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Q3 2022 | ECONOMIC & PORTFOLIO COMMENTARY

EMERALD GROWTH OPPORTUNITIES

"The Gang That Couldn't Shoot Straight"

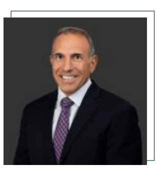
THE FEDERAL RESERVE STOLE THE SPOTLIGHT during the second quarter with actions that materially impacted the world's economies, currencies, interest rates and earnings. The same Fed that came under criticism for stridently resisting calls to drain liquidity from the system over a year ago, with inflation percolating, ramped up their hawkish rhetoric in spite of clear and convincing evidence of economic weakness materializing during the quarter. Equity markets sharply pulled back in September leading virtually all asset classes lower for the quarter (sans small cap growth), with the S&P 500 and small cap indices posting their third worst and worst starts on record, respectively, through the first three quarters of the year. In a reversal from the past several quarters, small cap performance beat mid and large on nascent mid-quarter signs of a Fed reversal and potential economic stabilization. As shown on the following Furey Research Partner's chart, correlations among asset classes in 2022 registered the highest in 40 years, making it very difficult to for active managers to earn a positive return in any asset class this year.

KEY POINTS:

- ***Emerald Growth Opportunities portfolio performance modestly trailed our Russell 3000 Growth benchmark for the quarter, but still maintains a performance lead year-to-date.***

- ***Portfolios benefited from our Dynamic Barbell strategy with Energy, Financial Services and Technology holdings outperforming, but saw weakness in the Materials, Consumer Discretionary, Healthcare and Industrial sectors.***

- ***We continue to like the setup of our portfolios being growthier than the benchmark, yet trading at a discount.***



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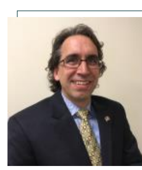

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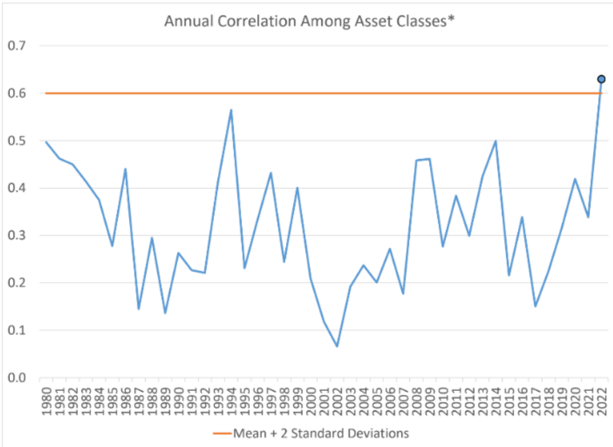
Fig. 4. **Correlations in 2022 are the highest in 40+ years**



Source: FRP, FactSet, Morningstar; as of 9/30/22
**Asset classes include U.S. Equity, Foreign Equity, U.S. Govt Bonds, U.S. Corp Bonds, U.S. HY Bonds, Commodities and REITs*

On the economic front, while employment indicators continued to suggest strength with 20+ straight months of job gains, most other indicators including the Leading Economic Index, GDP, New Homes Sales, Money Supply and ISM Manufacturing all pointed to significant economic weakness. Core and Real CPI and PCE figures also pointed to continued Fed tightening. Earnings estimates for the remainder of the year, while reasonably resilient, also started the invariable, and hopefully realistic, downward revision cycle accompanying dollar strength and economic weakness.

Beyond the abnormally high correlations shown above, valuation dispersions dropped during the quarter, but still are at elevated levels vs. historical averages. Growth beat value during the quarter, with lower ROE stocks and non-earners leading performance. Higher leverage names and not surprisingly, equities with lower foreign exposure, outperformed, as did names with higher revenue growth.

PORTFOLIO REVIEW

Emerald Growth Opportunities portfolio performance modestly trailed our Russell 3000 Growth benchmark for the quarter, but still maintains a performance lead year-to-date. Surging bond yields, persistent inflation and supply chain issues, and the aforementioned hawkish Fed, all served to drive multiples and market indices lower during the quarter. Portfolios benefited from our Dynamic Barbell strategy with Energy, Financial Services and Technology holdings outperforming, but saw weakness in the Materials, Consumer Discretionary, Healthcare and Industrial sectors.

