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Q1 2023 | ECONOMIC & PORTFOLIO COMMENTARY

EMERALD GROWTH OPPORTUNITIES

" What a Difference a Quarter Makes"

THE FIRST QUARTER MARKED A WELCOME REVERSAL

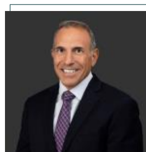
from 2022, with all major equity asset classes advancing. The S&P 500 registered a +7.5% total return, and our benchmark Russell 3000 Growth Index posted a robust +13.85% return. Against this favorable backdrop, after a tough 2022, the Emerald Growth Opportunities portfolios experienced strong absolute and relative performance, despite a late quarter, bank-crisis led, small cap selloff. As shown on the following chart, the quarter was all about large cap tech/consumer, with the top seven S&P 500 stocks accounting for an astounding 92% of performance (AAPL, MSFT, NVDA, TSLA, META, AMZN, GOOGL). Equities with high foreign sales, higher valuation, and Beta also significantly outperformed.

KEY POINTS:

- ***Emerald Growth Opportunities portfolios experienced a very strong absolute and relative quarter, led by positive stock selection, offsetting modest allocation and interaction effect headwinds.***

- ***Portfolios benefited from strong Materials, Consumer, Health Care, and Industrial sector performance, with modest detraction from Energy and Industrials.***

- ***Portfolios remain overweight Consumer Discretionary, Energy, Healthcare and Materials. We added to our Healthcare exposure during the quarter on a favorable regulatory climate and recession fears. We remain underweight Financials, Staples, Industrials, Real Estate and Technology.***



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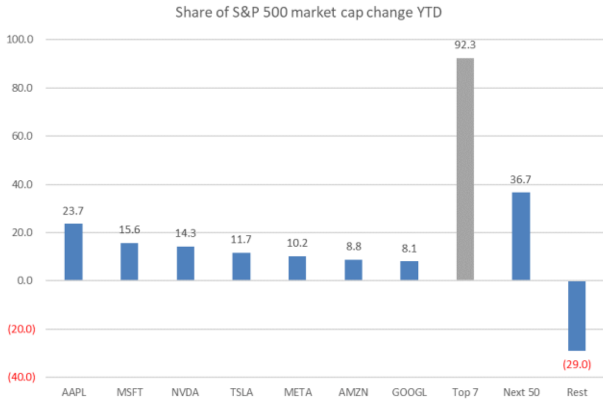
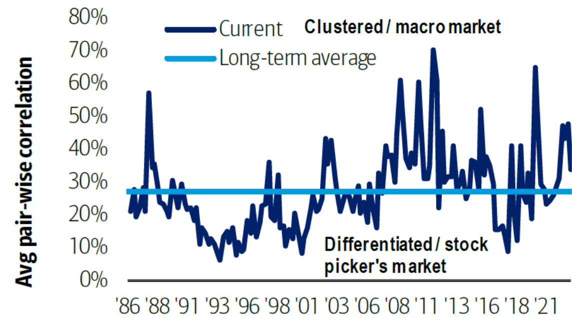


Beyond size, growth equities trounced value, with the Russell 1000 Growth topping the Russell 1000 Value Index by over 13 percentage points year-to-date. As noted, small caps sold off in March leading to Russell 2000 Growth stocks underperforming Russell 1000 Growth equities by over 800 basis points, one of the worst performances in the past 20 years.

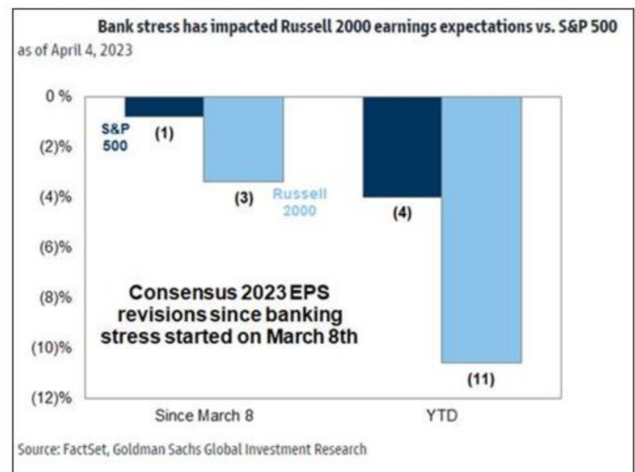
From an economic perspective, the quarter was all about the Fed, which raised rates by 25 basis points in February and again in March, and the subsequent regional banking crisis that erupted late in the quarter. The rapid rise in rates, lack of adequate risk management, and frictionless deposit availability, all contributed to the failure of two venerable regional banking institutions. These failures, along with the shutdown of a leading crypto lending bank during the quarter, exacerbated the markets' risk averseness and stoked concerns about the rapid tightening of loan growth and availability, choking off the already weakening economy. Most economic measures limped along at stall speed as the quarter progressed, with weakening manufacturing, durable shipments and new orders, profits, spending and housing related measures. Employment stayed strong, with the civilian unemployment rate near an all-time low. GDP projections also remained strong with Atlanta GDP Now projecting Q1 GDP of 2.5% as of quarter end (although this estimate dropped materially after the end of the quarter). Inflation continued to moderate, with February's Personal Consumption Deflator (PCED) easing to a 17-month low of 5% from last June's 7.0% peak.

