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EMERALD DIVERSIFIED SMALL CAP GROWTH

SMALL CAPS HURT BY BANKING CRISIS

2023 GOT OFF TO A BLISTERING START with the broad market indices including the Russell 2000 (+9.75%) and Russell 1000 (+6.70%) posting strong gains in January catalyzed by growing optimism of no landing/soft landing in the domestic economy. In February this enthusiasm transitioned to overheating fears with the market anticipating a return of 50 basis point hikes at the March meeting and a terminal Federal Funds rate of 5.70% (as of 3/8/23). The twin failures of Silicon Valley Bank and Signature Bank and the forced sale of Credit Suisse to UBS in March shifted the narrative yet again, sending shockwaves through the financial markets and igniting fears of a 2007-2008 Great Financial Crisis redux.

Although the panic has since faded as bank deposits have stabilized and wholesale borrowing has slowed, the prospect of a further tightening in lending standards, and more constrained credit availability in the wake of the Federal Reserve's near historic trajectory of interest rate increases and unwavering resolve to blunt inflation, have collectively driven renewed fears of a hard landing in the U.S. economy. Treasury volatility has been historic In proportion

KEY POINTS:

- ***After a strong start to 2023 with the Russell 2000 (+7.89%) leading the Russell 1000 (+4.17%) by 373 basis points through the month of February, the Russell 2000 (-4.78%) declined significantly during the month of March.***

- ***The Emerald Diversified Small Cap Growth portfolio trailed the Russell 2000 Growth benchmark for the first quarter of 2023. The portfolio was challenged by both stock selection and allocation effect as relative outperformance within the healthcare sector was more than offset by relative underperformance within the technology, industrials, consumer discretionary, energy and utilities sectors.***

- ***As we enter the second quarter of 2023, the portfolio currently holds the largest active exposures in the healthcare, consumer discretionary, and consumer staples***

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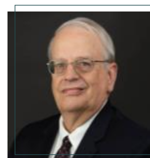

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with the two-year treasury yield moving from 4.28% in early January to a peak of 5.07% on March 8, only to fall to approximately 4.00% in early April, as market expectations for the path and pace of the Federal Funds rate rapidly reset.

With risk aversion running high, defense again became the best offense, with investors re-upping their early 2020 playbook and aggressively moving up the market capitalization spectrum and buying technology. Large capitalization stocks surged, with the S&P 500 and Russell 1000 gaining +3.67% and +3.16% respectively for the month of March, and +7.50% and +7.46% for the first quarter. Notably performance was very concentrated at the top of the market capitalization spectrum with the S&P 500 equal-weighted Index returning a much more modest (-0.88%) during March and +2.93% for the first quarter. This phenomenon was also evident within the Russell 1000, with the top quintile (largest) market capitalization stocks outperforming the Index overall by 100 basis points, while quintiles two through five collectively underperformed, according to an April 4, 2023, report from Steven DeSanctis, Equity Strategist at Jefferies.

This rapid transition in sentiment weighed heavily on small capitalization stocks. After a strong start to 2023 with the Russell 2000 (+7.89%) leading the Russell 1000 (+4.17%) by 373 basis points through the month of February, the Russell 2000 (-4.78%) declined significantly during the month of March. The magnitude of March's relative underperformance not only erased the Russell 2000 Index's early year lead, but also flipped the Russell 2000 from a year-to-date leader to a year-to-date laggard with a first quarter return of +2.74%, 472 basis points behind the Russell 1000 (+7.46%).

Underlying the relative strength in large capitalization stocks was a sizeable rotation into the technology sector driven by falling yields and rising recession fears. Within the Russell 1000, the technology sector, as defined by the Russell Industry Classification Benchmark according to FactSet, returned +25.25% for the quarter and contributed more than 600 basis points to the return of the Index. Although the technology sector did outperform within the Russell 2000 as well, the sector returned a significantly more modest +13.51% and contributed 137 bps to the Russell 2000's total return. To put the magnitude of this relative underperformance in context, and using the Nasdaq Composite as a proxy, the Russell 2000 (+2.74%) lagged the Nasdaq Composite (+16.77%) for the first quarter by approximately 1,400 basis points, the widest gap of underperformance since March 2020, according to the same report from Steven DeSanctis cited above.

