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EMERALD MID CAP GROWTH

"Finally, a Macro Reprieve!"

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 Russell 1000 Growth stocks besting Russell Mid-Cap Cap Growth equities by over 600 basis points. Against this challenging backdrop, Emerald Mid-Cap Growth portfolios experienced strong Q2 2023 performance, allowing us to build a material year-to-date lead over our Russell Mid-Cap Growth Index. Strong stock selection, as well as declining stock correlations and greater dispersion in equity returns – both positives for active management – contributed to robust absolute and relative returns.

KEY POINTS:

- ***Emerald Mid-Cap Growth portfolios experienced strong absolute and relative quarterly returns driven by favorable stock selection in the Technology, Energy, Real Estate, Healthcare, and Industrials sectors.***
- ***Portfolios continue to be overweight Consumer Discretionary, Staples and Energy and underweight Technology, Financials, Healthcare and Materials. We maintain an equal weight to Industrials and Real Estate.***
- ***The Emerald Mid-Cap Growth product has leveraged the strong fundamental research of Emerald's team of analysts to add mid-cap companies with company-specific growth drivers to our portfolio, while remaining mindful of the increasing concentration of larger mid-cap names within the Russell Mid-Cap Growth benchmark.***

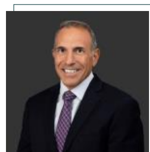
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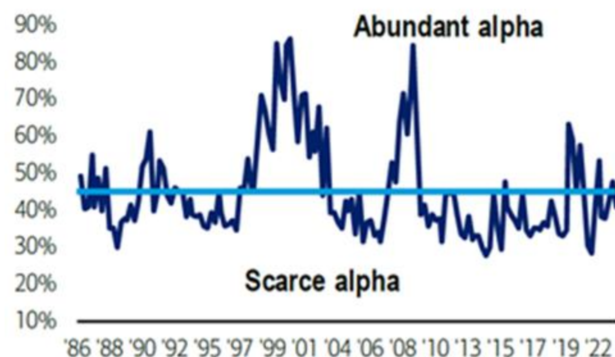
Exhibit 1: Pair-wise correlation in the S&P 500 fell below average
Average pair-wise stock correlations based on 90-day periods, daily frequency

Source: BofA US Equity & Quantitative Strategy, FactSet

Exhibit 3: Alpha opportunities in the S&P 500 are slightly below the historical average
Large cap dispersion in returns by top/bottom quintile



Source: BofA US Equity & Quantitative Strategy, FactSet

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 2 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 continued to defy expectations of weakening, pointing to growth of 2% for the quarter. However, money supply growth, a normal predicator of future GDP, continued to decline meaningfully during the quarter.

In terms of Mid-Cap Growth index sector performance, Industrials and Technology were the leaders – followed by Communication Services and Consumer Discretionary. Energy was the weakest performer, followed by Healthcare and Utilities. There was not much discernable differentiation in terms of performance characteristics in the quarter. Names with higher leverage, lower P/Es and ROE outperformed, as did higher sales growth equities in general. What is striking is the Index's concentration, with Jefferies estimating that the top 50 names in the benchmark now account for over 50% of the weight of the Index – the most concentrated ever.

PORTFOLIO REVIEW

As noted, Emerald Mid-Cap Growth portfolios experienced strong absolute and relative quarterly returns driven by favorable stock selection in the Technology, Energy, Real Estate, Healthcare, and Industrials sectors. Stock selection adversely impacted Materials, Consumer Discretionary and Financials. Portfolios continue to be overweight Consumer Discretionary, Staples and Energy and underweight Technology, Financials, Healthcare and Materials. We maintain an equal weight to Industrials and Real Estate. Portfolios also continue to be similarly sized vs. the benchmark with a weighted average market cap of $23.6 billion vs. $25.2 billion for the Russell Mid-Cap Growth benchmark, with estimated weighted average 3-5-year EPS growth of +18.38% % vs. +18.81% for the Index. While portfolios have similar expected EPS growth, valuations are still discounted vs. the benchmark on most major characteristics such as Price/Earnings, Price/Cash flow and Price/Book. While portfolio expected growth rates dropped modestly this past quarter, the valuation discount has been in existence for several years – a setup we have exploited successfully since before the onset of the pandemic.

