Emerald Advisers, LLC
Growth Opportunities

Q2 2022 | Economic & Portfolio Commentary

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"The Great Multiple Contraction – Fed Turns from Friend to Enemy"

Quarterly Summary

Emerald Growth Opportunities portfolios gave back some of our YTD outperformance in the 2nd quarter as strong performance in the Energy and Consumer Discretionary sectors failed to overcome weakness in Financials (Banks) and Technology. Equities had their worst start to the year since 1970, as inflation worries and late quarter economic growth concerns depressed multiples at a breakneck pace, with the S&P 500 forward P/E dropping to a below average 16x. Small caps and growth stocks continued to underperform large and value equities, as investors continued their risk-off positioning in the face of an ever more strident Fed and weakness showing up in various segments of economic growth.

Investors' main focus for the quarter was inflation, with PCE inflation showing a full 1% month-over- month increase in May, equating to an 8.6% increase from the prior year – the highest readings since 1981. Economic news became more consequential as the quarter progressed, as positively, the Civilian Unemployment rate stayed steady at just 3.6%, as did Initial Unemployment Claims which ticked up modestly to 235,000. Average hourly earnings continued to march higher (although below inflation) and ISM Manufacturing, Non-Manufacturing, Architectural Billings and Dodge Momentum indices all showing continued, albeit weakening, strength. On the negative side, retail sales, real GDP, industrial production and the Leading Economic Index (LEI) all showed weakness. Consumer confidence measures were particularly weak, registering their worst readings in over 40 years. The U.S. Dollar continued to strengthen, a harbinger of future corporate earnings weakness, and the money supply abruptly slowed as the Federal Reserve drained liquidity from the system. Worker productivity also slumped late in the quarter.

As noted above, large cap stocks outperformed both small and mid, and value continued to outpace growth equity performance. Small caps in particular were hard

Key Points:

- Emerald Growth Opportunities portfolios gave back some of our YTD outperformance during the quarter but are still outperforming the benchmark for the year. The two main characteristics of our quarterly underperformance were size and growth, with both attributes underperforming for the quarter.

- Emerald portfolios were overweight the Energy, Financials, Consumer Discretionary, Materials and Industrials sectors. We were underweight Staples, Healthcare, Real Estate and Technology. We raised cash towards the end of the quarter given the economic uncertainty and on hopes of deploying cash at lower levels given Fed tightening and accompanying market volatility.

- We believe our portfolio positioning with exposure to cyclicals, domestically exposed names, smaller capitalization names, and inflation protected segments will benefit our portfolios as the market bottoms; while our dynamic barbell provides some ballast to market volatility with exposure to mega-cap large benchmark stocks.

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hit, with the Russell 2000 off to its worst yearly start in history. Energy, Healthcare, Staples and Utilities were the best performing sectors for the quarter, with the Consumer Discretionary, Technology and Financial sectors all significantly underperforming. High-yield spreads widened during the quarter and now stand at 6%, which is above the long-term average, despite a lack of credit issues. Profit margins receded a bit, but forward earnings estimates for 2022 actually increased during the quarter despite the aforementioned economic challenges. The market remained very concentrated with the top five names in the S&P 500 weighing in at three times the size of the entire small cap market. Valuation dispersion remained at historically high levels.

