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Q4 2022 | ECONOMIC & PORTFOLIO COMMENTARY

EMERALD DIVERSIFIED SMALL CAP GROWTH

SMALL CAPS IN '23?

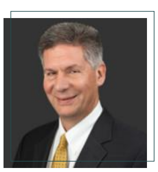
MACROECONOMIC AND GEOPOLITICAL shocks dominated the market narrative in 2022. Inflationary pressures that began bubbling up in the economy in 2021 were sent into overdrive by the Russian Invasion of Ukraine and persistence of unprecedented supply chain constraints. To combat these pressures, the Federal Reserve stepped on the accelerator raising the Fed Funds Rate from 0.1% to 4.4%, the largest annual move since 1973, according to Jonathan Golub of Credit Suisse. The 10-year Treasury yield surged from 1.5% to 3.9% and drove a meaningful compression in valuation multiples across the equity market. The U.S. Dollar made an aggressive move higher, with the DXY jumping +19.3% at its peak in September, before finishing the year +8.2%. The strengthening dollar added to inflationary pressures across the globe at the same time as the energy crisis in Europe and China's reluctance to remove its zero-COVID policy compounded global growth concerns. Collectively these factors contributed to making 2022 one of the more volatile equity market years on record, and the longest period of heightened volatility since the Great Financial Crisis of 2008/2009, according to a recent report from Goldman Sachs.

KEY POINTS:

- ***The fourth quarter was the first quarter in 2022 that equity returns were almost universally positive. The S&P 500 gained (+7.56%), the Russell 1000 (+6.56%) and the Russell 2000 (+6.23%).***

- ***Specific to the fourth quarter, the benefit from stock selection more than offset the headwind from allocation effect. At the sector level, stock selection driven relative outperformance within the healthcare, technology, and consumer discretionary sectors more than offset relative underperformance within the industrials and financial sectors.***

- ***As we enter 2023, the portfolio currently holds the largest active exposures in the healthcare, consumer discretionary, financials and consumer staples sectors.***



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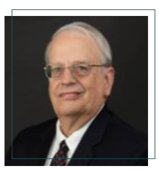

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The trifecta of macroeconomic uncertainty, geopolitical uncertainty, and elevated volatility created a brutal backdrop for returns across asset classes. For the full year 2022, the S&P 500 declined (-18.11%), the Russell 2000 declined (-20.44%), the NASDAQ composite fell (-33.10%), Bitcoin fell (-64.2%) and the Bloomberg U.S. Aggregate Government Treasury Long bond portfolio fell by (-29.26%). International markets were equally as challenging with the MSCI China-A index (-25.90%), and the MSCI World, ex-USA down (-14.29%). According to a January 4, 2022, report from the team at Furey Research Partners, the correlation among asset classes in 2022 was more than two standard deviations above the mean and was the highest recorded since 1980.

2022 also marked the sixth consecutive year that small capitalization stocks as measured by the Russell 2000 (-20.44%) benchmark have lagged their large capitalization peer the Russell 1000 (-19.13%). The Russell 2000's 2022 total return was the third worst annual return in its history following 2002 (-20.5%) and 2008 (-34%), and was comprised of the greatest number of down days in any year besides 1984 and 2002, with the magnitude of average Russell 2000 down days coming in as the fourth worst since 1979, according to the same Furey Research report cited above. Further, when the number of down days is combined with the magnitude of the average down day decline, 2022 was the second worst year for the Russell 2000 on record, behind only 2008.

From a style perspective, Value posted its second consecutive year of relative outperformance to Growth as the surge in the 10-year yield disproportionately pressured the valuation multiples applied to long-duration growth assets. Within the Russell 1000, the Russell 1000 Growth (-29.14%), lagged the Russell 1000 Value (-7.54%) by more than 2,100 bps for the full year 2022. This style bias was also apparent within the Russell 2000 index, with the Russell 2000 Growth (-26.36%), lagging the Russell 2000 Value (-14.48%), although the gap of relative underperformance was narrower at 1,188 bps for the same period. It is noteworthy, in our view, that the Russell 2000 Growth (-26.36%) outperformed the Russell 1000 Growth (-29.14%) by 278 bps for the full year, whereas the Russell 2000 Value meaningfully lagged.

Fourth quarter equity returns were a bright spot in an otherwise dismal year. The fourth quarter was the first quarter in 2022 that equity returns were almost universally positive. The S&P 500 gained (+7.56%), the Russell 1000 (+7.24%) and the Russell 2000 (+6.23%). From a style perspective Value continued its streak of outperformance, with Growth continuing to lag across the capitalization spectrum. As a testament to the growth headwinds, the Nasdaq Composite was one of the only broad market indices to post a negative return for the fourth quarter falling by (-1.03%).

