Emerald Advisers, LLC
Diversified Small Cap Growth

Q2 2022 | Economic & Portfolio Commentary

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Key Points:

- Negative returns weren't confined to the equity market, with long-term treasury bonds retrenching (-11.02%) for the quarter and (-20.07%) for the six months, while investment grade corporate bonds fell by (-6.71%) and (-13.93%) for the respective periods.
- The Emerald Diversified Small Cap Growth portfolio trailed the benchmark for the quarter as a result of challenging relative performance within the consumer discretionary, financials, consumer staples and industrials sectors. These areas of underperformance more than offset relative outperformance within the healthcare, real estate and technology sectors.
- Entering the third quarter of 2022, the portfolio held the largest active exposures in the healthcare, financial services and consumer discretionary sectors.
- 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.

Going From Bad to Worse

Market Update

Nowhere to run, and nowhere to hide as the tug of war between inflation and recession rages on. The S&P 500 declined (-16.1%) in the second quarter, pushing the index into bear market territory with a first half 2022 decline of (-19.96%). This was the worst first half return for this index since 1962 (-22%), and the second worst start to the year in history since 1935, according to a July 1, 2022 report from Savita Subramanian, Equity and Quant Strategist at B of A Securities. The record setting negative returns were unfortunately not just an S&P 500 phenomenon. For the Russell 2000, the (-17.20%) second quarter return represented the worst second quarter performance in the history of the index, with the (-23.4%) year-to-date return the worst first half return since 1973. Similarly, the MSCI All Country World Index price return fell (-8.6%) in June and (-20.9%) year-to-date, the worst first half calendar year price return in the 34-year history of the MSCI Index. Negative returns weren't confined to the equity market, with long-term treasury bonds retrenching (-11.02%) for the quarter and (-20.07%) for the six months, while investment grade corporate bonds fell by (-6.71%) and (-13.93%) for the respective periods. Given the headwinds to both equity and fixed performance it is not surprising that the first half of 2022 was the worst performance for a 60/40 portfolio since 1932 and the first time since 2001 where both stocks and bonds fell, according to the same report from Savita Subramanian cited above. No major asset class was left unscathed, with the selling pressure extending to energy, the broader commodity complex, gold, and cryptocurrency.

While all asset classes have succumbed to selling pressure, Growth stocks have borne the brunt of the pain, as rising treasury yields and persistent multiple compression have weighed heavily on growth stock multiples. Small capitalization stocks have been hit particularly hard, with the Russell 2000 Growth declining (-19.25%) during the second quarter, (-29.45%) year-to-date, and (-33.43%) over the trailing twelve month period. This compares to the Russell 1000 Growth that declined by (-20.92%) in the second quarter, (-28.07%) year-to-date and (-18.77%) over the trailing twelve months.

At the sector level within the Russell 2000 Growth, returns for the second quarter were broadly negative, with the real estate (-24.44%) and technology (-24.18%) sectors leading to the downside. Energy sector performance was also noteworthy given the

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velocity of the reversal, as the sector declined (-21.98%) during the month of June, after a positive start and finishing the quarter (-18.05%). On a year-to-date basis, the technology (-35.68%), consumer discretionary (-34.32%), real estate (-34.20%) and health care (-31.88%) sectors have all declined in excess of 30%. Only the energy sector (+3.55%) exited the June quarter with a positive calendar year-to-date return.

At the constituent level within the Russell 2000 Growth, underperformance was most noteworthy within the fastest growing companies, smallest market capitalization and lowest return on equity. While we were hopeful that we were starting to see a more sustainable narrowing in the performance gap between the fastest growing companies and the slowest growing companies, the spread widened again during the second quarter. According to a July 1, 2022 report from Steve DeSanctis of Jefferies, the top quintile of companies measured by sales growth returned (-24.61%) for the second quarter, reflecting relative underperformance of (-536 bps) vs. (-15 bps) in the first quarter. As for the non-revenue generating companies, interestingly the relative underperformance gap narrowed again sequentially during the second quarter (-775 bps) from (-1398 bps) in the first quarter and from (-2028 bps) and (-4632 bps), respectively for the fourth quarter and full year 2021. While improving, the gap of relative underperformance continues to be exceedingly wide. Notably while the full second quarter performance for this cohort lagged, the non-revenue generating companies actually outperformed during the month of June by 885 bps, largely driven, we believe, by the improving relative performance within the healthcare sector. We see a similar phenomenon by viewing performance by long-term earnings growth. According to a recent report from Savita Subramanian of B of A Securities, during the second quarter, those companies with long-term earnings growth rates above 20% returned (-22.2%), while the non-earners returned (-19.9%), lagging those companies with long-term earnings growth rates less than 10% and from 10-20% which returned (-18.9%) and (-17.4%) respectively. Interestingly, similar to the trend in the non-revenue generating companies highlighted above, the non-earners outperformed their earning peers during the month of June.

