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EMERALD MID CAP GROWTH

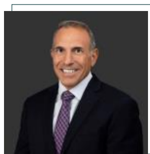
"What a Difference a Quarter Makes"

AFTER POSTING STRONG RELATIVE 2022 PERFORMANCE, Emerald Mid Cap Growth portfolios modestly lagged our Russell Midcap Growth benchmark return for the quarter, as our overweight to Energy hurt performance as did holdings in Financial Services and Healthcare. Midcap growth stocks trounced Midcap value equities in the quarter with a return of +9.14% vs. +1.32% for value. Size was a large determinant of performance with Mid trailing Large but outperforming Small. Equities with greater foreign sales, sales growth, and higher Beta outperformed; while factors such as lower quality, leverage, yield, and price also outperformed.

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

KEY POINTS:

- ***Emerald Midcap Growth portfolios lagged our benchmark performance for the quarter, as strength in Materials, Consumer Discretionary and Industrials, failed to offset weakness in Energy, Financials, Healthcare, Real Estate and Technology.***
- ***Portfolios remain overweight Consumer Discretionary, Energy and Healthcare. We remain underweight in Materials, Financials, Staples, Industrials, Real Estate and Technology.***
- ***Mid Cap Growth stocks, while not cheap, trade at a discount vs. Mid Cap Value stocks and vs. their long-term average P/E, Price/Book, Price/Sales and most importantly, P/E to Growth. It is this Mid Cap Growth earnings and sales growth advantage that keeps us positive on the asset class.***



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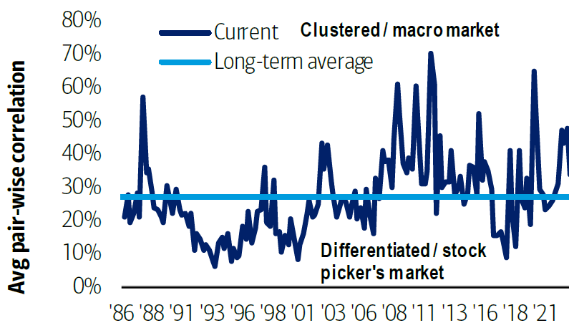
the quarter progressed, with weakening manufacturing, durable shipments and new orders, profits, spending and housing related measures. Employment stayed strong, with the civilian unemployment rate near an all-time low. GDP projections also remained strong with Atlanta GDP Now projecting Q1 GDP of +2.5% 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.

Pair-wise correlation in the S&P 500 has declined but is still above average

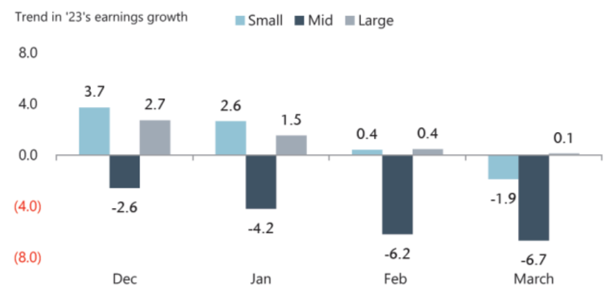
Average pair-wise stock correlations based on 90-day periods, daily frequency



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 small, mid, and large caps, with mid-caps bearing the brunt of the negative revisions.

'23's earnings estimates have fallen further for Small & Mid



Source: FactSet; Standard & Poor's; Jefferies

PORTFOLIO REVIEW

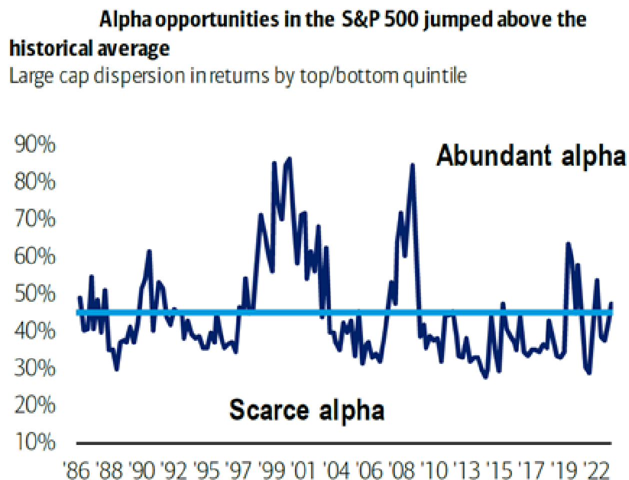
As noted above, Emerald Midcap Growth portfolios lagged our benchmark performance for the quarter, as strength in Materials, Consumer Discretionary and Industrials, failed to offset weakness in Energy, Financials, Healthcare, Real Estate and Technology. Portfolios continued to be smaller than the benchmark with a weighted average market cap of $21.4BN vs. $26.4BN for the Index. Portfolios also maintained their growth advantage vs. the benchmark with estimated weighted average 3-5-year EPS growth of 20.37% vs. 17.32% for the Russell Midcap 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 and Healthcare. We added to our Healthcare exposure during the quarter on a favorable regulatory climate and recession fears. We remain underweight in Materials, 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.



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

Similar to our Growth Opportunities strategy, we employ a modified barbell framework in our Mid Cap Growth product in which we balance a myriad of factors when constructing portfolios. These can include secular vs. cyclical growth, foreign vs. domestic exposure, faster vs. slower growth, higher vs. lower P/E, yield, beta, smaller vs. larger benchmark holdings 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**. This approach caused us to 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.

While we are not a top-down manager, 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 comparisons give us some confidence, that unless the landing is hard, much of the pain from an analyst revision and valuation perspective – especially for small and mid-caps – has already been largely discounted by the market. Mid Cap Growth stocks, while not cheap, trade at a discount vs. Mid Cap Value stocks and vs. their long-term average P/E, Price/Book, Price/Sales and most importantly, P/E to Growth. It is this Mid Cap Growth earnings and sales growth advantage that keeps us positive on the asset class.

"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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