PORTFOLIO REVIEW

The Emerald Diversified Small Cap Growth portfolio bested the Russell 2000 Growth benchmark for the fourth quarter and full year 2022. For the full year, thanks to solid fourth quarter relative outperformance, the Emerald Small Cap Growth portfolio outperformed the Russell 2000 Growth benchmark. Stock selection was the largest positive contributor to return as relative outperformance within the health care, technology, and real estate sectors more than offset relative underperformance within the financials, industrials, consumer staples, and consumer discretionary sectors.

Specific to the fourth quarter, the benefit from stock selection more than offset the headwind from allocation effect. At the sector level, stock selection driven relative outperformance within the healthcare, technology, and consumer discretionary sectors more than offset relative underperformance within the industrials and financial sectors.

The healthcare sector was the largest positive contributor to return for the quarter driven by stock selection within the biotechnology and medical equipment industries. Throughout the second half of 2022, Emerald has been increasing its healthcare exposure, as valuations looked increasingly attractive, clinical data flow improved, M&A volumes accelerated, and elective procedure volumes began to normalize. The medical equipment, pharmaceutical and biotechnology industries now represent the largest relative overweight positions within the sector. This is noteworthy, in that the biotechnology and medical equipment industries were the largest sources of relative outperformance.

Performance within the technology sector was also a positive contributor to return driven by stock selection within the computer hardware, semiconductors, and computer services industries. The portfolio moved to an underweight position during the second quarter and remains underweight relative to the benchmark exiting fourth quarter. In that regard, while allocation was a very modest benefit to performance, stock selection was the biggest driver of outperformance within the sector.

The consumer discretionary sector was also a source of relative outperformance in the quarter driven by stock selection within the recreational service and specialty retail industries.

Also noteworthy was performance within the energy sector. While overall sector performance was only modestly ahead of the benchmark, stock selection was a notable standout, with two of the portfolio's top 10 contributors to return falling within the energy sector.

Partially offsetting the positive contributors to return outlined above was stock selection driven relative underperformance within the industrials and financial services sectors. Performance within the industrials sector was challenged both by stock selection and allocation effect, as the industrials sector represents the portfolio's largest relative underweight position.

Performance within the financial services sector also detracted from return for the quarter driven largely by challenging stock selection within the property and casualty industry.

As we enter 2023, the portfolio currently holds the largest active exposures in the healthcare, consumer discretionary, financials and consumer staples sectors. Thoughts on those sectors and other notable areas of exposure are highlighted below.

- The healthcare sector represents the portfolio's largest nominal and active exposure. At the industry level, the portfolio currently holds the largest nominal and relative overweight positions within the medical equipment, biotechnology, and pharmaceuticals 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. Approximately 60% of the portfolio's therapeutics (biotechnology and pharmaceutical) exposure is held within companies that have revenue. The remaining non-revenue generating companies have drugs that have progressed to the late stages of clinical development.

- The portfolio also ended the quarter with an overweight position to the financials 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, with loan growth greater than 8%. However, we believe net interest margins will peak in Q1-23 for the asset sensitive community banks as deposit betas have increased at a more rapid pace in Q4-22 and will continue to increase in Q1-23 and Q2-23. We believe while year-over-year net interest income will continue to grow in the first half of 2023 we do believe NIMs will peak in Q1-23 and will be flat to slightly down in Q2-23 before expanding once again in the second half of 2023. We now believe that banks will benefit from the recovery of tangible book value related to Accumulated Other Comprehensive Loss related to securities that were marked-to-market in the available-for-sale securities portfolio. Banks are trading at historically attractive valuations. According to S&P Global, Nasdaq BANK Index is currently trading at less than 9.5x 2023 P/E, levels seen less than 5% of the time, and historically, providing solid +30% returns over the S&P over the ensuing 12 months. Further, Emerald continues to focus on Property and Casualty companies with strong balance sheets, exposure to growing specialty end-markets with sustained pricing power, and with the ability to stay ahead of loss cost trends with a strong or improving margin profile. We believe these companies are best positioned to exhibit high ROEs and thus should be some of the strongest performers in the group next year. Pricing power should persist in 2023, though rising reinsurance costs and continued inflationary pressures would likely limit margin improvement. We also like the insurance brokers and expect them to deliver above historical average organic growth while maintaining or even slightly expanding already lofty margins profile.

- 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. The consumer proved to more resilient than the market expected during 2022 and we believe, barring an overreach by the Federal Reserve that results in a significant increase in the unemployment rate, that the consumer will demonstrate a similar resiliency, as inflationary pressures abate, and real wages turn positive. That being said we do believe that the rate of change in consumer spending growth will likely decelerate as spending behavior and savings rates normalize and therefore remain focused on select opportunities in those companies offering differentiated products and services that we believe are well positioned to gain market share.