From a market capitalization perspective, the smallest companies within the Russell 2000 Growth lagged with the <$500 million market cap companies underperforming by 660 bps for the second quarter and 1062 bps for the year-to-date period. That same cohort outperformed by 348 bps during the month of June. We see a very similar trend, when analyzing performance by ROE. Specifically, while the highest ROE quintile outperformed by 578 bps for the second quarter, the lowest ROE quintile, which lagged by 1164 bps for the second quarter and 1583 bps for the year-to-date period, outperformed by 205 bps during the month of June.

Portfolio Review

The Emerald Diversified Small Cap Growth portfolio trailed the benchmark for the quarter as a result of challenging relative performance within the consumer discretionary, financials, consumer staples and industrials sectors. These areas of underperformance more than offset relative outperformance within the healthcare, real estate and technology sectors.

After strong relative outperformance during the first quarter, the consumer discretionary sector was the largest negative contributor to return for the quarter driven largely by stock selection. Upward pressure on gasoline prices, rising inflation expectations and declining consumer confidence raised further concerns that the weakness currently being witnessed within the goods categories would ultimately spread to the services industries. As a result the portfolio's holdings within recreational services, airlines and restaurants were disproportionately pressured.

Holdings and positioning within the financial services sector, particularly the banking industry, also detracted from performance during the second quarter. The portfolio's growth banks led to the downside.

Performance within the consumer staples sector was also challenging as a result of underperformance within the food industry.

Stock selection presented similar challenges within the industrials sector driven by disappointing stock selection within the professional business services, defense, commercial vehicle-equipment, and transaction processing services industries.

Partially offsetting the aforementioned headwinds was stock selection driven relative outperformance within the healthcare, real estate and technology sectors. Amongst these, the healthcare sector was the largest positive contributor to return. The portfolio's strong relative outperformance within the sector was driven by a combination of stock selection and allocation effect within the biotechnology and pharmaceutical industries.

From a portfolio positioning perspective, entering the third quarter of 2022, the portfolio held the largest active exposures in the healthcare, financial services and consumer discretionary sectors. Thoughts on those sectors and other notable areas of exposure are highlighted below.

- The healthcare sector now represents the portfolio's largest nominal and active exposure. At the industry level, the portfolio currently holds the largest relative overweight within the medical equipment and pharmaceuticals industries, and the largest nominal exposure within the biotechnology industry, although remains underweight relative to the benchmark. Emerald continues to identify selective opportunities within the pharmaceutical and medical equipment industries and has been building exposure to those areas of the healthcare sector. We continue to be focused on medical device and diagnostic companies that are profitable and not trading on a revenue multiple. For therapeutics, we are focused on the few companies that are profitable and those with quality assets generating revenue with a view towards profitability. We have very little exposure to development stage biotech at this point in time.
- The financial services sector, comprised of holdings within the bank, full line insurance, investment services, and property and casualty insurance industries, remained the portfolio's largest relative overweight position at quarter-end. As it relates to the banking industry, we believe loan growth for community banks will continue in the second half of 2022 in the annualized range of 8-12%. Further we believe that the narrower 2YR Treasury/ Fed Funds relationship will lead to a lower deposit beta in the second half of 2022. Increased loan portfolio yields and lower than anticipated deposit betas should bode well for community bank net interest margins, net interest income and thus earnings per share in the second half of 2022. While we remain overweight, Emerald has been selectively reducing exposure to the banking industry over the course of the second quarter.
- 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 specialty retail, recreational services, recreational products, restaurants, casinos and gambling, and auto parts industries among others. While the market has become increasingly concerned with the outlook for consumer spending given the step up in inflationary pressures and tightening financial conditions, we continue to believe the consumer in aggregate remains healthy, and continue to see select opportunities for those companies offering differentiated products and services the ability to gain

market share.

Market Outlook

The market remains in limbo, paralyzed by the persistence of inflation and the specter of recession. In this backdrop, while all of the broad equity market indices have succumbed to significant selling pressure, small capitalization stocks, to our dismay, have been standouts on the downside with the Russell 2000 (-29.50%) from the November 2021 peak through June 30, 2022. Declines of this magnitude have been largely associated with recessionary periods, with the average peak-to-trough decline around a recession approximating (-36%) since 1953, and approximately (-40%) since 1980, according to May 10, 2022 report from Jill Carey Hall, Equity & Quant Strategist at of B of A Securities. This implies the market has already embedded a high probability of a recession into the current valuation of the Russell 2000. The Russell 2000 forward P/E has declined by approximately 40% as compared to 33% on average around recessions over the last 25 years, and now on an absolute basis, according to July 11, 2022 from Jill Carey Hall, stands 24% below the long-term average, and approximates levels last seen at the lows of the Global Financial Crisis and below the COVID and 2001 recession lows. Relative valuations also look increasingly attractive with the Russell 2000 now trading at a historical discount to the Russell 1000 on all metrics (trailing P/E, Forward P/E, Price to Book, Price to Sales, P/E to Growth and EV/FCF). According to the same report, valuations today imply ~12% annualized returns over the next decade for the Russell 2000 vs. ~9% for the Russell 1000. In the near-term the outlook looks similarly attractive. Historically according to a July 6, 2022 report from Steve DeSanctis of Jefferies, when small capitalization stocks have traded in the 15th percentile on a relative basis, small capitalization stocks have outpaced large caps by 5.8% over the next year.

