EMERALD DIVERSIFIED SMALL CAP GROWTH

WENT FROM BAD TO WORSE

THE SUMMER RALLY TO START THE THIRD QUARTER FIZZLED AT THE END OF AUGUST, as hopes of a Federal Reserve pivot and prospects for a soft landing were dashed as the Federal Reserve doubled down on its "keep at it" mantra to tame inflation. Volatility across the global fixed income, currency and equity markets surged with market jarring dislocations within the U.K Gilt market and rising speculation on the health of Credit Suisse. The US Dollar continued to build on its year-to-date gains surging (+7.0%) in the quarter, reaching a new multi-decade highs versus a broad swath of currencies. The U.S. 10-year Treasury yield breached 4% intra-month, driving a significant sell-off in long-term treasury bonds, which fell (-8.0%) in September and (-9.95%) for the third quarter. As treasury yields surged, equity markets swooned with the S&P 500 falling (-9.2%) in September, and (-4.9%) for the quarter, representing the worst third quarter for that index since 2015.

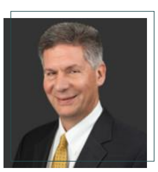
The Russell 2000 similarly succumbed to selling pressure, but notably, despite the surge in treasury yields and historic strength in the US Dollar, small capitalization stocks held their own on a relative basis in the face of the broad-

KEY POINTS:

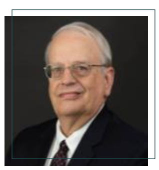
- ***The Russell 2000 (-2.19%) outpaced the Russell 1000 (-4.61%) ending a five quarter streak of relative underperformance. Even more noteworthy, was the relative outperformance within the growth component of the Russell 2000.***

- ***Although small capitalization stocks did underperform their large capitalization counterparts during the month of September at the height of market anxiety, we believe the underlying small capitalization benchmark internals are showing some encouraging signs.***

- ***From a portfolio positioning perspective, entering the fourth quarter of 2022, the portfolio held the largest active exposures in the healthcare, financial services and consumer discretionary sectors.***



JOSEPH W. GARNER
PORTFOLIO MANAGER & DIRECTOR OF RESEARCH



KENNETH G. MERTZ II, CFA
PORTFOLIO MANAGER, PRESIDENT & CIO

STACEY L. SEARS
PORTFOLIO MANAGER & SENIOR VICE PRESIDENT

based market turmoil. The Russell 2000 (-2.19%) outpaced the Russell 1000 (-4.61%) ending a five quarter streak of relative underperformance. Even more noteworthy, was the relative outperformance within the growth component of the Russell 2000. Not only did the Russell 2000 Growth Index (+0.24%) outperform the Russell 2000 Value (-4.61%), the Index also substantially outpaced its larger cap peer, the Russell 1000 Growth (-3.60%). Although small capitalization stocks did underperform their large capitalization counterparts during the month of September at the height of market anxiety, we believe the underlying small capitalization benchmark internals are showing some encouraging signs. Specifically, the relative strength in the healthcare sector is noteworthy given the sector's challenging performance since February of 2021, as is the relative outperformance of the top quintile of companies measured by sales growth and non-earning cohorts, which represents a significant departure from the value style leadership that has been firmly entrenched since the fourth quarter of 2020. While one quarter does not make a trend, the relative outperformance of both the Russell 2000 and specifically the Russell 2000 Growth during the third quarter is worth highlighting.

PORTFOLIO REVIEW

Market volatility for all of these reasons outlined above has been extreme. According to an October 3, 2022 report from the team at Furey Research Partners, the Russell 2000 has experienced +/-1% movements in the value of the index on 63% of the trading days this year. In the history of the Russell 2000 Index, back to 1979, the index has only experienced greater volatility during the Great Financial Crisis in 2008. Given this nearly unprecedented level of macroeconomic driven market volatility, equity market pairwise correlations have surged, creating a challenging backdrop for active managers and alpha generation.

The Emerald Diversified Small Cap Growth portfolio finished the quarter essentially flat with the Russell 2000 Growth benchmark, as challenging July performance was offset by improved relative performance during the subsequent two months of the quarter. At the sector level, stock selection driven relative outperformance within the technology and financial sectors offset relative underperformance within the healthcare, energy, and telecommunications sectors.

The technology sector was the largest positive contributor to return for the quarter driven by stock selection within the computer hardware and semiconductor industries.

Stock selection also drove relative outperformance within the financial services sector. The most noteworthy contributor to return were holdings within the property and casualty industry.

Neutralizing the tailwinds to performance outlined above was stock selection driven relative underperformance within the healthcare and energy sectors. Although three of the Emerald Small Cap Growth portfolios' top ten contributors to return for the period were healthcare holdings, the healthcare sector in aggregate was the largest detractor to return for the quarter. The relative underperformance to the benchmark was a result of stock selection related challenges within the biotechnology and pharmaceutical industries.

