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Q2 2023 | ECONOMIC & PORTFOLIO COMMENTARY

EMERALD GROWTH OPPORTUNITIES

"Finally, a Macro Reprieve!" "Opportunities are Wherever You Find Them…."

OVER THE YEARS, Emerald Growth Opportunities portfolios have espoused the value of an actively managed, large/all-cap investment strategy as an ideal vehicle to leverage strong fundamental research. The ability to dynamically balance exposure to the largest of the mega-cap universe with smaller, well-researched growth companies should provide investors with the alpha-generating potential of small- and mid-cap firms, without losing sight of the mega-cap dominated broad index. We believe performance for the first half of 2023 provides some validation for that line of thinking.

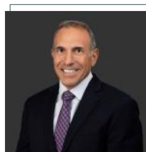
According to BofA Securities, the first half of 2023 marked the narrowest market breadth in history, with just 25% of stocks outperforming the S&P 500. Large-cap stocks and growth stocks were the leaders for the quarter, with the Russell 3000 Growth Index beating the comparable Value Index by over 800 basis points and Russell 1000 Growth stocks besting Russell 2000 Small Cap Growth equities by almost 600 basis points. Against this backdrop, Emerald Insights Fund/Growth Opportunity portfolios experienced strong Q2 2023 performance, building on our substantial first quarter 2023 lead over the

KEY POINTS:

- ***Emerald Growth Opportunities portfolios experienced strong absolute and relative quarterly returns driven by favorable stock selection in the Technology, Financials, Industrials, and Energy sectors.***

- ***Across the portfolio, we continue to add to names that possess company-specific growth drivers, in many cases with limited economic exposure.***

- ***In terms of sector performance, Technology was the leader – no surprise – followed by Consumer Discretionary. Energy was by far the weakest performer with a slightly negative quarterly return.***



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mega-cap dominated benchmark Russell 3000 Growth Index. Strong stock selection in some of our mega-cap and small-cap holdings, as well as declining stock correlations and greater dispersion in small- and mid- cap equity returns – both positives for active management – contributed to robust absolute and relative returns.

Exhibit 1: Pair-wise correlation in the S&P 500 fell below average
Average pair-wise stock correlations based on 90-day periods, daily frequency

Source: BofA US Equity & Quantitative Strategy, FactSet

Exhibit 4: Alpha opportunities are back above average in the Russell 2000
Small/midcaps dispersion in returns by top/bottom quintile

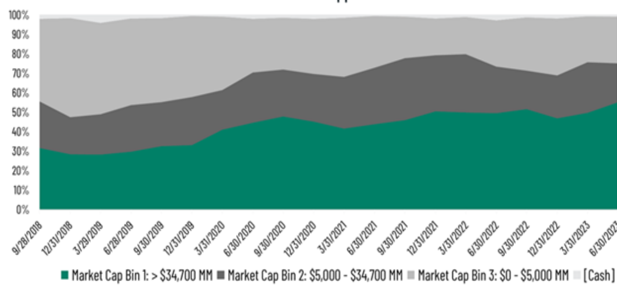
Source: BofA US Equity & Quantitative Strategy, FactSet
Small caps based on the Russell 2000. Midcaps based on the Russell Midcap.

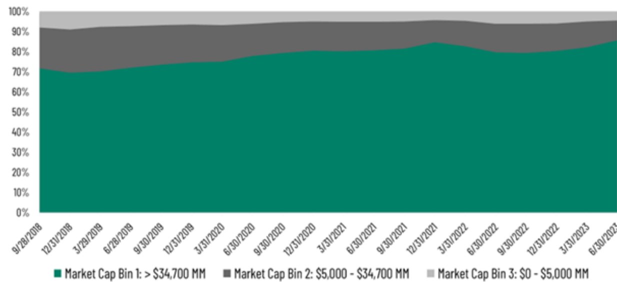
From an economic and monetary policy perspective, the Fed only raised rates 25 basis points in the quarter, with a pause in June, taking some of the policy-driven pressure off the equity markets. Nonfarm employment continued to expand at a moderate pace, although the Civilian Unemployment rate ticked up two-tenths of a percentage point. Average hourly earnings stayed steady, increasing 0.4% each month in the quarter, while CPI and PCE inflation indicators moderated. ISM Manufacturing indicators continued to weaken, while ISM Non-Manufacturing activity picked up in June. The Leading Economic Index continued to trend downward having registered negative readings every month of the past twelve. The Atlanta Fed GDPNow forecast for Q2 2023 GDP continued to defy expectations of weakening, pointing to growth of +2% for the quarter. Money supply growth, a normal predictor of future GDP, continued to decline meaningfully during the quarter.