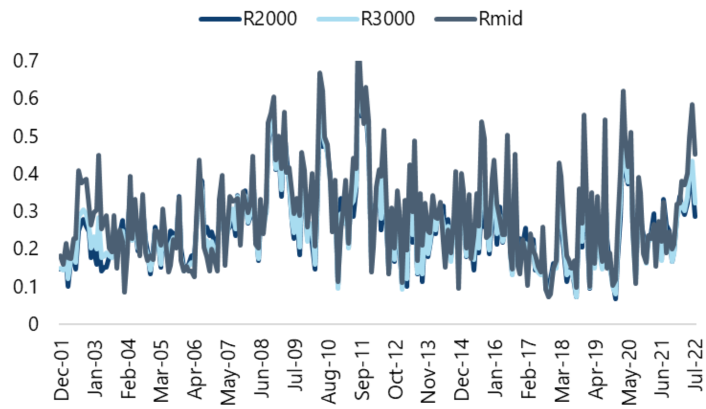
Portfolio Review

As noted above, Emerald Growth Opportunities portfolios gave back some of our YTD outperformance during the quarter but are still outperforming the benchmark for the year. The two main characteristics of our quarterly underperformance were size and growth, with both attributes underperforming for the quarter. Emerald portfolios were smaller than the benchmark with a weighted average market cap of $581B vs. $687B for the Russell 3000 Growth Index and have a higher projected growth rate than the benchmark with an estimated 3-5 year EPS growth rate[1] of 18.84% for the portfolio vs. 16.73% for the Russell 3000 Growth Index. Portfolios were also more cyclically biased, which penalized performance given investors' economic growth concerns. Portfolios trade at a materially lower valuation level than the index with FY1 and FY2 PE estimates of 17.05 and 14.82 for the portfolio vs. 20.22 and 18.84 for the Russell 3000 Growth Index. It is interesting to note that the portfolio multiples listed above are approximately 1,100 and 800 basis points lower than the same forward multiples just six months ago – despite long-term earnings estimates barely declining. Portfolios also traded at a significant discount to the index on Price/Sales, Price/Cashflow and Price/Book valuation metrics.

Emerald portfolios were overweight the Energy, Financials, Consumer Discretionary, Materials and Industrials sectors. Our overweight to Energy and Discretionary benefited performance during the quarter. Overweighting Financials, Materials and Industrials all detracted from performance. We were underweight Staples, Healthcare, Real Estate and Technology. We raised cash towards the end of the quarter given the economic uncertainty and on hopes of deploying cash at lower levels given Fed tightening and accompanying market volatility.

Market Outlook

A looming recession, runaway inflation, an energy and currency crisis in Europe, a war causing massive supply chain issues, continued China lockdowns, cratering consumer sentiment, profit concerns, a historically strong US dollar and a recently intransigent Fed...Geez, it's a wonder we can even get out of bed in the morning! These are just some of the issues the market is having to deal with on a daily basis; issues that we, as active managers, have to factor into our portfolio construction process. We believe we have formulated the right balance of offense and defense to at least "Keep us in the Game" during this extremely volatile and uncertain time. As an active manager closely covering our companies, we oftentimes experience frustrations navigating highly-correlated, macro-driven markets and have to wait until macro influences subside to exploit the mismatch between earnings estimates and actual results. Following is a Jefferies chart on monthly pairwise stock correlations showing stock correlations peaking in the quarter to levels last seen during the early pandemic phase – a very tough time for active managers to distinguish themselves.

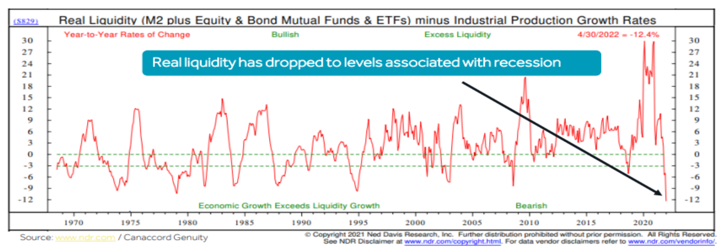


Source: Jefferies

It's not a good use of our time to dwell on our thoughts regarding each of the variables impacting the economy and markets as we could write pages and pages and would probably come to the same erroneous conclusions as most market pundits and strategists who, like us, really can't predict the levels of interest rates, U.S. dollar, GDP etc. However, one variable we did predict well was inflation, as we were very clear in past commentaries and in our portfolio positioning that inflation would NOT be transitory and would be much deeper and protracted than the Fed or most financial pundits predicted. Following is a short passage from our Q1 2022 commentary:

"We expressed concerns about how baked-in inflation was becoming in every aspect of the economy. The war in Ukraine just served to reinforce our inflation concerns as energy, food and other goods and service prices spiked. The Fed is now in the unenviable position to walk the fine line battling inflation, while at the same time not pushing the economy into recession. Inflation may be peaking for some goods-oriented categories such as used cars and household appliances, but inflation related to wages and shelter both lag and have likely not come near a peak, and thus will be problematic for months to come."