Relative performance within the energy sector also proved challenging due to a combination of allocation effect and stock selection. The portfolio was underweight the renewable energy equipment and oil: crude producer industries, which were sources of outsized gains within the sector given the fervor surrounding the U.S. Inflation Reduction Act (IRA). Conversely, the portfolio's overweight and stock selection to the oil equipment and services industries detracted from performance as holdings in the industry bore the brunt of the downward pressure on energy related equities stemming from the -24.8% decline in WTI crude prices during the quarter. Going forward we are very constructive on oil and natural gas prices as the physical markets, especially for crude, which are likely to remain tight as OPEC cuts its production quota, the strategic petroleum reserve releases trail off, and the Russian sanctions reduce oil and natural gas supply to Europe and Asia.

From a portfolio positioning perspective, entering the fourth 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 nominal weights within the medical equipment, biotechnology and pharmaceuticals industries, with the largest relative overweight positions falling within the medical equipment and pharmaceutical industries. Emerald remains 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.

- The portfolio also ended the quarter with an overweight position to the financial services sector, comprised of holdings within the bank, full line insurance, investment services, and property and casualty insurance industries. We maintain a positive bias to the regional and community banks as we expect core net interest income to grow by more than 20% year-over-year every quarter through the first half of 2023. Emerald invests in community and regional asset sensitive banks. These banks have a focus on commercial loans and maintain a small branch footprint. We believe this subset of the banking industry will benefit more than the bank universe in general as their net interest margins should outpace the average for the industry as they will benefit to a greater degree from the rising rate environment and higher loan yields, loan growth greater than 8% and rational deposit pricing. However, all eyes will be on deposit levels and deposit betas, as well as Accumulated Other Comprehensive Income (AOCI), which reflects the impact of bond losses held in a bank's securities portfolio. We believe the collective impact of these factors will heavily influence relative stock performance. While we believe there will be credit deterioration amongst the financial technology stocks in the subprime retail lending space, we do not anticipate credit deterioration among the regional and community banks over the next twelve months.

- 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 Federal Reserve has now raised rates by 300 bps in the last seven months, and at the same time adjusted the Central Tendency within the Federal Reserve's summary of economic projections for the 2023 Federal Funds rate to a range of 4.4% to 4.9%. This level now stands substantially above the 1.4% to 1.9% range anticipated by the Federal Reserve in the December 15, 2021 summary of economic projections. With each successive rate hike, the pathway to a soft landing domestically has been narrowing, at the same time dislocations within the global economies and other asset classes have become more pronounced. The U.S. Dollar has surged to decade highs relative to the Pound, Euro, Yuan and Yen causing foreign governments to intervene to stabilize their currencies. Volatility in the bond market has surged across the globe, forcing the Bank of England to step in and buy Gilts to stabilize the U.K's domestic bond market after a wave of margin calls sent the U.K. bond market reeling. Two wrongs do not make a right, and these sizeable dislocations in the currency and bond markets globally may be foretelling of a Federal Reserve that may have developed tunnel vision in its pursuit of price stability and 2% inflation.

The global economy is decelerating, at the same time the strength in the U.S. Dollar is accentuating the inflationary pressures that central banks across the globe are working to defend against, creating unprecedented challenges abroad. Domestically, good news has become bad news, as persistent strength in employment and consumer spending adds fuel to the Federal Reserve's resolve to push the terminal rate higher. With the Federal Reserve in the driver's seat, idiosyncratic stock specific behavior has taken a backseat to macroeconomic factors, with even good earnings reports and guidance being doubted as the rising risk of recession looms large. Bearish sentiment is pervasive in the investment community and the corporate suite, with CEO confidence measures tanking over the course of this year.

New market leadership however can be born out of bear markets and as we sift through the market carnage and pervasive negative sentiment, the outperformance of small capitalization stocks and growth as a style are noteworthy standouts in this backdrop. This was the first quarter in the last five quarters that the Russell 2000 has outperformed the Russell 1000. That was the longest streak of underperformance for the Russell 2000 since in the six-quarter run that ended in the first quarter of 1999, according to Furey Research. On the later, the relative outperformance of growth as a style is also notable, as the performance of Growth versus Value has been nearly perfectly correlated to the 10-year real rates since 2018 (approximately 92% until August 2022), according to an October 3, 2022 report from Savita Subramanian of B of A Securities. That nearly four-year relationship decoupled during the third quarter, as growth stocks outperformed across the capitalization spectrum. Given the significant relative outperformance of the value style across the market over the trailing periods, this decoupling in the hardest hit area of the market in the midst of heightened volatility and market turmoil is similarly noteworthy.

