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Q3 2023 | ECONOMIC & PORTFOLIO COMMENTARY

EMERALD MID CAP GROWTH

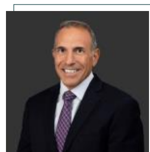
"The Dreaded Summer Swoon"

EMERALD MID CAP GROWTH PORTFOLIOS posted negative absolute and relative returns in the 3rd quarter, as macro factors such as increasing interest rates, fears of a government shutdown, and a continued hawkish Fed, caused equity investors to take a risk off attitude, driving markets lower in August and September. Portfolios benefited from being overweight Energy, the best performing sector for the quarter, while performance in the Industrials and Technology sectors detracted from quarterly returns.

From an economic perspective, GDP forecasts for the 3rd quarter improved as the quarter progressed, with the Atlanta Fed GDPNow estimate ending the quarter at close to 5% growth. Rates, as mentioned above, surged, led by a 46-basis point jump in the 10-year yield. Inflation continued to moderate, with core PCE inflation decelerating to a 0.1% month over month rate in August. While retail sales, selected output and capacity measures and employment indicators stabilized or improved as the quarter progressed, a few indicators, such as the Leading Economic Index and the ISM Manufacturing report continued to point towards a weakening economy.

KEY POINTS:

- ***Emerald Mid-Cap Growth portfolios posted negative absolute and relative returns in the 3rd quarter, as macro factors such as increasing interest rates, fears of a government shutdown, and a continued hawkish Fed, caused equity investors to take a risk off attitude, driving markets lower in August and September.***
- ***Portfolios benefited from our Energy overweight and strong stock selection in that sector, as well as from strong stock selection in the Healthcare and Consumer Staples sectors. Portfolios underperformed in the Materials, Consumer Discretionary, Financials, Industrials and Technology sectors.***
- ***We believe our focus on companies with idiosyncratic growth drivers, oftentimes small in the benchmark, coupled with our practice of covering at least some portion of the weighting of many of the larger benchmark weighted names, allows for the opportunity to add material alpha, while at the same time minimizing portfolio risk.***



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During the 3rd quarter, large cap equities beat small and mid, with the Russell 1000 Growth benchmark outperforming the Russell Mid Cap and 2000 (Small Cap) Growth Indices by 200 and 400 basis points respectively. Specifically related to the Russell Mid-Cap Growth segment, companies with lower leverage, foreign sales and P/Es outperformed, as did companies with lower sales growth, which certainly penalized higher growth managers such as Emerald.

PORTFOLIO REVIEW

As noted, Emerald Mid-Cap Growth portfolios experienced negative absolute quarterly returns and moderately trailed our benchmark. Portfolios benefited from our Energy overweight and strong stock selection in that sector, as well as from strong stock selection in the Healthcare and Consumer Staples sectors. Portfolios underperformed in the Materials, Consumer Discretionary, Financials, Industrials and Technology sectors. Beyond our overweight to Energy, portfolios maintain an underweight to Financials and Technology.

Portfolios widened their growth advantage vs. the benchmark with estimated weighted average 3–5-year EPS growth of +19.40% % vs. +17.20% for the Russell Mid Cap Growth Index. While portfolios have materially higher expected EPS growth, valuations are still discounted vs. the benchmark on all major characteristics such as Price/Earnings, Price/Cash Flow, Price/Sales, and Price/Book Value. This valuation/growth disparity in our portfolios has been in existence for several years – a setup we have tended to exploit successfully since before the onset of the pandemic.

MARKET OUTLOOK

Last quarter and in several preceding quarters, we questioned the sustainability of the Mega-Cap-driven equity rally, which accounts for a huge percentage of major growth equity index YTD returns. Year to date, we have thus far been wrong about the sustainability of this outperformance. The performance disparity between small, mid, and large has persisted and **grown,** despite an increasing valuation disparity and unprecedented index concentration. But we stick by our belief that over time market breadth will improve, and small- and mid-caps can and will make up some of their longer-term underperformance.

Russell Index Mid Cap Growth valuations still trade at a premium to their long-term averages on most valuation metrics such as Price/Earnings, Price/Book, Price/Sales, and Price/Cash Flow. However, Russell Index Mid Cap Growth stocks do look reasonably valued vs. large cap growth stocks. Expected 2024 earnings growth rates for Russell Index Mid Cap Growth stocks are relatively in line with Large Cap Growth stocks. Given its characteristics, investors in Emerald's strategy own a portfolio of Mid Cap Growth stocks that trade at hefty discount to Russell Index Mid Cap Growth equities, and Russell Mid Cap and Large Cap Growth indices. Investors also own a portfolio that should grow earnings over 200 basis points faster than the index over the next 3-5 years. This set-up leaves us very positive towards our Mid Cap portfolios, even assuming a modest recession.

As we wrote in last quarter's commentary, we do believe a recession is coming. We look at the Leading Economic Indicators which have registered negative readings for the last 18 consecutive months - a timeframe that has always predicted a recession. In addition, according to Tony Dwyer from Canaccord, it has been 15 months since the yield curve inverted, a timeframe which is in line with the median lead time to recession. Money supply, which normally correlates in some way to GDP, has been in negative territory for several months – the first time in history. Bank lending standards have tightened, signaling recessionary conditions, while at the same time loan demand has deteriorated. The ISM Manufacturing survey also remains in contraction although at levels just above those signaling recession.

As it relates to rates and inflation, we are confident the Fed is done raising rates. Geopolitical strife, a potential domestic government shutdown, union strikes, and student loan repayment issues should keep the Fed on hold. Also, when factoring QT and bank lending, the San Fransico Fed estimates the effective Federal Funds rate at over 7% - certainly sufficiently restrictive to satisfy the Fed inflation hawks. We

think inflation will continue to surprise to the downside driven by owners' equivalent rents, auto prices and a myriad of other inputs.

From a portfolio positioning viewpoint, we continue to meaningfully overweight the Energy sector, particularly offshore/international oilfield services as we believe we are in the early innings of a multi-year capex cycle for international and offshore energy production. We have also added to our Utility/Alternative Energy allocation, given the large pullback in share prices in the industry and our belief that rates are peaking and should be less of a headwind for that industry. We continue to underweight Financials given the challenges that higher rates and potential slower economic growth have posed to that sector but are looking to add to our financial exposure on weakness. We added to our Consumer Staples exposure last quarter given our recession concerns and maintain a strong position in healthcare for the same reason.

WE BELIEVE THIS BARBELL STRATEGY, THAT WE HAVE SUCCESSFULLY EMPLOYED IN OUR MULTI-CAP GROWTH OPPORTUNITIES PORTFOLIOS, AFFORDS US THE OPPORTUNITY TO OUTPERFORM IN VARIOUS TYPES OF MARKETS: INCLUDING BOTH HIGHER AND LOWER ECONOMIC GROWTH ENVIRONMENTS.

Despite a challenging 3rd quarter, and some weakness vs. our benchmark over the past year, Emerald Mid Cap portfolios have performed well over the past three years mainly due to our barbelling the portfolio to overweight selected cyclical areas of the market like Energy and Consumer Discretionary, while at the same time holding many secular oriented names in Healthcare, Technology, and other sectors. We believe this barbell strategy, that we have successfully employed in our multi-cap Growth Opportunities portfolios, affords us the opportunity to outperform in various types of markets: including both higher and lower economic growth environments. We believe our focus on companies with idiosyncratic growth drivers, oftentimes small in the benchmark, coupled with our practice of covering at least some portion of the weighting of many of the larger benchmark weighted names, allows for the opportunity to add material alpha, while at the same time minimizing portfolio risk.

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