Portfolios continue to be overweight Energy, Consumer Discretionary, Industrials and Utilities and we have been adding to Healthcare since early in the quarter, while reducing Consumer Discretionary exposure. We remain underweight Technology, Consumer Staples and Real Estate. As has been the case for many quarters, Emerald's portfolios were materially smaller than the benchmark with a weighted average market cap of $538.5B vs $664.7B for the Russell 3000 Growth index. True to our growth style, portfolios have a higher estimated 3-year EPS growth rate of 19.88% vs. 16.8% for the index. As has also been the case for many years – not by our design – portfolios trade at a discounted multiple vs. the index on virtually all valuation statistics – Price/Earnings, Price/Cash flow, Price/Book and Price/Sales. We continue to like the setup of our portfolios being growthier than the benchmark, yet trading at a discount.

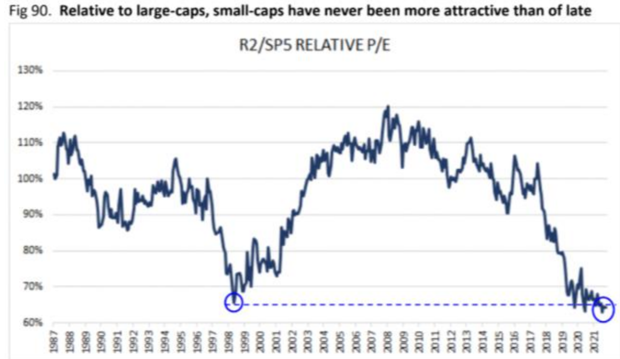
MARKET OUTLOOK

Clearly third quarter and full year 2022 equity market performance has been challenging for both passive and active investors. It's certainly been hard to add substantial alpha in such a macro driven environment, with BofA Securities noting that 60/40 stock/bond portfolios are having their worst year since 1920. Unfortunately, we don't expect the Fed/Macro influences to subside anytime soon. We actually expect some more volatility when factoring in Q3 and Q4 earnings, which have just recently seen substantial consensus estimate changes. This does not mean we are negative on the markets – quite the contrary - from a technical and fundamental perspective we are becoming more and more bullish on the market, especially for small caps. We believe wholeheartedly that the Fed should pause in its historic liquidity draining policy in the next few months either because the data leads them to conclude that expected inflation in the form of 5-year, 5-year Forward Inflations Expectations is moving quickly to their 2% target (2.15% presently); or something in the mechanics of financial systems breaks forcing the Fed to pause or reverse course. We certainly hope it is not the latter as that would be negative for financial markets worldwide, as an old quote goes "When central banks slam on the brakes something goes through the windshield."

It's a tale of two markets presently: employment seems to be staying quite strong as employers are loathe to lose employees given the tightness of the market, although job openings are dropping dramatically, and average hourly earnings growth is moderating; yet most other segments of the economy are exhibiting meaningful degrees of stress led by rate sensitive sectors such as housing. Consumer and CEO confidence and sentiment are at recessionary levels and market technicals are nearing multi-decade lows. Unfortunately, the stronger the labor market stays, the more resolve the Fed has to keep raising rates, regardless of the impact their tightening has on other aspects of the economy, and just as importantly, other developed and emerging markets.

