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EMERALD GROWTH OPPORTUNITIES

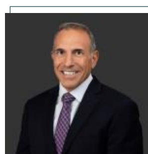
"Emerald's View: When Good News Is Bad News – Small Caps Poised to Outperform"

EMERALD GROWTH OPPORTUNITIES portfolios experienced a rough end to 2022, as our smaller, growthier positioning vs. our benchmark detracted from performance, as did idiosyncratic driven weakness in several of our higher growth small- and mid-cap names. For the year, portfolios modestly trailed our Russell 3000 Growth benchmark, despite a strong start to the year. Continued Fed induced risk off trading resulted in a massive 31% P/E contraction in the Russell 1000 Growth index for the year, with Value stocks beating Growth stocks by over 20 percentage points. The Fed's unprecedented liquidity draining, inflation fighting actions, as exemplified by the Fed Funds rate rising from 0.1% to 4.4%, drove investors towards defensive and lower price/slower growth equities as the year progressed. Smaller, small cap stocks –Emerald's bread and butter – materially underperformed given extremely poor liquidity detracting from our returns. Large cap growth stocks – an area of emphasis for us also given our Dynamic Barbell strategy – also underperformed materially.

Our second half underperformance is not surprising given the Growth Opportunities strategy's investment philosophy of seeking out innovative and

KEY POINTS:

- ***Emerald Growth Opportunities portfolios experienced a rough end to 2022, as our smaller, growthier positioning vs. our benchmark detracted from performance, as did idiosyncratic driven weakness in several of our higher growth small- and mid-cap names.***
- ***In terms of positioning, portfolios continue to overweight Energy, Materials, Consumer Discretionary, Utilities and Healthcare, underweight Staples, Financials, Real Estate and Technology and approximately equal weight Industrials.***
- ***Emerald's Growth Opportunities strategy - anchored by our Dynamic Barbell approach to portfolio construction - will continue to identify high growth, innovative and disruptive companies with strong management teams and competitive positioning and pricing power.***



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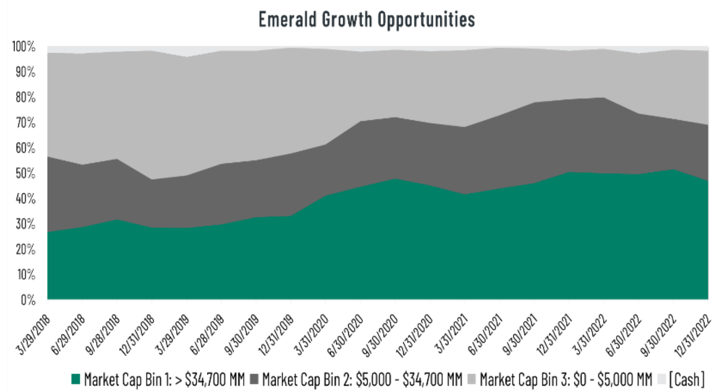
disruptive companies and technologies – particularly through investment in selected small and micro-cap names, offset by ownership in some of the largest, fastest growing names in the domestic equity universe. In fact, we find our modest year-to-date underperformance vs. the index rather benign, given that other innovation/disruption-oriented strategies were typically off 60-70% for the year. Our innovation and growth biases drive us away from slower growth Consumer Staples like the large soft drink companies, and while we did have exposure to what we perceived as more defensive Industrial and Consumer names, many of our holdings, as noted above, were smaller cap names that experienced significant underperformance.

4th Quarter economic statistics were generally negative, bolstering the market's doom and gloom attitude, with November's Leading Economic Index down for 9 months in a row, weak housing, and retail sales data, and deteriorating ISM Manufacturing, Non-Manufacturing, and industrial production indicators. The bright spots for the economy continued to be growth in nonfarm employment and very low unemployment claims data, all leading to a continuing decline in the civilian unemployment rate to a decades-low 3.5%. Importantly, inflation, as measured by both CPI and PCE (core and non-core) continued to decline, particularly for energy and selected goods. Money supply, an important predictor of future growth, continued to drop, with M2 year-over-year growth grinding to a halt in November.