From a style perspective, the outperformance of the technology sector and underperformance of financials drove a resurgence in growth as a style, with the Russell Growth indices outperforming their Value counterparts across the capitalization spectrum. Within the Russell 1000, the Russell 1000 Growth (+14.37%), significantly outpaced the Russell 1000 Value (+1.01%). Similarly, within the Russell 2000 Index, the Russell 2000 Growth (+6.07%) outpaced the Russell 2000 Value (-0.66%), although the gap of relative outperformance was substantially narrower at 673 bps for the same period.

Although growth as a style outperformed across the market capitalization spectrum, when comparing the composition of returns within the Russell 2000 Growth Index to those of the Russell 1000 Growth Index there were several noteworthy divergences. For example, according to an April 4, 2023 report from Steve DeSanctis of Jefferies, when comparing the performance of the fastest growing companies as measured by sales growth within the Russell 2000 Growth, the top quintile or fastest growers underperformed the Index overall by 541 basis points, while that same cohort within the Russell 1000 Growth outperformed by 1,120 basis points. There were also interesting differences when viewing performance by P/E quintile. While the highest P/E quintile companies outperformed within both indices, that cohort within the Russell 2000 Growth outperformed by 400 basis points, as compared to the same cohort within the Russell 1000 Growth, which outperformed by 995 basis points. Similarly, whereas the non-earnings cohort underperformed by 363 basis points within the Russell 2000 Growth Index, the non-earnings cohort within the Russell 1000 Growth Index outperformed by 287 basis points. Interestingly, despite the growing concerns over credit availability and rising recession risks, the more highly leveraged companies within the Russell 2000 Growth

performed inline to slightly better than the Index overall, while the more highly leveraged companies within the Russell 1000 Growth underperformed by 373 basis points relative to the Index overall.

Also noteworthy was the distribution of performance by market capitalization. Within the Russell 1000 Growth, we think it is interesting that like the Russell 1000 discussed above, the relative outperformance within the Index was concentrated in the largest market capitalization quintile, with this subset returning +15.53% and outperforming by 116 basis points. The remaining four quintiles underperformed the Russell 1000 Growth Index overall. Within the Russell 2000 Growth, the smallest market capitalization underperformed by 984 basis points, but unlike the Russell 1000 Growth the largest quintile also underperformed by 45 basis points. Only quintile two within the Russell 2000 Growth demonstrated relative outperformance, outpacing the benchmark overall by 235 basis points.

PORTFOLIO REVIEW

The Emerald Diversified Small Cap Growth portfolio trailed the Russell 2000 Growth benchmark for the first quarter of 2023. The portfolio was challenged by both stock selection and allocation effect as relative outperformance within the healthcare sector was more than offset by relative underperformance within the technology, industrials, consumer discretionary, energy and utilities sectors.

The technology sector was the portfolio's top detractor to return for the quarter, as both allocation effect and stock selection weighed on relative performance. After lagging throughout 2022, the technology sector surged +14.92% during the first quarter of 2023. Although Emerald's technology sector weighting increased during the first quarter, strength within the sector was broad-based and, as a result, performance headwinds were most acute in those industries where the portfolio was underweight, including semiconductors, production technology equipment and software. Notably, there were no technology companies within the top 10 detractors to portfolio performance.

Performance within the industrials sector was also challenging, weighed down by a combination of stock selection and allocation effect resulting from the portfolio's sizeable underweight relative to the benchmark. At the industry level, relative outperformance within the transaction processing and defense industries was not enough to overcome the portfolio's underweight position and stock selection headwinds within the professional business support and services industry.

Also detracting from performance was stock selection within the consumer discretionary sector. At the industry level, the positive contribution to return from holdings within the casinos and gambling, restaurant, recreational services, and airlines industries was more than offset by the negative contribution to return from holdings within the specialty retail industry.

Relative performance also proved challenging within the energy sector. The energy sector of the Russell 2000 Growth Index was the worst performing sector for the quarter, declining (6.82%) as WTI Oil and Henry Hub natural gas prices retrenched, reflecting a warmer than normal winter and ample domestic supply growth. From a portfolio perspective, Emerald's performance lagged that of the benchmark as the overweight and composition of the portfolio's energy service and equipment holdings were caught in the crosshairs of both a sector rotation out of energy, and concerns about oil and gas producers' capex spending plans.

