Emerald Advisers, LLC
Mid Cap Growth

Q4 2021 | Economic & Portfolio Commentary

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"Emerald Mid Cap Growth Portfolios Outperform Benchmark in 2021"

Quarterly Summary

The returns of Emerald Mid Cap Growth portfolios exceeded our benchmark Russell Mid Cap Growth performance for the full year 2021 despite trailing the benchmark moderately in the 4th quarter. For the year our overweight to cyclicals and reopening plays, as well as strong stock selection in Healthcare, drove performance. For the 4th quarter, while these same factors helped performance, our overweight to select higher growth and valuation names in Consumer Discretionary, Technology and Industrials weighed on relative performance, as did portfolios being more growthy and slightly smaller than the benchmark, where larger, slower growth names outperformed for the quarter and the year.

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 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.

Key Points:

- The returns of Emerald Mid Cap Growth portfolios exceeded our benchmark Russell Mid Cap Growth performance for the full year 2021 despite trailing the benchmark moderately in the 4th quarter.

- Emerald Mid Cap Growth portfolios exceeded the benchmark return for the year, but trailed for the quarter as selected software, educational services and industrial names either missed financial expectations or were part of the higher growth and valuation cohort that was severely punished towards the later part of the year.

- 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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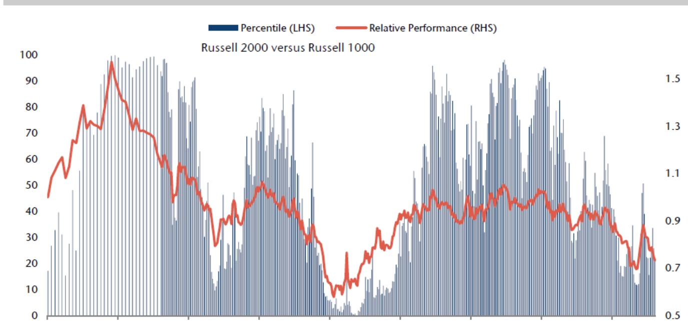
As noted above, larger Russell Mid Cap Growth names substantially outperformed the smallest index stocks dramatically for the quarter. High ROE stocks with material foreign sales outperformed, as did lower P/E stocks vs. low and non-earners. High sales growth names severely underperformed in what can be described as a risk-off growth to value sector rotation. This was most pronounced in December with lower risk, bond-proxy like securities in the Utilities and Consumer Staples sectors substantially outperforming other sectors. In a testament to the strength of larger cap names vs. smaller (including SMID caps), in Q4 large caps saw their multiples hold relatively steady declining only 1% vs. a 20% multiple contraction for small cap stocks, despite superior small cap earnings growth.

Industrials, Real Estate and Materials were the sector return winners in Q4 with Telecommunications, Consumer Discretionary and Healthcare lagging. For the full year Energy, Industrials 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 Mid Cap Growth portfolios exceeded the benchmark return for the year, but trailed for the quarter as selected software, educational services and industrial names either missed financial expectations or were part of the higher growth and valuation cohort that was severely punished towards the later part of the year. Good stock selection in other areas – particularly Biotech – failed to offset this quarterly underperformance. Besides being slightly smaller than the index, at a weighted average market cap of $23.9BN vs. $29.7BN for the Russell Midcap Growth Index, portfolios were growthier than the benchmark with estimated 3-5 year EPS growth of +22.09% vs. +21.64% for the index, yet traded at materially lower valuation levels than the benchmark with FY1 and FY2 PE estimates of 26.26 and 21.79 vs. 29.16 and 25.59 for the Russell 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 larger cap, less growthy names in the benchmark 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 mid cap companies, with the best management teams, advantaged competitive positions and pricing power. This portfolio construction process, utilizing our time-tested, deep-dive, fundamental research-based approach, normally results in a portfolio with expected growth rates equal to or faster than the index with a slight small cap bias. While this bias to some of the smaller, faster growing names in the index hurt in Q4 in particular, we continue to stick to our strategy of focusing on earnings growth, which leads us to bias towards cyclical and reopening-oriented stocks.

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 strategy, and especially favorable to the smaller economically sensitive names. Given our growth expectations 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, 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 higher valuations that have, and may continue to be, challenged by 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 of 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, larger-caps will likely continue to dominate equity returns and smaller caps, cyclicals and reopeners – all portfolio overweight's – will 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 long-standing fundamental, research-based, growth 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.

To learn more about Emerald Advisers, please visit us at teamemerald.com.

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