Emerald Advisers, LLC
Diversified Small Cap Growth

Q4 2021 | Economic & Portfolio Commentary

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Volatility Increases

Market Update

The emergence of the Omicron COVID variant, and a more hawkish Federal Reserve added yet another wrinkle to the market narrative during the fourth quarter. While Omicron certainly contributed to the year-end volatility, it was the aggressively hawkish pivot made by the U.S. Federal Reserve that drove price action exiting the year. The Federal Reserve went all-in at the last FOMC meeting of the year doubling the pace of tapering and at the same time signaling three hikes in 2022 and three more in 2023. This represented a material change in direction for the Fed in the eyes of the market and adds further support to the Federal Reserve's movement away from "transitory" as a descriptor of inflation. Volatility rose as the market's interpretation of this signaling continued to vacillate between doubting the durability of economic growth, which is positive for secular growth, to the Fed moving ahead with tapering/hiking, which is positive for the cyclical trade. Despite this late quarter series of events, December market returns finished in positive territory across the capitalization spectrum, capping off a solid fourth quarter and another strong year for equity returns.

Large capitalization returns were noteworthy standouts with the S&P 500 gaining +11% and +28.7% for the fourth quarter and full year 2021, respectively. The Russell 1000 posted similarly strong performance gaining +9.78% for the quarter and +26.46% for the year. Small capitalization stock returns, while positive, lagged significantly relative to large capitalization peers. The Russell 2000 gained +2.1% and +14.8% for the fourth quarter and calendar year respectively trailing the S&P by 890 basis points and 1,390 basis points, respectively.

For the full year, the Russell 2000 underperformed the Russell 1000 by 1,160 basis points, marking the largest underperformance by small capitalization stocks since 1998, according to Steve DeSanctis, Equity Strategist at Jefferies. From a style perspective, the persistent underperformance of the growth component of the benchmark, was the most meaningful headwind to performance of the Russell 2000. The Russell 2000 Growth benchmark gained a modest +0.01% for the quarter and only +2.83% for the full year 2021, meaningfully trailing the Russell 2000 Value benchmark which gained +4.36% and +28.27% for the quarter and the year.

The Russell 2000 Value's 25.4% outperformance of the Russell 2000 Growth in 2021

Key Points:

- Small capitalization stock returns, while positive, lagged significantly relative to large capitalization peers. The Russell 2000 gained +2.1% and +14.8% for the fourth quarter and calendar year respectively trailing the S&P by 890 basis points and 1,390 basis points, respectively.

- The Emerald Diversified Small Cap Growth portfolio performed essentially in-line with the benchmark for the fourth quarter, as the positive contribution from allocation and stock selection offset the negative contribution from interaction effect.

- From a sector perspective, relative outperformance within the healthcare, technology, energy and financials sectors offset relative underperformance within the consumer staples, industrials, consumer discretionary and real estate sectors.

- As we enter our 30th anniversary year managing client funds, Emerald 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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represented its second best annual relative outperformance in its 43-year history (only the +45% relative difference posted in 2000 was better), according to Jim Furey of Furey Research. At the sector level, the healthcare sector was the largest headwind to the Russell 2000 Growth's performance falling by (11.77%) for the quarter and (22.15%) for the full year. While the healthcare sector was the largest drag on Growth's performance to Value, every sector of the Russell 2000 Growth, with the exception of telecommunications, lagged that of its Value peer. Weighing most heavily on Growth's relative performance across sectors, has been the relative underperformance of both the fastest growing companies and the non-revenue/non-earnings companies within the Russell 2000 Growth benchmark. According to a January 2, 2022 report from Steve DeSanctis of Jefferies, the top quintile of companies measured by sales growth returned (6.68%) and (9.1%) for the fourth quarter and year respectively, meaningfully lagging the slower growing cohorts in quintiles 3 and 4, which appreciated +2.90% and +4.20% in the fourth quarter and +14.4% and +19.87% for the full year 2021. The non-revenue generating cohort was most challenged from a performance perspective declining by (20.27%) during the fourth quarter and (43.5%) for the full year 2021.