Partially offsetting the sources of weakness outlined above was the stock selection driven relative outperformance of the Healthcare sector. Despite the negative contribution to return from allocation effect as the healthcare total return of the Russell 2000 Growth Index lagged that of the Index overall, solid stock selection and relative outperformance within the medical equipment and medical services industries drove the sector's positive contribution to return.

As we enter the second quarter of 2023, the portfolio currently holds the largest active exposures in the healthcare, consumer discretionary, 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, pharmaceuticals, and medical services industries. We continue to be 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 our therapeutics (biotech + pharma) exposure is in companies that have revenue. The non-revenue generating companies we hold are quite mature relative to our historical holdings.

- 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. At the same time 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 also exited the first quarter with an overweight position within the consumer staples sector. Emerald remains 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 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

Recession fears return to the forefront. After a strong start to 2023, driven by stronger than expected economic data, domestic economic growth is again showing signs of deceleration. The Atlanta Fed GDP Now first quarter 2023 forecast has decelerated from the 3.2% expected at the end of February to 1.5% as of April 5 as recent high frequency economic indicators (ISM services, ISM manufacturing, construction spending) have proven weaker than expected. Financial conditions have tightened meaningfully over the last 12 months with the Federal Reserve of San Francisco's Proxy Federal Funds rate (a measure of the effective Fed Funds rate adjusted for quantitative tightening) reaching 6.27% as of March 31, 2023, a level not witnessed since the fall of 2000.

Given the significant level of monetary tightening already working through the financial system and conditions poised to tighten further as lending standards adjust to reflect recent stresses in the banking system, we believe the Federal Reserve has done its job. Economic growth is decelerating, inflationary measures are showing signs of exhaustion, job gains are slowing, job openings are declining, wage pressures are easing, and corporate earnings are being revised lower. All these factors, in our opinion, should provide sufficient grounds for the Federal Reserve to pause its pace of Federal Funds rate hikes.

That being said, a pause may not be enough in the near-term to give the market comfort as the Fed Funds Futures curve is currently pricing in three cuts this year (August, October and November) and five rate cuts in 2024. The bond market has similarly priced in a more dire economic outlook, with the two-year treasury yield moving from more than 5% to approximately 4% over the last four weeks. Therefore, while we ultimately expect the Federal Reserve policy transition to be a positive for the market, in the short-term the tug-of-war between the soft landing and recession narratives and ongoing fluctuations in treasury yields and Fed Funds futures curve is likely to continue to create a choppy and volatile backdrop for both the equity and bond markets. Not to mention residual fears of credit contagion within commercial real estate market, the looming debt-ceiling deadline and more persistent geopolitical tensions, which have the potential to add consternation to this already challenging market backdrop.

… HIGH AND DECELERATING INFLATION HAS HISTORICALLY PROVIDED A STRONG BACKDROP FOR SMALL CAPITALIZATION OUTPERFORMANCE, AS HAS SMALL CAPITALIZATION PERFORMANCE EXITING A BEAR MARKET AND RECESSIONS.

Consequently, we believe the defensive posture of the market assumed in March is likely to persist blunting what we believed was the start of a mean reverting outperformance cycle for small capitalization stocks. While the path in the short-term has been muddled by the reverberation of stresses in the banking system, over the long-term we continue to believe that after six consecutive years of relative underperformance for small capitalization stocks that a reversion to the mean is inevitable. Small cap valuations on an absolute basis and relative to both the S&P 500 and Russell 1000 remain at a significant discount to the long-term averages. Further, we believe we are closer to the end of the Federal Reserve tightening cycle as discussed above and 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. 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 recessions. Lastly, after the longest consecutive losing streak for the Russell 2000 on record according to an April 4, 2023 report from Steve DeSanctis of Jefferies, small capitalization representation of the overall equity market has receded to less than 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 1930's. For all these reasons, Emerald remains optimistic that the small capitalization market leadership that began in earnest in January of 2023 is poised to resume as the market gains greater clarity on the forward path for economic growth.

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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