- The portfolio was also ended the fourth quarter with an overweight position to the consumer staples sector. Emerald is incrementally more positive on the fundamental outlook for consumer packaged goods companies entering 2023. There are several emerging signs that the broad-based cost inflation and supply chain issues that plagued the industry throughout 2021 and 2022 are abating, which should result in higher profit margins as the year progresses. We continue to focus on companies with disruptive brands, category leadership positions, strong secular growth opportunities, and improving profit margins that should enable them to navigate an often turbulent business environment and post industry leading revenue and earnings growth.

MARKET OUTLOOK

As we enter 2023, recessionary fears continue to loom large. The Federal Reserve remains firm in its resolve to get inflation back to its 2% inflation target and although the market continues to hold out hope for a pause/pivot in Federal Reserve messaging, the Federal Reserve has continued to press ahead. While the pace of the increase stepped back to 50 bps in December, the terminal rate took another leg higher edging up another 50 bps from the September meeting to 5.1%, according to the Federal Open Market Committee's December Summary of Economic Projections. Financial conditions have tightened substantially over the last 12 months, with the Federal Reserve of San Francisco Proxy Federal Funds rate which measures the effective Federal Funds rate adjusted for the impact quantitative tightening, sitting at 6.42% as of November 30. 2022, an increase of more than 700 bps from just eighteen months ago. The 10yr/2yr yield curve inverted in July of this year, with the November average spread of 62 bps, nearing an all-time extreme (half a percent relative to history since 1962), according to a December 1, 2022 report from Dubravko Lakos-Bujas, Equity Macro Strategy at J.P Morgan. Also ominous, according to the same report, is the November inversion of the 10 year/3-month yield spread, which has had a higher historical recession predictive power. While recession isn't a certainty, financial conditions have tightened and high frequency macroeconomic datapoints have softened. The consumer has been steadfast in the face of unprecedented inflationary pressures, riding the wave of a strong labor market, increased savings and wage growth, is now one year further into working down the excess savings accumulated during COVID, and is increasingly at the mercy of a Federal Reserve that is dead set on softening a structurally challenged jobs market that heretofore has demonstrated an impressive level of resiliency.

> **MARKET TURMOIL, THROUGH HISTORY HAS BEEN A CATALYST FOR SHIFTS IN MARKET LEADERSHIP AND WE BELIEVE THAT THE EQUITY MARKET IS ENTERING A MEAN REVERTING OUTPERFORMANCE CYCLE FOR SMALL CAPITALIZATION STOCKS.**

There are however some reasons for optimism. The market is likely moving past peak Federal Reserve hawkishness, peak rates of inflation, the peak in the U.S. Dollar, China is rolling back its zero-COVID policy, and a warmer early winter in the U.S. and Europe helping to ease the burden of higher energy costs. Sentiment indicators have been washed out, consumer confidence has recently ticked up, real wages are starting to inflect positively, and we are likely closer to end of the Federal Reserve hiking cycle. That being said, the tail effects of tightening financial conditions are still rolling through the economy. In this regard, all eyes remain on corporate profit margins and earnings and as such we expect the fourth quarter earnings reporting season will be an important factor in setting the tone for the balance of 2023.

Market turmoil, through history has been a catalyst for shifts in market leadership and we believe that the equity market is entering a mean reverting outperformance cycle for small capitalization stocks. Although calendar 2022 marked the sixth consecutive year of small capitalization stock relative underperformance, relative performance has improved since mid-year with the Russell 2000 (+3.89%) outpacing the Russell 1000 (+2.30%) over the last six-months of calendar year 2022. Small cap valuations on an absolute basis and relative to both the S&P 500 and Russell 1000 remain at historical discounts to the long-term averages, implying the market is already embedding expectations for a substantial negative reset to earnings growth. Large capitalization leadership is waning and could be reminiscent of the fall from glory of Nifty Fifty in the 1970s, which marked a positive inflection for small capitalization relative performance. In addition, high and decelerating inflation has historically provided a strong backdrop for small capitalization outperformance, as has small capitalization performance exiting a bear market and post mid-term election cycles. Further, at some point in 2023 the Federal Reserve will have to stop hiking rates. According to a January 4th report from Furey Research, the Russell 2000, exiting the last six hiking cycles beginning in 1984, has posted positive forward returns on a median basis at 6 months, 12 months and 24 months annualized of 16.4%, 21.0% and 12.1%, respectively. Lastly, after the longest consecutive losing streak for the Russell 2000 on record according to a January 2, 2023 report from Steve DeSanctis of Jefferies small capitalization representation of the overall equity market has receded to just 4%, meaningfully below its historical average of 7%. The last time small capitalization stocks had retreated to this level of the equity market was briefly in 2020 and prior to that the 1930s. For all these reasons, Emerald remains optimistic that market leadership is shifting in the favor of small capitalization stocks.

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.

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