Equity correlations dropped through most of the quarter, but are still above average due to macro factors, making it more difficult for active managers to outperform.



Source: BofA US Equity & Quantitative Strategy, FactSet. Past performance is not necessarily a guide to future performance.

High Yield spreads stayed relatively tame (surprisingly) during the quarter despite the banking-related credit stress. The trade weighted dollar declined and US money supply, as represented by M2, experienced its seventh straight declining month – a factor that must manifest in GDP weakness at some point. Earnings expectations, as shown by negative revisions, have been dropping materially throughout the year for both small and large caps, with small caps bearing the brunt of the negative revisions.



PORTFOLIO REVIEW

As noted, Emerald Growth Opportunities portfolios experienced a very strong absolute and relative quarter, led by positive stock selection, offsetting modest allocation and interaction effect headwinds. Portfolios benefited from strong Materials, Consumer, Health Care, and Industrial sector performance, with modest detraction from Energy and Industrials. Portfolios continued to be smaller than the benchmark with a weighted average market cap of $639BN vs. $774BN for the Russell 3000 Growth Index. Portfolios also maintained their growth advantage vs. the benchmark with estimated weighted average 3-5-year EPS growth of 19.43% vs. 15.01% for the Russell 3000 Growth Index. While portfolios have higher expected EPS growth, valuations are still discounted vs. the benchmark on all major characteristics such as Price/Earnings, Price/Cash flow, Price/Book and Price/Sales. This valuation/growth disparity in our portfolios has been in existence for several years – a setup we have exploited successfully since before the onset of the pandemic.

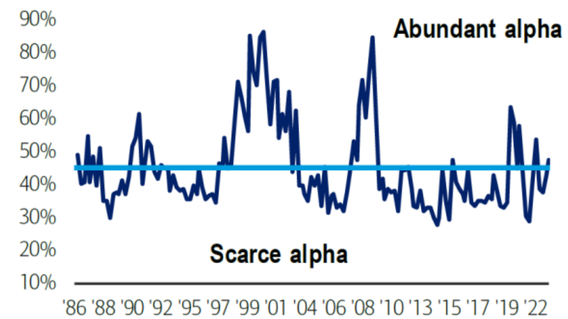
Portfolios remain overweight Consumer Discretionary, Energy, Healthcare and Materials. We added to our Healthcare exposure during the quarter on a favorable regulatory climate and recession fears. We remain underweight Financials, Staples, Industrials, Real Estate and Technology.

MARKET OUTLOOK

We hate macro driven markets! They are especially tough for active, fundamental, research-driven managers like Emerald – at least in the short term. But at the same time, fear driven markets expose many opportunities to exploit dramatic equity mispricing. We are amid one of those times. As an example of mispricing, see the following BofA Global Research chart showing a jump above the historical average in dispersion, showing an increase in potential alpha in the first quarter – the same is the case for mid and small-caps. We see this mispricing-related dispersion continuing through the year.

Alpha opportunities in the S&P 500 jumped above the historical average

Large cap dispersion in returns by top/bottom quintile



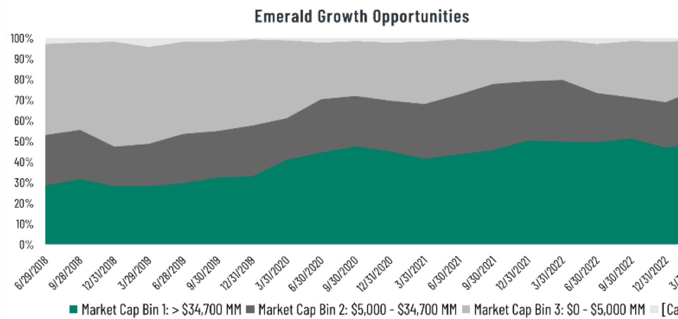
Source: BofA US Equity & Quantitative Strategy, FactSet. Past performance is not necessarily a guide to future performance.