Notably, despite this valuation compression, earnings growth for small capitalization stocks have been relatively resilient to date. According to the same report cited above, 2022 small capitalization earnings growth is currently forecasted at approximately +14.8%, representing a slight downtick from the +15.4% expected at the end of May. This continues to compare favorably to large capitalization stocks which are expected to grow earnings by +11.0%, representing a slight uptick from the +10.9% expected at the end of May. While we acknowledge that negative earnings revisions are likely forthcoming as monetary policy tightens and economic growth decelerates, we continue to expect that small capitalization earnings will be less impacted than their larger capitalization peers. We believe this is especially true as we expect the U.S. economy will maintain a relative growth advantage compared to the global economy in aggregate in light of recent geopolitical events, the impact of China's zero-COVID policy on China's GDP growth and their implications to global growth. We believe the recent surge in the U.S. Dollar will only add further to the revenue and earnings headwinds from slowing growth abroad. According to a recent report from Jill Carey Hall of BofA Securities, only 20% of sales within the Russell 2000 are derived from overseas, which compares favorably to the approximate 28% exposure for the S&P 500. In addition, according to the same report, small capitalization stocks are more exposed to services over goods spending and in that way are more closely aligned to the US economy, which we expect will demonstrate relative resiliency.

So where do we go from here? With a significant amount of the multiple compression already behind us, Emerald believes there are multiple ways for small capitalization stocks to advance. First, while the probability of recession remains difficult to handicap, it is noteworthy that small capitalization stocks have historically appreciated during the recessionary periods prior to the Great Financial Crisis, and tend to outperform their larger capitalization peers in recession rebounds. According to a June 10, 2022 report from Lori Calvasina, Head of US Equity Strategy at RBC Capital Markets, in the periods exiting the last six recessions, the

Russell 2000 has outperformed the S&P 500 100% of the time, while the MSCI Global ex U.S. has outperformed only 25% of the time and the Dow Jones Industrial Average has outperformed only 17% of the time. Small capitalization stocks similarly did well on both a relative and absolute basis during the stagflationary period from 1974 to 1982, according to Jim Furey of Furey Research, with annualized real returns of in the low to mid-teens versus low-single digit returns for large capitalization stocks and the annualized inflation rate of 8.7%.

On the other hand, if the economy skirts recession, bear market recoveries have historically favored small capitalization stocks. According to a July 5th report from Jim Furey of Furey Research Partners, the average 6-month and 1-year forward absolute price change off a bear market bottom for the Russell 2000 has been approximately 39.5% and 59.4% respectively. On a relative basis, returns for the Russell 2000 outpaced to the S&P 500 by 1100 and 2600 bps respectively over those periods. Further with the mid-term elections rapidly approaching, we also thought that is was noteworthy that according to same report from Jim Furey, that average small capitalization returns following a mid-term election since 1960 have averaged approximately 25%.

While all of the aforementioned scenarios are supportive of a shift in market leadership to small capitalization stocks, we believe the market in aggregate is likely to remain rudderless until the corporate earnings outlook is believed to be representative of the highest probability economic outcome. In our opinion, the combination of Federal Reserve rhetoric, recent adjustments to monetary policy and market actions have collectively done much of the heavy lifting for the Federal Reserve. Economic growth is slowing, financial conditions are tightening, sentiment indicators have plummeted with the University Michigan Consumer Sentiment Index at a 70-year low and the NFIB Small Business Owners' Expectations Index at a 48-year low, longer-term inflation expectations have been falling and there are several signs that near-term inflation is poised to decelerate from the recent peak. That being said corporate earnings estimates are still considered broadly to be too high given all of the aforementioned headwinds. As a result, we believe the second quarter earnings reporting season could prove to be a meaningful gut check for the market, and provide all of the market participants with incremental clues to the forward direction of the economy. That being said, as earnings expectations are reevaluated and reset, and the path of inflation and monetary policy come more clearly into view, for all the reasons outlined above, Emerald believes that the stage is being set for a return to small capitalization equity outperformance.

Although risks to this outlook are numerous, we believe the pace and path of monetary policy and the structural challenges within the energy sector and the implications to inflation are likely the most meaningful risks to market returns in the near-term. All that being said, 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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