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%. As noted, mid-cap growth stocks performed well in Q2 2023, but trailed large-cap growth Indices. The quarter-end saw a very significant benchmark reconstitution, with Healthcare increasing by a whopping +6.4% and Tech slimming down by (-4.6%). Financials gained almost +3% and Consumer Discretionary dropped by (-2.5%). We have been working diligently to add to our Healthcare exposure but are up against many of the same concentration issues we have seen for years in our all-cap growth product – a very few names making up the bulk of the Index Healthcare weight. The same is the case in Financials. To deal with excess concentration, we look to use some of the same Dynamic Barbell portfolio construction principles that we employ in our all-cap growth product within mid-cap. These include dynamically balancing exposure to the largest names in the mid-cap growth universe with smaller, well-researched mid-cap growth companies that should provide investors with meaningful alpha-generating opportunities.

The Russell Mid-Cap Growth Index P/E grew to 26 times earnings at quarter end, with most of the performance in the quarter driven by P/E expansion. Mid-Cap Growth stocks are not cheap, but trade at a discount to both small- and large-caps and trade at a lower premium to their average P/Es than either small- or large- caps.

Fortunately for Emerald Mid-Cap Growth investors, portfolio valuations are materially lower than the benchmark with P/Es averaging a 20% discount to the benchmark, cashflows trading at a 27% discount, and book values trading at half the levels of the benchmark. On a Price/Sales basis, portfolios trade at a modest premium. We highlight these valuation comparisons to make it clear that Emerald portfolios are not expensive compared to the broader market. This is mainly based on stock selection and portfolio construction which has us overweight "Cheaper" sectors such as Energy, Materials and Consumer Discretionary – some of the less expensive areas of the market. We have been able to construct portfolios in such a fashion without sacrificing growth, as noted above, portfolios are estimated to have future EPS growth roughly equivalent to the benchmark.

It is our contention that market breadth will continue to expand to include cyclicals, small- and mid- caps and unprofitable Tech and Healthcare. Growth will continue to outperform and lead the market higher, which should be very positive for our portfolios. 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

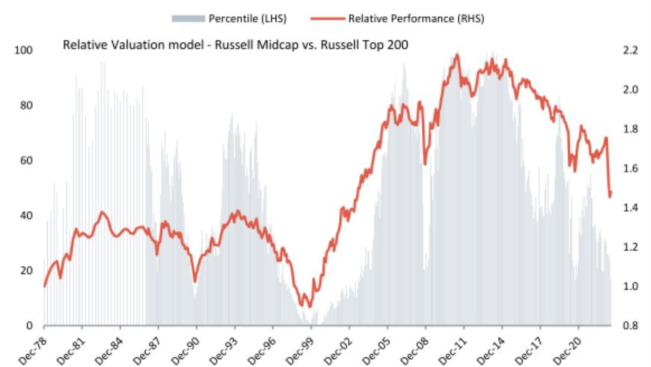
that it pushes the Fed to do more to slow down the economy. We believe we have been in a rolling recession for several quarters with slowdowns seen in manufacturing and other sectors. The Leading Economic Indicator remains historically weak. Inflation adjusted S&P operating earnings are at recessionary 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. We think 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. Mid-cap growth earnings are expected to fall -9.4% in 2023 vs. just -0.5% at the beginning of the year, showing analysts have been very aggressive in revising earnings downward. Small- and mid-caps have generally been beating revised earnings estimates, which is also positive for small- and mid-caps. We would also expect analyst estimates for 2024 mid-cap earnings to be materially higher than for large-caps.

Credit conditions – High yield spreads, a major determinant of small-cap performance, have been very benign over the past quarter, although 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 mid-caps vs. large, as shown by the Russell Mid-cap vs. the Russell top 200, is back to levels form the early 2000s and is showing at only the 17th percentile relative valuation.

Chart 22 - ...17th when compared to the Top 200



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 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 are strengthening. Per the benchmark reconstitution, we have been adding Healthcare and Financial exposure to align ourselves more closely with the index and add more defensive characteristics to the portfolio. 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-/mid-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.

The Emerald Mid-Cap Growth product has leveraged the strong fundamental research of Emerald's team of analysts to add mid-cap companies with company-specific growth drivers to our portfolio, while remaining mindful of the increasing concentration of larger mid-cap names within the Russell Mid-Cap Growth benchmark. The 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 focus of this fund on some of the fastest growing, most dynamic mid-cap growth companies without losing sight of the broad benchmark is a unique, and valuable, characteristic. We believe this research-backed flexibility will continue to benefit portfolios regardless of market factors.

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