The Russell 2000 has lagged the Russell 1000 by more than 600 bps over the trailing one-year, more than 500 bps annualized over the trailing 5-year period, and by approximately 300 bps annualized over the trailing 10-year period ended September 30, 2022. As a result of this underperformance, small capitalization stocks today represent less than 4% of the US equity market, a level not witnessed since the 1930's, outside of the brief March 2020 COVID related market sell-off, according to a recent report from Steve DeSanctis of Jefferies. From a valuation perspective, relative to the S&P 500, according to Furey Research, there has been no other time in history that the Russell 2000 has been as attractive relative to large-caps. The Russell 2000 forward P/E is currently at 10.8x, the lowest since 1990 and 30% below its long-term average since 1985, according to an October 7, 2022 report from Jill Carey Hall, Equity and Quant Strategist at B of A Securities. Conversely, large capitalization stocks remain the most expensive size segment, trading in-line with the long-term average (since 1985). Further, according to the same report, the relative forward P/E of the Russell 2000 vs. Russell 1000 held at 0.71x, a 30% discount to its average of 1.01x. Notably, this is the lowest this ratio has been since the Tech Bubble. Further, based on the current valuation dispersion and looking longer-term, as this metric which has historically been more predictive over a ten-year horizon than near term implies approximately 13% annualized returns over the next decade for the Russell 2000 as compared to approximately 10% for the Russell 1000, according to Jill Carey Hall.

Despite the substantial multiple compression already reflected in current valuations, the debate on where corporate earnings will base rages on. In that regard, the recent analysis of the correlation of the Russell 2000 forward P/E to the Institute of Supply Management Manufacturing Purchasing Managers Index (ISM) referenced in the same report from Jill Carey Hall provides some perspective. Since 1985, the Russell 2000 forward P/E has had a 0.37 correlation with the ISM, and today's multiple at approximately 11x is pricing in an ISM of approximately 30 which is consistent with the record low readings posted in the 1974 and 1980 recessions. For reference, according to the same report, the average US manufacturing PMI has troughed around 39 during the last four recessions. If this correlation holds, small capitalization stocks appear to be already factoring in a deeper than average recession.

SMALL CAPITALIZATION STOCKS ARE INHERENTLY LESS EXPOSED TO INTERNATIONAL MARKETS AND WITH THE PERSISTENT STRENGTH IN THE U.S. DOLLAR, AND NOTEWORTHY ECONOMIC PRESSURES IN BOTH EUROPE AND CHINA, WE CONTINUE TO BELIEVE THAT SMALL CAPITALIZATION STOCKS REMAIN RELATIVELY BETTER POSITIONED.

Therefore, while we acknowledge that slowing economic growth will translate to slower earnings growth we remain firm in our belief that small capitalization earnings should demonstrate a relative resiliency versus their large capitalization peers. Small capitalization stocks are inherently less exposed to international markets and with the persistent strength in the U.S., Dollar, and noteworthy economic pressures in both Europe and China, we continue to believe that small capitalization stocks remain relatively better positioned. In this regard, during the course of the third quarter, within the Russell 2000 Growth benchmark, those companies with foreign sales representing 20% or less of total revenue outperformed the index by 271 bps for the period, according to an October 3, 2022 report from Steve DeSanctis, Equity Strategist at Jefferies.

While the path of corporate earnings will serve as the ultimate arbiter of equity valuations, in the near term the Federal Reserve remains in the driver seat and the path and pace of monetary tightening remains the predominant driver of market direction. As a result, we expect market volatility to remain elevated as the market assessment of the distribution of outcomes for both the path of interest rates and the implications to economic growth evolve. Consequently, as has been the case year-to-date we believe the rolling shifts in sentiment surrounding the path of rate hikes will continue to have an outsized impact on the direction of the equity market and risk assets. That being said, in the near-term seasonality has moved in the favor of improved equity returns. According to Savita Subramanian of B of A Securities, the fourth quarter has seasonally been the strongest quarter (+4.5% on average positive 81% of the time), this is particularly true in midterm years (+7.7% on average, with an 86% positive hit rate). The months of November and December in particular tend to be the seasonally strongest period of the year for small caps both on an absolute basis and relative to large capitalization peers.

Emerald, as always, remains vigilant and focused on utilizing our fundamental bottom up research process to identify the most attractive growth opportunities within the small capitalization universe.

CONTACT US

Emerald Advisers, LLC

Phone: 1-800-722-4123
info@teamemerald.com

3175 Oregon Pike | Leola, PA 17540
King of Prussia, PA | Pittsburgh, PA | Cleveland, OH

TO LEARN MORE ABOUT EMERALD OR TO SCHEDULE A CALL WITH OUR TEAM, VISIT:

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