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EMERALD MID CAP GROWTH

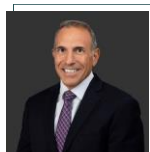
"Tough Quarter, But Strong Annual Performance"

EMERALD MID CAP GROWTH 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 Industrial and Financial mid-cap names. For the year, portfolios outperformed our Russell Mid Cap Growth benchmark with particular strength in Energy, Consumer Discretionary and Healthcare stocks. Our 2022 performance was particularly gratifying, when, according to Jefferies', only 32.1% of Mid Cap Growth managers beat the benchmark for the year.

Continued Fed-induced risk-off trading resulted in a massive P/E contraction in the Russell Mid Cap Growth index, with JP Morgan noting the index's current P/E vs. its 20-year average P/E dropped 60% from the beginning of the year through year end 2022. Mid cap value stocks beat growth by a whopping 14.7 percentage points in 2022. 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. Lower valuation stocks outperformed higher valuation names by over 14% for the quarter and 30% for the year; while high growth

KEY POINTS:

- ***For the year, portfolios outperformed our Russell Mid Cap Growth benchmark with particular strength in Energy, Consumer Discretionary and Healthcare stocks.***
- ***Portfolios benefited from strength in several of our Healthcare names, as well as our overweight to that sector, along with overweighting Energy and Consumer Discretionary.***
- ***Portfolios continue to trade at a discount to the index on most valuation metric such as Price/Earnings, 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.***



DAVID A. VOLPE, CFA
PORTFOLIO MANAGER & DEPUTY CIO

STEPHEN L. AMSTERDAM
PORTFOLIO MANAGER & SENIOR RESEARCH ANALYST

names underperformed by almost 21% for the fourth quarter. As a true mid cap growth manager, this massive underperformance by higher growth names in the quarter materially detracted from performance.

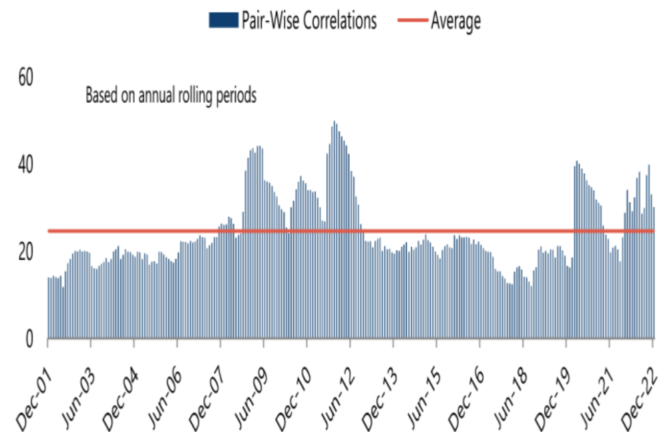
4th Quarter economic statistics were generally negative, bolstering the market's doom and gloom attitude, with the November Leading Economic Index down for the 9th month in a row, weak housing, and retail sales data, and deteriorating ISM Manufacturing, Non-Manufacturing, and industrial production indicators. 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

Emerald Mid Cap Growth portfolios 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 Mid Cap Growth portfolios underperformed in the 4th quarter primarily because of our smaller, growthier positioning vs. the benchmark. Portfolios benefited from strength in several of our Healthcare names, as well as our overweight to that sector, along with overweighting Energy and Consumer Discretionary. Our ownership of two high growth banks in the Financial Services sector detracted from performance, as did holdings in two higher growth industrials names. Technology results in Semiconductors and Software also detracted from performance.

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 manager, 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 $19.8 BN vs. $23.9 BN for our Russell Mid Cap Growth index, the expected 3-5-year EPS growth rate of portfolio holdings actually increased for last quarter with an expected growth rate of 20.63% vs. 18.24% 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 the best sales growth quartile according to Jefferies down (-5.4)% for the quarter vs. a gain of +15.42% for the worst sales growth quartile. As noted above, our higher sales growth positioning hurt performance despite portfolios being meaningfully underweight high growth, high valuation names in the Technology sector.