Portfolio Review

The Emerald Diversified Small Cap Growth portfolio performed essentially in-line with the benchmark for the fourth quarter, as the positive contribution from allocation and stock selection offset the negative contribution from interaction effect. From a sector perspective, relative outperformance within the healthcare, technology, energy and financials sectors offset relative underperformance within the consumer staples, industrials, consumer discretionary and real estate sectors.

The healthcare sector was again one of the top contributors to performance for the quarter driven by the stock selection and allocation effect within the biotechnology industry.

The technology sector also contributed positively to return for the quarter driven by stock selection within the software, consumer digital services, and production technology industries.

Performance within the energy and financials sectors also contributed positively to return driven by relative outperformance within the renewable energy equipment and banking industries. Specific to the banking industry, the combination of the portfolio's relative overweight position and stock selection drove the positive contribution to return.

The aforementioned positives were largely offset by the relative underperformance within the consumer staples, industrials, consumer discretionary and real estate sectors. Within the consumer staples sector, performance was challenged by disappointing stock selection within the food products industry.

Relative underperformance within the industrials sector was also a headwind to portfolio performance, as challenging stock selection within the industrial machinery industry more than offset relative outperformance within the professional business services and building materials industries.

Performance within the consumer discretionary sector also proved challenging this quarter, resulting from the relative underperformance of holdings within the education services industry.

In addition to the aforementioned headwinds, performance within the real estate sector also detracted from the performance during the quarter. The real estate sector of the Russell 2000 Growth benchmark was the best performing sector this quarter appreciating +13.86%, and the portfolio's relative underweight position was a gating factor to relative performance.

Exiting 2021, the portfolio held the largest active exposures in the financial services, consumer discretionary 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, and property and casualty insurance industries, was the portfolio's largest relative overweight position at quarter-end. Emerald has maintained its exposure to holdings within the banking industry as we remain constructive on the opportunity for increased new loan yields, if in fact the Fed begins to raise interest rates. The KBW Nasdaq Regional Banking Index is trading at a P/E ratio of 13.2x 2022 Est. and 11.9x 2023 Est., a discount to the 10-year historical median of 14.2x, and at 60% of the S&P's P/E Ratio versus a historical 10-year median of 87%. On a Price-to-Earnings basis, the smallest banks remain the least expensive with banks $250M to $1B in size trading at 12.2x 2022 P/E and banks sub-$250M trading at only 10.5x. Meanwhile, all other segments trade in the 13.5x to 14.4x range with Banks in the $5B to $10B range screening as the most expensive on both 2022 and 2023 P/E. M&A activity remains a large theme, as we believe activity remains strong as we enter 2022. According to S&P Global, 2021 U.S. bank M&A deal value surpassed 2019's full-year level and has become the biggest year for U.S. bank M&A since 2007.

- 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. While the surge in Omicron has the potential to create some near-term volatility in spending patterns, with the economy likely to remain open, the labor market recovering, wages on the rise and consumer net worth expanding, we believe the outlook for consumer spending remains attractive and believe there remains meaningful opportunity for share gains for those companies offering differentiated products/services with strong value propositions.

- The portfolio also 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, active nutrition and "better-for-you" beverages.

- As it relates to the technology sector, the portfolio exited the quarter with technology sector positioning largely in-line with the benchmark. The technology sector weighting on an absolute basis is now the largest nominal portfolio weight. Within the technology sector, the semiconductor and software industries are currently the portfolio's largest industry exposures. As we look into 2022, we continue to believe that the digital transformation of the enterprise that began in earnest during the global pandemic will remain a key driver of investment in ecommerce, digital forms of entertainment, the enterprise technology infrastructure, cybersecurity and cloud-related software opportunities. In addition, we continue to see a strong rebound in industrial and automotive production, though significant supply constraints remain in the global tech supply chain. Based on recent commentary from TSMC, we believe pricing could be up more than 20% for the semiconductor industry along with units that could grow double digits in 2022 – a uniquely strong backdrop for semiconductors. As such, we remain significantly overweight the semiconductor industry.

