed rate hikes. If economic growth slows despite an accommodative Fed and fiscal policy, mega-caps will likely continue to dominate equity returns and small caps, cyclicals and reopeners – all portfolio overweights – will likely continue to be disadvantaged. While Omicron and supply chain induced constraints will create volatility, we believe that markets will ultimately move with the direction of earnings, which we believe should remain positive until credit spreads widen dramatically and money supply constraints restrict growth. Until that time, we stick with the following positives put forth by one of our favorite strategists, Tony Dwyer from Canaccord Genuity:

- *Historically low Real Fed Funds Rate*
- *A 3 month/5 year US Treasury Yield Curve that is steepening*
- *Loose financial conditions and easy bank lending standards*
- *Continued excess liquidity*
- *Growth in domestic consumer services should more than offset goods slowdown*
- *Positive global growth expectations (albeit mixed)*

We are proud of the returns we generated in the quarter and full year as we think they prove our enduring fundamental research based growth Barbell approach works even in the face of historically high concentration of returns and an environment of increased equity correlations. While 2022 will be volatile given it is the second year of the Presidential cycle with 3-4 expected rate hikes and the continuing evolution of COVID, ultimately the market will move with earnings growth, which we expect to be substantially positive throughout 2022.

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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.

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