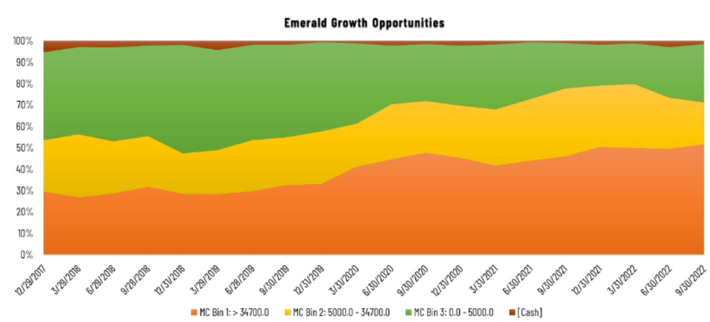
At Emerald our mantra is that earnings growth drives stock prices. Earnings estimates for most major indices have recently started to fall based in large part on U.S. Dollar strength, fears of inflation and interest rate increases. For Q322, B of A Securities estimates earnings to grow yoy 3.7% for S&P 500 companies, with estimates falling a larger than normal 7% since July 1. Something that most investors do not realize is that excluding Energy, Q322 earnings growth is actually expected to be -(2.8%) yoy, as Energy is expected to grow earnings at over 120% - no surprise we are materially overweight Energy. Another factor most investors fail to grasp is that according to Jefferies Steven DeSanctis, small cap growth earnings are expected to significantly outgrow large caps 16.5% vs. 2.8% in 2022 (again with most if not all of the earnings growth coming from Energy names). As a style, small cap growth, according to JP Morgan Asset Management, trades at a 33% discount to its 20-year average P/E valuation. Beyond projected earnings growth rates, according to Furey Research Partners, valuations for small caps relative to large-caps have never been more attractive and small caps tend to outperform in periods where inflation is high and falling – both conditions that are likely to prevail in 2023. Speaking of 2023, there is little doubt that Factset estimates of 7.9% earnings growth will have to be lowered to account for the appreciating dollar and forthcoming economic slowdown.

Fig 90. **Relative to large-caps, small-caps have never been more attractive than of late**



Source: Furey Research Partners and FactSet. Data as of 9/30/22. Represents median P/E using latest available trailing 12-month earnings. Profitable companies only.

Not to belabor the point, but small cap valuations are at extreme levels with B of A Securities' Jill Carey Hall noting that small cap forward P/Es are pricing in an ISM Manufacturing index of 30 consistent with the index's record low readings seen in 1974 and 1980 recessions. Not surprisingly, Emerald portfolios are biased towards small caps with a meaningfully lower weighted average market cap than our benchmark and increased weighting in small cap names through most of this year as shown in the following Growth Opportunities Fund market cap chart from FYE 2017 thru 9/30/2022.



Beyond small caps and Energy, our Dynamic Barbell has been pointing for us to maintain our overweight to cyclicals, given supportive growth rates and earnings and sales estimates for secular names are still falling faster than cyclicals. We like Healthcare here given its relative immunity to inflation and economic weakness, our expectations of M&A picking up, and a more favorable regulatory environment. We have added to some names with foreign exposure, as China lockdowns have to end at some point and we see some government stimulus in that country. For these names to work, the U.S. Dollar has to plateau, and it's anyone's guess when that happens. We also think that Financials should start to catch a bid at some point as higher rates benefit banks materially and this sector will move the most when the Fed does take their foot off the gas.

"THROUGH ALL OF THIS TURMOIL, WE BELIEVE EMERALD'S TIME-TESTED DYNAMIC BARBELL APPROACH TO MULTI/LARGE-CAP ACTIVE MANAGEMENT HAS SHOWN ITS METTLE BY ALLOWING US TO DEFTLY AND FLEXIBLY MOVE IN AND OUT OF SEGMENTS OF THE MARKET WITH THE GREATEST EXPECTED GROWTH IN MOST MARKETENVIRONMENTS."

The returns of virtually every asset class in virtually every geography depend on the Fed's actions to battle inflation – a battle they started too late and that could result in curing the disease (inflation) by killing the patient (the economy). The US economy at present is actually doing reasonably well all things considered. We subscribe to economist Ed Yardeni's thesis that instead of a true hard landing, the economy is presently in a series of "rolling recessions" hitting different industries at different times. Currently, the rolling recession is running through the single family housing industry, as well as various elements of retail, and we are seeing signs in the auto industry as well. Yardeni who actually titled a chapter in a book on the Fed, "Jerome Powell: Pragmatic Pivoter" sees the Fed's actions raising the risks of a another serious financial crisis, arguing the Fed should pause to assess the global impact of the 300 basis point increase in rates since March.

Through all of this turmoil, we believe Emerald's time-tested Dynamic Barbell approach to multi/large-cap active management has shown its mettle by allowing us to deftly and flexibly move in and out of segments of the market with the greatest expected growth in most market environments. Given the aforementioned rolling recession scenario, Emerald's Dynamic Barbell approach is even more vital in terms of guiding us to areas of the economy that should still experience growth (either secular or cyclical) versus those more impacted by a recessionary environment. We believe our fundamental, bottom-up research model – honed over our company's more than 30-year history – should give our investors the best opportunity for outperformance.

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