On a positive note, the five-year expected inflation rate has dropped significantly over the past few months from 3.5% to around 2.5%. The Fed may be able to rely on this to some extent to temper their fervor towards rate increases. We also were very clear that supply chain issues would take several quarters to be remedied and that taking away the liquidity punchbowl would have a very detrimental impact on the markets and the economy. See the following chart from Canaccord's Tony Dwyer showing the unprecedented amount of monetary tightening that has occurred in just the past few months.



We noted that we had positioned the portfolio cyclically but offset that cyclicality through our Dynamic Barbell by owning some of the mega cap stalwarts, as well as selected lower growth/valuation Technology names and selected small caps that are more domestically-focused and in industries less impacted by inflationary input costs. While frustrating at times during the 2nd quarter, we still like our small cap overweight, as small performance YTD, according to Jefferies' Steven DeSanctis, has been worse that the first half of a normal recession and bear market. Small caps now represent less than 4% of the US equity markets and trade at a huge discount to large caps on a Price/Sales basis.

One of the things we probably did not factor into our portfolio construction enough was the very quick pivot that investors made from dealing with excess inflation to dealing with a recession. We assumed the economy would weaken but did not assume that we would see a recession. Certainly not a recession in 2022. Employment, Manufacturing and

Nonmanufacturing PMIs are just too strong to assume a near-term recession regardless of a technical recession derived from two consecutive quarters of GDP contraction.

Recognizing we don't assume a recession in 2022 but do foresee material economic weakness, we have reduced some of our Consumer Discretionary exposure and added materially to our Healthcare and Consumer Staples exposure. Presently, portfolios remain overweight Energy, Materials and Financials and underweight Technology and Consumer Staples. Some may question our cyclical bias given the current and expected economic weakness, with overweights to Energy and Materials. While we have reduced the portfolio's cyclicality in the last month or two, we still believe that selected industries and equities, by virtue of idiosyncratic supply and demand influences, will be able to dramatically increase earnings in 2022 and 2023, even in the face of a mild/moderate recession. This is especially led by Energy given the massive underinvestment to the sector over the past decade and the relatively inelastic nature of demand. It is currently our view that for the most part energy company earnings estimates still have to be revised upwards from current levels.

As an active multi-cap growth manager, we believe earnings drive stock prices. This is our mantra – something we stress again and again. We have positioned the portfolio through the use of our Dynamic Barbell and ten step research process in industries and stocks that we believe will be able to grow, or at least protect earnings in most market environments. We believe our portfolio positioning with exposure to cyclicals, domestically exposed names, smaller capitalization names, and inflation protected segments will benefit our portfolios as the market bottoms; while our dynamic barbell provides some ballast to market volatility with exposure to mega-cap large benchmark stocks. We take some solace that during a run of the mill recession, equity markets normally drop 30% from peak, a level we are getting close to at this point in time. Additionally, if inflation does cool and growth does not slow as materially as markets are predicting, we could be getting close to a tradable market bottom. As always, we are confident that Emerald's fundamental research process will help navigate whatever curveballs the market throws at us and our Dynamic Barbell approach will put us in position to outperform over time.

Definition

[1]3-5 year EPS growth rate: The estimated 3-5 year earnings growth rate is calculated utilizing a pre-calculated mean long-term EPS growth rate estimate for portfolio holdings, as available, provided by FactSet and sourced from brokerage estimate submissions to estimate services (FactSet, IBES, First Call, etc.). The estimated 3-5 year earnings growth rate for the portfolio is then calculated utilizing the weighted average of the individual portfolio holding estimated 3-5 year earnings growth rates. The data reported is as of the report date.

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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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