Our Dynamic Barbell framework causes us to balance a myriad of factors when constructing portfolios. These can include secular vs. cyclical growth, large vs. small market cap holdings, foreign vs. domestic exposure, faster vs. slower growth, higher vs. lower P/E, yield, beta, and many other factors. This balancing approach takes into consideration macro factors such as recession, inflation, rates, etc., **but specific company, industry and sector factors weigh more heavily in our construction process**. Being cognizant of our Dynamic Barbell pushes us to hold weightings in many of the largest weighted benchmark mega-caps, which greatly benefited us last quarter. This approach also has us trim selected names that could be more impacted by macro-economic uncertainty and drove us to reduce our weighting in several Consumer Discretionary names last quarter, while adding to Health Care and Consumer Staples exposure. We also added to our weighting in companies with strong international exposure given the recent dollar weakness and strong growth opportunities in selected international economics, but our moves tend to be more incremental and gradual.

Our approach has driven us to overweight cyclical holdings for the better part of three years, as many cyclicals, because of recession fears are trading at valuations closer to Great Financial Crisis levels, while many secular growers trade at very high multiples of sales. The same can be said of our underweight to Bond Proxies, which also trade at extremely elevated price/sales multiples, despite limited growth. We believe the market is significantly mispricing selected cyclical

names on recession fears. This is especially the case with Energy names that are trading at extreme valuation discounts to the broader market despite dramatically improved balance sheets, strong expected earnings growth, shareholder friendly management teams and a supportive commodity environment. We added to our Energy exposure in the first quarter and think this could be a significant area of outperformance as the year progresses.

The following chart graphically shows portfolio's market cap weight allocation over time. We clearly have a small and mid-cap bias vs. our large cap tilted benchmark. We modestly added to mid and large-caps last quarter given those equities' perceived stability vs. small caps, but still have a substantial small cap bias given our positive thoughts on valuation, lower inflation, long-term underperformance, and the prospects of some reversion to the mean.



While our process is clearly not macro-factor based, we do consider macro factors in weighting names and for modest portfolio modifications. That said, based on our observations we are clearly in or soon to be in a recession. We agree with Canaccord strategist Tony Dwyer who posits: "the current levels of (1) U.S. Treasury Yield Curve Inversions, (2) Conference Board of Leading Economic Indicators, and (3) Commercial & Industrial Lending Standards are all at levels associated with being in/near recession." We all agree that robust employment trends have been the outlier of recessionary indicators, but Tony recently added a March decrease in the Conference Board Employment Trend Index as a chink in the armor in the employment strength argument, as one more indicator of an impending economic slowdown.

So, as a manager who believes that earnings growth drives stock prices, we must consider the impact of a recession on the earnings trajectory of our portfolio companies. Let's be clear, most companies will have their earnings impacted during a recession, especially companies that exhibit greater growth. Margins will also take a hit. But in some ways, it is more important to follow the path and trajectory of analyst earnings revisions to determine the short-term pricing of equity securities. On that front, 1Q23 forecasts have fallen -6.6%, worse than normal. In addition, according to Credit Suisse's Jonathan Golub:

"The current bottom-up EPS projections point to a -6.4% YoY decline in 1Q. However, expectations for the median company appear much stronger (+0.6%). Profits are likely to bottom out in 2Q, assuming a similar pace of revisions experienced in recent quarters, and turn positive in 4Q23, helped by easy comps."

This bottoming out process, followed by easier back half 2023 comps give us some confidence, that unless the landing is hard, much of the pain from an analyst revision and valuation perspective – especially for small caps – has already been largely discounted by the market. The RBC Capital Markets strategist is still positive on small caps noting that small caps tend to bake in recessions early and start to outperform large caps when unemployment starts to rise. We see unemployment increasing imminently and thus continue to stay positive on our small cap overweight.

MARKET TURMOIL HAS ALWAYS ULTIMATELY BEEN GOOD FOR EMERALD AND OUR CLIENTS - WE DON'T THINK THIS TIME WILL BE ANY DIFFERENT.

At Emerald we have Five P's that define the Emerald Advantage. People, Philosophy, Process, Persistence all contribute to generating Performance. We can think of no more important "P" at turbulent, uncertain times like these than Persistence. Persistence is defined as: "firm or obstinate continuance in a

course of action despite difficulty or opposition." It is the tenacity and unwavering commitment to fundamental, bottom-up research that has defined our firm and our investment process and philosophy for over 30 years. That determination and resolve doesn't change in the face of short-term market machinations, fads, or prognostications. Market turmoil has always ultimately been good for Emerald and our clients – we don't think this time will be any different.

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