PORTFOLIO REVIEW

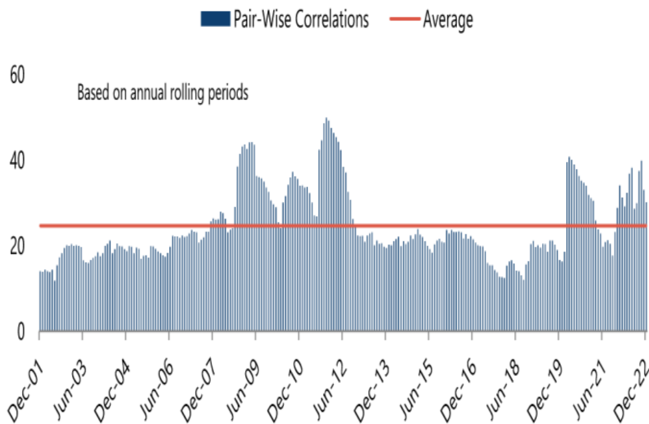
The Emerald Growth Opportunities portfolios and the associated fund portfolio had a change in portfolio management in the quarter as Associate Portfolio Manager Joe Hovorka left to join a registered investment adviser as CIO. We wish Joe well, and expect to continue to work with him given his new role. Longtime Senior Analyst and Associate Portfolio Manager Stephen Amsterdam has been promoted to Portfolio Manager and he and Deputy CIO and Portfolio Manager David Volpe, CFA will continue to manage portfolios as a team as they have for the past 9 years.

As noted above, Emerald Growth Opportunities portfolios underperformed in the 4th quarter because of our smaller, growthier positioning vs. the benchmark. As the following chart shows, we have added to our small cap exposure consistently throughout 2022 as a result of that asset class's superior growth, and valuation characteristics, along with many other positive attributes.



As further evidence of this small cap bias, we now have 9 names in the portfolio with market caps of less than $1 billion and an additional 11 names with market caps below $2 billion. While small caps actually outperformed in the 3rd and 4th quarter, our portfolios, as shown above, were tilted more towards smaller, small cap equities which were most impacted by the Fed's liquidity draining actions. Liquidity in these names dried up, the result being far more selling than buying, with the added negative of a particularly brutal tax-loss selling season. While this hurt Q4 and overall 2022 performance, we believe the setup is extremely strong for small cap names in 2023 with individual price targets in many cases 50-100% above current prices.

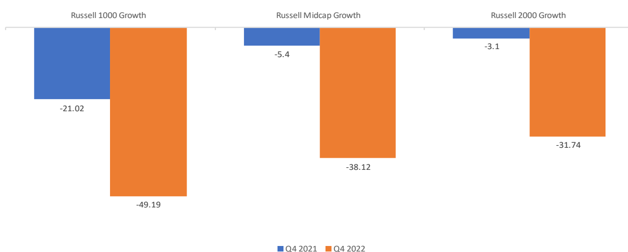
Another factor impacting performance was a spike in pair-wise stock correlations in the latter half of 2022 as shown in the following chart from Jefferies' Steve DeSanctis. While not a perfect relationship, as a fundamental, bottom-up managers, we will oftentimes struggle when macro driven factors drive up correlations – and this is exactly what occurred in the past five months.



Source: Jefferies

Beyond being positioned smaller than the benchmark, with a Weighted Average Market Cap of $470 BN vs. $570 BN for our Russell 3000 Growth index, the expected 3-5-year EPS growth rate of portfolio holdings actually increased for last quarter with an expected EPS growth rate of 20.41% vs, 15 .1% for the index. This higher growth positioning detracted from performance as the best sales growth names experienced the worst equity performance for both the 4th quarter and the year, with, interestingly, the fastest large cap growth names lagging the fastest small cap growth names for the first time in many years. Unfortunately, portfolios had significant exposure to both the largest and smallest growth names which were among the worst performers for both the quarter and the year.

Stock Performance by Sales Growth (Top Quartile)



Source: FactSet, FTSE Russell, Jefferies

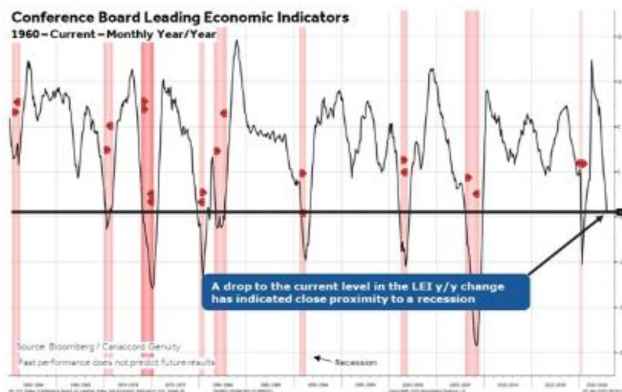
Portfolios continue to trade at a discount to the index on most valuation metric such as Price/Earnings, Price/Sales, Price/Cashflow and Price/Book, which when considering our higher expected EPS growth rates gives us some confidence that this mismatch will correct in time.