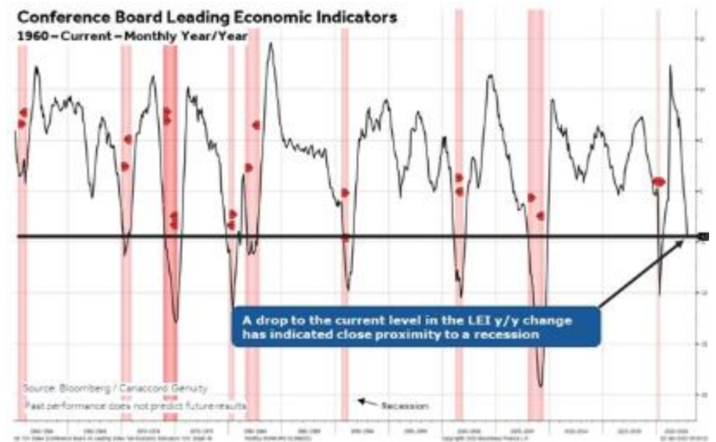
Portfolios continue to trade at a discount to the index on most valuation metric such as Price/Earnings, Price/Cashflow and Price/Book, which when considering our higher expected EPS growth rates, gives us some confidence that this mismatch will correct in time.

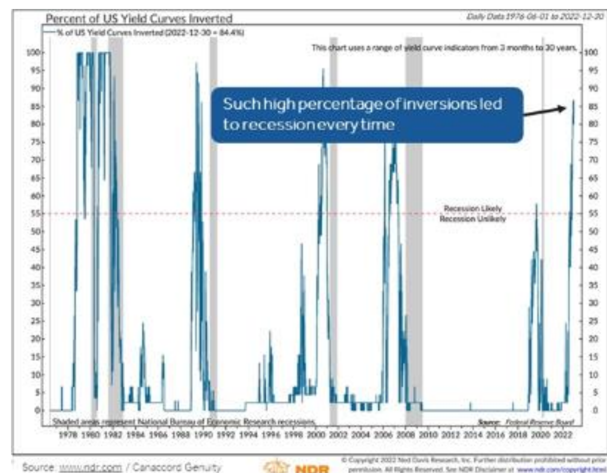
In terms of positioning, portfolios continue to overweight Energy, Consumer Discretionary, and Healthcare, and underweight Staples, Financials, Industrials and Technology. Our overweight to Energy is both valuation and earnings related and based on a weakening dollar, improving global economies, a large supply/demand mismatch, lack of investment, and of course the impact on Russian crude and product exports. Tactically, we have been carrying a larger than normal allocation to cash (while staying within our mandated range) in the past two quarters, and we would expect to deploy much of that cash in the first quarter of the new year.

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 and mid-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 investor to shift expectations towards a future beat and rising earnings picture setting the

stage for an equity rally. When exactly this happens is anyone's guess, but expect strong returns if history is any guide.

> **...SELECED MID-CAP NAMES, PARTICULARLY THOSE COMPANIES WITH PRICING POWER, A KEY DETERMINANT FOR PORTFOLIO INCLUSION, SHOULD OUTPERFORM DESPITE COOLING INFLATIONARY PRESSURES.**

We think the Fed pause, along with lower real yields should result in a cyclical growth mid-cap equity 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. In our opinion, selected mid-cap names, particularly those companies with pricing power, a key determinant for portfolio inclusion, should outperform despite cooling inflationary pressures. Most 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. Companies with strong and/or improving balance sheets – including select secular growers should also thrive in this environment.

Emerald mid-cap growth portfolios have achieved three straight years of outperformance versus their benchmark index for periods ended December 31, 2022 by focusing on mid-cap companies with strong revenue and earnings growth, exemplary management teams, strong competitive positioning, and positive pricing power and/or market differentiation. After a tough fourth quarter of 2022, we like the portfolios' set-up for this year with our overweight positioning in Energy, given our positive supply/demand expectations for commodities and services, and our overweight to several mispriced Consumer Discretionary names that are less impacted by recessionary factors than the market believes. We also like our Healthcare positioning given our expectation that 2023 will see more M&A in that sector. Lastly, while we are modestly underweight Technology given the index's high percentage of low/no profitability high growth, high valuation companies, we do maintain significant exposure to a number of "beaten-up" Tech companies that should benefit from expectations of lower rates and economic stability. We expect 2023, like 2022, to be volatile, which is the prime reason we have been carrying a greater percentage of cash than normal. We would expect to deploy this cash on any weakness early in the year.

Emerald, as always, remains vigilant and focused on utilizing our fundamental, bottom-up research process to identify the most attractive growth opportunities within the mid-cap growth 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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