In terms of performance characteristics for the quarter, as noted, large-cap stocks contributed most towards Index returns, although small- and mid-caps were strong performers. Equities with a high portion of foreign sales dramatically outperformed, as did companies with lower leverage and higher price/earnings ratios. Curiously, the worst and best sales growth companies both outperformed, as did stocks with lower yields. In terms of sector performance, Technology was the leader – no surprise – followed by Consumer Discretionary. Energy was by far the weakest performer with a slightly negative quarterly return.

PORTFOLIO REVIEW

As noted, Emerald Growth Opportunities portfolios experienced strong absolute and relative quarterly returns driven by favorable stock selection in the Technology, Financials, Industrials, and Energy sectors – with Energy providing a positive absolute contribution to portfolio return versus generating negative returns for the benchmark. Stock selection adversely impacted Materials, Consumer Discretionary and Utilities. Portfolios continue to be overweight Consumer Discretionary, Energy, and Healthcare and underweight Technology, Consumer Staples, and Industrials. Portfolios also continue to be smaller than the benchmark with a weighted average market cap of $803 billion vs. over $1 trillion for the Russell 3000 Growth benchmark. Portfolios are meaningfully overweight small- and mid-cap stocks vs. the benchmark given our thoughts on relative valuation and growth.





We continue to rely on our barbell portfolio construction framework of dynamically repositioning holdings by market cap, growth, economic sensitivity, geographic exposure, yield, momentum, and many other factors. This Dynamic Barbell approach allowed us to maintain exposure to selected large and mega-caps regardless of valuation, while at the same time allowing positioning in selected smaller cyclical-oriented names and equities with company-specific growth drivers.

Portfolios also maintained their growth advantage vs. the benchmark with estimated weighted average 3-5-year EPS growth of +20.2% % vs. +18.08% 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.

As noted above, Technology stocks were the stars of the quarter with several longer-term Artificial Intelligence (AI) related holdings exploding to the upside during the quarter.

MARKET OUTLOOK

After the second quarter's strong equity market performance we must question the sustainability of the current mega-cap driven rally. It's striking to note that the "Magnificent 7" stocks, in the aggregate, gained +23% in the 2nd quarter, while all other names in the S&P 500 returned just +4.1%. We sincerely doubt this performance disparity can repeat itself, even with all the AI related hoopla and the monopoly-like dominance of these huge household names. Given the valuation disparity between mega-caps and the rest of the market - with mega-caps trading at a valuation of 3x the average small-cap stock – we believe market performance will broaden out to include small- and mid-cap stocks which should be very positive for our portfolios. This is not to say that we will severely underweight mega-cap tech given our Dynamic Barbell construction process, but it does mean we will continue to underweight these names. Many factors will play into the ability of the broader market to rally. We are starting to see some of these factors play out in the past few weeks. We will briefly touch on some of the determinants that we believe will propel small- and mid-cap outperformance vs. large-caps.

Rates – As long as the 10-year Treasury can stay in the 3.5%-4.5% band, we believe equities, particularly small- and mid-caps, including cyclicals, can work and gain ground on large-caps.

Inflation – It has been our belief that inflation would decline at a greater pace than being imputed by the Fed. So far, we have been correct, with goods and housing inflation dropping faster than expected. Services inflation, particularly wages, is proving to be sticky, but should still allow the Fed to increase rates only modestly over the next few months. Lower Inflation could take the Fed out of play, allowing rates to stabilize, improving credit conditions and sentiment, and allow for the market to broaden as we have seen in the past few weeks.

The Fed – The Fed will likely raise rates 25 basis points in July and may raise another 25 basis points in September, but we believe that will end this rate hiking cycle.

Recession/Soft Landing – Can the Fed engineer a soft landing? We have our doubts. Monetary policy takes a while to take hold and recessions are an immutable economic

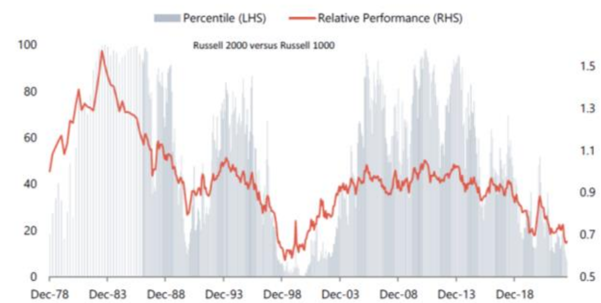
phenomenon. In many ways a soft landing is bad for markets in that it pushes the Fed to do more to slow down the economy. We believe we have been in a rolling recession for several quarters with slowdowns seen in manufacturing and other sectors. The Leading Economic Indicator remains historically weak. Inflation adjusted S&P operating earnings are at recessionary lows. The yield curve has been inverted for a year and monetary indicators suggest a recession is nearby. On the other hand, strength in Average Hourly Earnings (AHE) should bolster consumer spending and serve to mitigate recession risk. We think a modest recession could occur towards the end of this year and believe the market has already imputed a modest recession in the valuation and prices of many small- and mid-cap stocks.