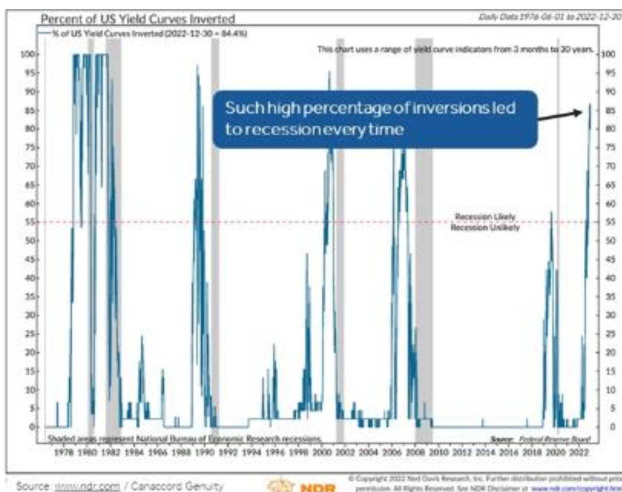
In terms of positioning, portfolios continue to overweight Energy, Materials, Consumer Discretionary, Utilities and Healthcare, underweight Staples, Financials, Real Estate and Technology and approximately equal weight Industrials. Our overweight to Energy and Materials is both valuation and earnings related and based on a weakening dollar, improving global economies, a large supply/demand mismatch, lack of investment and of course the impact on Russian crude and product exports.

MARKET OUTLOOK

This is a tough outlook to write because there is such divergence of opinion on the economy, Fed, interest rates, recession, corporate profits, etc. 2022 will be long remembered as a year driven by macro-driven factors such as unprecedented Fed rate increases, surging inflation, the war in Ukraine, election uncertainty, a pandemic and supply chain issues just to name a few. Through all this the Fed has pressed ahead in its inflation fight with the terminal rate moving up to 5.1% according to the FOMC December Summary of Economic Projections and the effective Federal Funds rate, adjusted for the impact of quantitative tightening, yielding 6.42%, up 700 basis points from just 18 months earlier. Fortunately, our belief is that many of these macro issues are abating and/or already more than fully priced into the market setting the stage for selected companies to outperform – particularly small cap companies that have been forced to become very good at managing their businesses -. Inflation is clearly cooling, and wage pressures seem to be abating, likely allowing for a Fed rate pause with no official NBER-declared recession at least through mid-year 2023. China's zero-Covid policy is being rolled back and energy prices have declined materially with European Natural Gas prices dropping 60% from their highs. These factors should serve to reduce high pair-wise correlations – the bane of active managers – in 2023 allowing a chance of strong performance.

This does not mean that a more protracted employment and profit driven recession is fully baked in. It is not. And the data that has been released early in the quarter is not encouraging, with continued weak industrial production, retail sales and producer prices. It's likely just a matter of time before employment growth slows to a halt and unemployment claims start to increase. The following two charts from Canaccord Genuity show that economic and interest rate data are pointing to a recession with Leading Economic Indicators and Yield Curve Inversion clearly presaging recessionary conditions.





Recession expectations will continue to force analysts to cut 2023 earnings estimates through the first half of 2023, but at some point, analysts will become too aggressive in their negative revisions allowing actual earnings to come in better-than-expected, setting the stage for an equity rally.

> **…WE THINK THE SET UP FOR SOME OF OUR PORTFOLIO'S MICRO AND SMALL-CAP NAMES IS EXTREMELY STRONG WITH INTERNAL PRICE TARGETS IN SOME CASES 50-100% ABOVE CURRENT PRICES.**

We think the Fed pause, along with lower real yields should result in a cyclical growth/small cap driven market rally at least through the first half of the year. Cyclical growers led by Energy and Materials and Consumer Discretionary equities, which continue to trade close to valuation lows with earnings holding up quite well, should lead in this environment. Small caps which have underperformed large caps for six straight years and trade at historic absolute and relative valuation discounts vs. large caps are already pricing in material negative reductions to earnings growth – earnings revisions that are just starting to show up for large caps. As we noted earlier, we think the set up for some of our portfolio's micro and small-cap names is extremely strong with internal price targets in some cases 50-100% above current prices. Companies with pricing power, a key determinant for portfolio inclusion, should outperform despite cooling inflationary pressures. Secular growers will continue to lag as valuations still tend to be expensive with falling 2023 earnings estimates. Bond proxies, after a strong 2022 will also lag as they are starting to trade at valuation extremes, especially given cooling inflation and falling real yields.

Through all this Emerald's Growth Opportunities strategy - anchored by our Dynamic Barbell approach to portfolio construction - will continue to identify high growth, innovative and disruptive companies with strong management teams and competitive positioning and pricing power. This strategy which pairs equities based on market cap, growth attributes, geography, cashflow, yield, catalysts and many other factors allows us pivot and bias our investments to those attributes

that should yield stronger returns depending on the macro environment. Sometimes this process takes some time to play out, but we believe that over time we have demonstrated the process works and should yield favorable results.

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