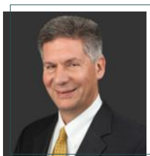
EMERALD DIVERSIFIED SMALL CAP GROWTH

SEASONALITY AND HIGHER LONG-TERM YIELDS LOWER THE BOOM ON EQUITIES

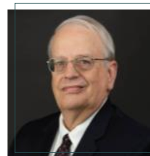
SINCE 1928, THE S&P 500 has closed in negative territory 52 times during September, more than any other month, according to Yardeni Research. With September of 2023 now in the record books, you can make that 53 times, with the last month of the third quarter certainly living up to its billing. The treasury market hit a tipping point as the collision of a persistently stronger labor market, waning disinflation resulting from the surge in oil prices, a rapidly widening fiscal deficit and increasing bond supply, propelled U.S. Treasury yields higher across the curve. The long-end of the curve hit escape velocity with the 10-year yield breaching 4.80% and the 30-year yield approaching 5.0%, levels for each not witnessed since 2007. As yields surged, equity and bond markets retreated, with the S&P 500 (-4.77%), the Russell 1000 (-4.70%), and the Russell 2000 (-5.89%) each declining mid-single digits, while the Bloomberg US Aggregate Government Treasury Long Index fell (-7.29%). The depth of the September market retrenchment pushed equity market returns for the third quarter into negative territory across all market capitalizations and styles.

KEY POINTS:

- ***The depth of the September market retrenchment pushed equity market returns for the third quarter into negative territory across all market capitalizations and styles.***
- ***The Emerald Small Cap Diversified Growth portfolio underperformed the Russell 2000 Growth Index for the third quarter driven by negative selection effect.***
- ***At the sector level, underperformance within the consumer discretionary and healthcare sectors more than offset the positive contribution to return from holdings within the basic materials and energy sectors.***
- ***As we enter the fourth quarter of 2023, the portfolio currently holds the largest active exposures in the healthcare, consumer staples and financials sectors.***



JOSEPH W. GARNER
PORTFOLIO MANAGER & DIRECTOR OF RESEARCH



KENNETH G. MERTZ II, CFA
PORTFOLIO MANAGER, PRESIDENT & CIO

STACEY L. SEARS
PORTFOLIO MANAGER & SENIOR VICE PRESIDENT

Small capitalization stocks remained a relative laggard with the Russell 2000 falling (-5.13%) for the quarter and trailing the Russell 1000 which declined by a more modest (-3.15%). From a style perspective, value led across the capitalization spectrum with the Russell 2000 Value (-2.96%) outpacing the Russell 2000 Growth (-7.32%). At the sector level, weakness within the Russell 2000 Growth index was broad-based, with only the energy sector (+11.18%) registering a positive return for the third quarter, whereas the telecommunications (-18.73%), utilities (-14.57%), and healthcare (-14.29%) sectors led to the downside.

The rising cost of capital weighed particularly hard on the non-revenue/non-earnings generating companies within the benchmark, with these cohorts underperforming the Russell 2000 Growth by 311 bps and 643 basis points respectively, according to an October 1, 2023, report from Steve DeSanctis, Equity Strategist at Jefferies. The relative underperformance of the healthcare sector similarly weighed on the fastest growers as measured by sales growth, with that cohort underperforming the Russell 2000 Growth benchmark overall by approximately 196 basis points.

PORTFOLIO REVIEW

The Emerald Small Cap Diversified Growth portfolio underperformed the Russell 2000 Growth Index for the third quarter driven by negative selection effect. The tailwinds that helped drive the portfolio's relative outperformance in the second quarter turned to headwinds, as the healthcare sector and the higher-multiple, faster-growers and non-earners lagged. At the sector level, underperformance within the consumer discretionary and healthcare sectors more than offset the positive contribution to return from holdings within the basic materials and energy sectors.

The consumer discretionary sector was the portfolio's largest detractor to return for the period. Rising concerns over the direction of consumer spending in the wake of rising gas prices, decelerating late August and September spending trends, waffling consumer confidence, and the resumption of student loan payments weighed heavily on sentiment in the more service-oriented industries within the sector. These headwinds combined with more challenged stock selection drove relative underperformance within the restaurant, specialty retail, casinos and gambling, airlines, and recreational services industries.

Performance within the healthcare sector also detracted from relative performance for the quarter, driven largely by the allocation effect as stock selection was a positive contributor to return. From an allocation perspective, Emerald's large nominal (avg. weight 29%) and active exposure (avg. overweight +700 bps) proved to be a significant headwind to performance, despite the positive contribution from stock selection, given the sizeable underperformance of the Russell 2000 Growth healthcare sector (-14.29%) as compared to the Russell 2000 Growth (-7.3%). Positioning within the sector was an additional headwind as the portfolio's concentration of holdings within the biotechnology industry and overweighting to the medical equipment, healthcare services and medical services industries proved to be a negative as these industries further underperformed the index as the dual headwinds of rising rates and perceived threats to future demand as a result of broad adoption of the anti-obesity medications drove significant multiple compression across these industries.

Partially offsetting the above detractors to return was relative outperformance from the basic materials and energy sectors. Holdings and positioning within the energy sector also contributed positively to performance. The portfolio's overweight position to the energy sector which was the best performing sector within the Russell 2000 Growth this quarter, and strong selection within the oil equipment and services industry were the key drivers of the portfolio's relative outperformance this quarter.

As we enter the fourth quarter of 2023, the portfolio currently holds the largest active exposures in the healthcare, consumer staples and financials sectors. Thoughts on those sectors are highlighted below.