- 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 and healthcare services industries. Emerald believes performance within the biotech industry was challenged throughout 2021 for a number of reasons including: rare disease niches getting crowded with competition, risks around governments responding to 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, and less M&A activity possibly driven by a tougher FTC.

Market Outlook

Nearly two years after surfacing on U.S. shores, COVID and the long-tail of the COVID-19 variants is continuing to wreak havoc on the market and the linearity of the domestic economic recovery. Prior to the surge of this most recent COVID variant, economic momentum was demonstrating a strong rebound from the third quarter trough with the fourth quarter Atlanta Fed GDPNow forecast tracking to 7.6% GDP growth as of December 31, 2021. We believe that economic momentum, ex-the first quarter Omicron induced speed bump, is likely to continue throughout 2022 driven by continued strength in consumer spending, business investment, the inventory replenishment cycle and the effect of the extraordinary growth in money supply that is continuing to filter through the system.

From the perspective of the consumer, there remains a great deal of cynicism regarding the durability of consumer spending, as benefits from stimulus subside and inflationary pressures persist. We remain optimistic that wage growth, a return to full employment, strong gains in consumer net worth and a solid base of savings should support further gains in consumer spending throughout 2022.

Emerald is similarly optimistic on the outlook for business investment. CEO confidence continues to rise with the most recent index reading from the Business Roundtable's survey of CEO confidence reaching a record high of 123.5 during Q4. This series, according to Ed Yardeni of Yardeni Research, has historically been a very good coincident indicator of the y/y growth rates of both nominal and real capital spending in GDP. In addition to the positive support from CEO confidence, we believe spending is further supported by strong corporate earnings, rising corporate cash balances, and easy lending conditions. For example, Morgan Stanley is currently forecasting private capex growth of 5.9% in 2022 (5.9%Y), and 5.3% in 2023 (5.6%Y). Collectively, we believe that the combination of strong consumer spending, elevated levels of business investment, and an inventory replenishment cycle should continue be supportive of earnings growth throughout 2022.

In this regard, small capitalization stocks should be particularly well positioned with earnings currently projected to grow by 16.2% year over year in 2022, substantially better than the 10% and 8.2% growth projected for mid-cap and large capitalization stocks, respectively, according to a January 4, 2022 report from Steve DeSanctis. Valuations are also skewing in the favor of small caps. After lagging the Russell 1000 by more than 1,160 basis points over the course of 2021, the worst relative performance gap since 1998, the valuation of the Russell 2000 now stands in the 21st percentile relative to the Russell 1000. For context, this represents a sequential step down from the 25th percentile at the end of the third quarter, and the 37th percentile at the end of the first quarter of 2021. Historically, according to the same report, when the relative valuation of the Russell 2000 to the Russell 1000 has fallen within the first quintile, which we are currently approaching given the retrenchment, small caps have outperformed by 5.8% over the next twelve months 75% of the time. Second, and also noteworthy, is that after the last record year of relative underperformance in 1998, small capitalization stocks embarked on a multi-year cycle of outperformance.

While risks to this outlook are numerous, the market's adjustment to the Federal Reserve's new path of monetary policy is likely the most meaningful risk to market returns in the near-term. The early January release of the FOMC minutes confirmed the early December hawkish pivot by the Federal Reserve, with members fully on board with an accelerated pace of tapering and putting a March rate hike on the table in the eyes of the market. The release of the minutes accelerated the selloff that was already underway in the treasury market, with 10-year yields surging from 1.52% at the end of 2021 to 1.76%, an eye-popping 24 bps surge. This is a more than two standard deviation move in yields, wreaking havoc on the market to start the year, with all of the broad market indices tracking in negative territory. We believe the volatility that we are seeing to start the year likely persists in the near-term as the market navigates the path of monetary policy adjustments and assesses the pace inflation. Over and above the aforementioned, while geopolitics has had little impact on the market throughout the pandemic, tensions with Russia and China remain an ever-present risk.

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