Earnings – According to FactSet, analysts estimate S&P 500 earnings growth of +0.8% in 2023 and +12.4% in 2024. We question the 2024 estimates given our recession forecast. Small- and mid-cap earnings are expected to fall in 2023, with Jefferies forecasting an earnings decline of (-10%) for small caps in 2023, but then rebounding to +15% growth in 2024. Certainly, a positive for small-caps. Small-cap stocks have seen materially worse earnings revisions over the past year vs. large but have generally been beating earnings estimates. We would expect this trend to continue, which is also positive for small-caps. We take solace in the fact that companies in our portfolios are expected to grow earnings over the next 3-5 years at a weighted average growth rate of +20.2% % vs. +18.08% for the Russell 3000 Growth Index.

Credit conditions – High yield spreads, a major determinant of small cap performance, have been very benign over the past quarter, and Bank lending standards remain tight. The Fed's Quantitative Tightening (QT) is showing up in surging mortgage spreads.

Valuations - As the following Jefferies chart shows, the relative valuation of small-caps vs. large, as shown by the Russell 2000 vs. Russell 1000 Indices, is at levels last seen in 2002. Small-caps are now back to being only 4% of the equity market capitalization and Apple is now larger than the entire Russell 2000 index market cap. We do not believe this valuation disparity is sustainable, regardless of the monopoly nature of Apple's business.

Chart 8 - ...And the relative model is in the 7th percentile, last here in Feb '02



Source: FactSet; FTSE Russell; Jefferies

Flows – Given that the top five market cap equities have equity valuations totaling almost $10 trillion, just a small reallocation of market cap from these large names into small- and mid-caps could have a profound impact on those equity classes' valuations.

Dollar – The dollar has weakened recently which is a positive for commodity-oriented cyclicals and small caps.

M&A – The recent pick-up in M&A and IPO issuance is generally positive for small-caps vs large-caps.

Across the portfolio, we continue to add to names that possess company-specific growth drivers, in many cases with limited economic exposure. We are happy to report that the number of names possessing these idiosyncratic opportunity sets has been on the rise given investors' preoccupation with mega-caps, leaving many small- and mid-cap names under-followed and covered by stale research. We have continued to add to our small-cap and cyclical exposure, positing that tamer inflation will put the Fed on hold, benefiting the underlying economy – at least for a time. We have added to names with international exposure given our belief that the U.S. Dollar has peaked and that selected countries' economies – such as India – are very strong. We particularly like the set up for Energy names given their 1st half 2023 pullback and our expectation of WTI crude strengthening as the year progresses. We have meaningfully biased our Energy positioning to service names with international exposure and this has benefited portfolios nicely over the last month.

Our favorable attitude towards active management and small-caps does not mean that the rest of the year will be clear

sailing. Summers, particularly August and September, tend to be challenging for our portfolios as earnings season ends and macro factors such as the Fed, rates, geopolitics, elections etc. creep back into the market's psyche. We likely will be modestly adding to our Consumer Staples exposure and other defensive areas of the market to help to stabilize portfolios against summer doldrum-induced market volatility.

WE BELIEVE THAT ACTIVE MANAGEMENT WORKS WHEN INVESTORS ARE NOT CONSUMED BY MACRO ISSUES SUCH AS RATES, INFLATION, GEOPOLITICS, ETC.

We purposely added two titles to this quarterly commentary to highlight two important aspects of the market: 1) We believe that active management works when investors are not consumed by macro issues such as rates, inflation, geopolitics, etc.; and that 2) Emerald's Growth Opportunities all-cap dynamic-barbell strategy is ideally situated to take advantage of market dislocations such as the one we are currently encountering. We contend the excessive concentration of returns and valuation disparities seen in the first half, with the top seven mega-caps (the "Magnificent 7") accounting for virtually all of the S&P 500 quarterly returns, is not sustainable. Due, in part, to some relief from macro concerns, pair-wise stock correlations dropped markedly in the second quarter and dispersions (or as BofA Securities terms Alpha opportunities), particularly amongst small-caps, moved above historical averages. Both factors contributed nicely to our quarterly and YTD outperformance.

The second quarter, and the first half of 2023, serve as a validation of the value of dynamic-barbell portfolio construction. Emerald has outperformed while simultaneously biasing our portfolios to take advantage of the inevitable broadening of investor interest beyond mega-cap, household names; and we believe this research-backed flexibility will continue to benefit portfolios regardless of market factors. Our team's ability to generate alpha through stock selection has been a hallmark of Emerald throughout its 30-year history and we believe the ability to identify secular themes and company-specific/idiosyncratic growth opportunities, coupled with the ability to bias the portfolio across the capitalization spectrum without losing sight of the broad benchmark is an enduring, valuable characteristic of the Growth Opportunities portfolios.

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