- The healthcare sector represents the portfolio's largest nominal and active exposure. At the

industry level, the portfolio currently holds the largest nominal and relative overweight positions within the medical equipment, biotechnology, pharmaceuticals, and medical services industries. We continue to be focused on medical devices and diagnostic companies that are profitable and not trading on a revenue multiple. For therapeutics, we are focused on profitable companies and those with quality assets generating revenue with a view towards profitability. Approximately 70% of our therapeutics (biotech + pharma) exposure is in companies that have revenue.

- The portfolio also exited the third quarter with an overweight position within the consumer staples sector. We remain positive on the fundamental outlook for growth-oriented consumer packaged goods companies. We see mounting evidence that the broad-based cost inflation and supply chain issues that plagued the industry throughout 2022 are abating, which should result in higher profit margins entering 2024. We continue to focus on companies with disruptive brands, category leadership positions, strong secular growth opportunities, and improving profit margins that may enable them to navigate an often-turbulent business environment, resulting in industry leading revenue and earnings growth.

- Emerald also held an overweight position within the financial sector driven by holdings within the bank, full line insurance, investment services, and property and casualty insurance industries. The largest concentration of exposure is held within the full line and property casualty insurance industries where Emerald continues to focus on companies with strong balance sheets, and exposure to growing specialty end-markets with sustained pricing power.

MARKET OUTLOOK

When will the Federal Reserve stop raising rates and when will they cut? That is the riddle the market has been trying to solve since the Federal Reserve embarked on this hiking cycle. Treasuries have been repricing since the Silicon Valley Bank failure. Over this time the 10-year Treasury yield has risen approximately 153 bps, first as a reflection of better-than-expected growth and falling recession probabilities, and most recently in response to the growing momentum behind the higher for longer interest rate regime supported by resilient labor market, and the recent surge in oil prices. However, with more than 500 bps of Federal Funds rate increases now in the rearview mirror, and no rate relief in sight, concerns are rising that the longer rates stay high, and the tighter financial conditions become, the more likely something is going to break. Surging fiscal deficits, government disarray, waffling consumer confidence and decelerating consumer spending through September added further to this growing consternation. The early October Hamas attack and declaration of war from Israel, the prospect of U.S. involvement and the potential impact to energy prices only adds to the building wall of worry. While that question is unlikely to be resolved in near-term, we believe the significant tightening in financial conditions since the Federal Reserve meeting in September, the more recent dovish commentary from Fed officials, and the flight to quality resulting from the war in Israel, will likely result in some retrenchment in Treasury yields in the near-term and provide some breathing room for equities.

... WHILE WE HAVE BEEN EARLY IN OUR CALL FOR A SHIFT IN LEADERSHIP BACK TOWARD SMALL CAPITALIZATION STOCKS, TACTICALLY WE BELIEVE THAT GIVEN THE SIGNIFICANT YEAR-TO-DATE RELATIVE UNDERPERFORMANCE OF THE RUSSELL 2000 (+2.54%) TO THE RUSSELL 1000 (+13.0%), THERE IS A NEAR-TERM OPPORTUNITY FOR SMALL CAPITALIZATION STOCKS TO CLAW BACK SOME OF THAT RECENT UNDERPERFORMANCE.

Corporate earnings season is set to kick off this week and given the underlying strength in forecasted third quarter economic growth, we believe earnings season could offer additional near-term support to the market as we enter the seasonally strongest period for equity returns. In this regard, while we have been early in our call for a shift in leadership back toward small capitalization stocks, tactically we believe that given the significant year-to-date relative underperformance of the Russell 2000 (+2.54%) to the Russell 1000 (+13.0%), there is a near-term opportunity for small capitalization stocks to claw back some of that recent underperformance. According to a September 30, 2023 report from Steve DeSanctis Equity Strategist at Jefferies, the Russell 2000 rallied more than 10% during the fourth quarter 12x in its 44-history, with those rallies largely occurring when small caps have lagged large caps through the first 9-months of the year.

On a longer-term basis, the sizeable underperformance of the small cap segment remains an outlier relative to history with the rolling 5-year return for the Russell 2000 standing at 2.7% vs. 10% for the Russell 1000, a differential of 7.3% which falls in the 7th percentile relative to history, according to same report cited above. The sizeable underperformance over the rolling periods has pushed the relative valuation of the Russell 2000 to the Russell 1000 into the 7th percentile vs. history, a level last reached in February 2002, with the index trading at a double-digit discount relative to the long-term average based on trailing P/E, forward P/E, price to book, price to cash flow, price to sales and P/E to growth. It is also noteworthy, according to same report, that this record streak of large capitalization outperformance has been driven by a subset of the Russell 1000 index, with the top 10 names now accounting for 28.8% of the Russell 1000 index, and over 51.2% of the Russell 1000 Growth Index. For reference, at the peak of the Tech Bubble, the top-10 positions within those indices accounted for 23.8% and 36.5%, respectively.

Ultimately something must give, and while it is always difficult to call the exact inflection point, we believe that a durable resumption in small capitalization stock leadership will be predicated on a further deceleration in the rate of inflation, a stabilization in employment gains and wage growth, a definitive end to the Federal Reserve hiking cycle, and further confidence in a reacceleration in the corporate earnings growth in 2024.

Emerald, as always, remains vigilant and focused on utilizing our fundamental bottom-up research process to identify the most attractive growth opportunities within the small capitalization universe.

CONTACT US

Emerald Advisers, LLC

Phone: 1-800-722-4123
info@teamemerald.com

3175 Oregon Pike | Leola, PA 17540
King of Prussia, PA

TO LEARN MORE ABOUT EMERALD OR TO SCHEDULE A CALL WITH OUR TEAM, VISIT:

WWW.TEAMEMERALD.COM