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EMERALD GROWTH OPPORTUNITIES

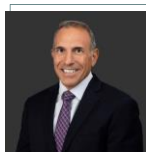
"Three Years All Rolled into One"

THE EMERALD GROWTH OPPORTUNITIES Multi-Cap Strategy finished 2023 strong with robust annual absolute and relative performance vs. our Russell 3000 Growth benchmark. While results trailed our benchmark for the 4th quarter, they were still strong on an absolute basis, led by solid returns in the Technology, Healthcare and Financial Sectors. Our overweight to Energy hurt relative returns for the quarter, as did performance in the Industrials and Real Estate sectors. As a testament to positive stock selection, results exceeded our benchmark for the year despite being consistently underweight the "Magnificent Seven" of mega-cap stocks which as a group were up approximately 70% for the year.

As noted in the title of this commentary, Emerald's annual performance can be separated into three distinct periods. Our performance in the first half of the year was strong both absolutely and relatively, as our overweight to some small caps that lagged in 2022 contributed to performance, as these names bounced back from tax loss selling and under-ownership. We also benefited from strong performance of a few, select Artificial Intelligence (AI) related over-weights, as well good Healthcare stock selection. We gave back much of our

KEY POINTS:

- ***The Emerald Growth Opportunities Multi-Cap Strategy finished 2023 strong with robust annual absolute and relative performance vs. our Russell 3000 Growth benchmark.***
- ***Portfolios experienced positive attribution in the Consumer Discretionary, Staples, Healthcare and Financials sectors while our overweight to Energy – the quarter's worst performing sector - hurt performance, as did stock selection in Technology and Industrials.***
- ***Presently, we are underweight Technology, Mega caps, and Industrials and overweight Healthcare and Energy, with other sectors generally equal weight.***



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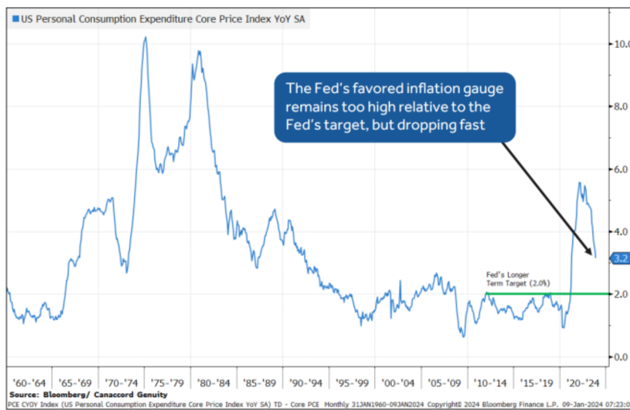
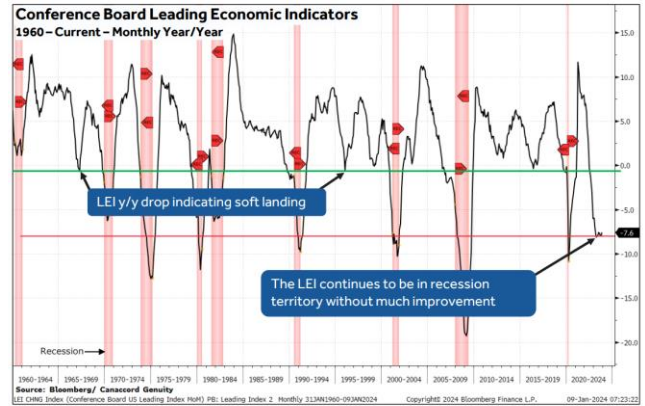
outperformance in the very painful July – October period, that was characterized by extreme risk-off sentiment towards small caps, cyclically oriented names, and non-"Magnificent Seven" growth stocks. The Fed's "higher for longer" rate rhetoric, fears of a government shutdown and persistent inflation and recession fears, as well the 10-year U.S. Treasury spiking above 5%, all served to feed the "Summer Swoon" dreaded by most equity investors. Then in October, everything, and we mean everything, changed. The Fed, on the back of softening inflation data, and soft, but not negative economic reports, abruptly changed its tune - causing rates to cascade lower and the market to move dramatically higher in the last two months of the year. Small caps and cyclicals, two portfolio overweights, led the market higher in what turned out to be a profitable year for most equity investors.

From an economic perspective, multiple indicators continued to show relative strength during the quarter led by employment - with continued low civilian unemployment and initial unemployment claims - positive GDP growth and Consumer Confidence and markedly improving productivity. The big market story was the continued softening of inflation measures, with the core PCE registering a market-friendly 0.1% growth in October and November.

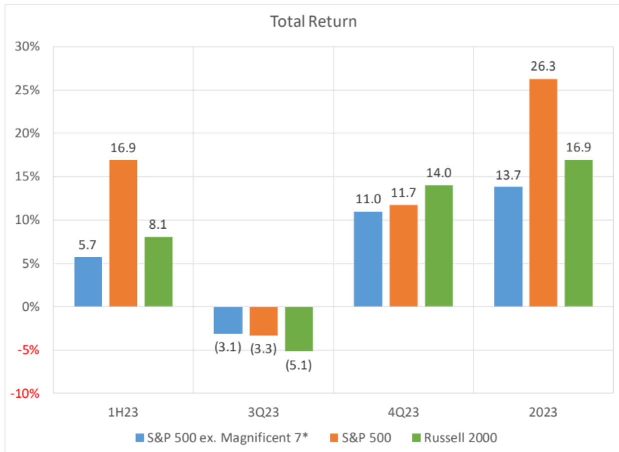


That is not to say all was wine and roses, as numerous output and capacity measures continued to point to weakness in the manufacturing and selected service sectors of the economy. In particular, the Leading Economic Indicator (LEI) has been in the red an astounding 20 months in a row and the ISM Manufacturing PMI has trended below 50 for every month of 2023. Money supply has been persistently negative, and the 2/10 US Treasury bond spread was inverted every day in 2023 except two – certainly not a positive economic indicator.



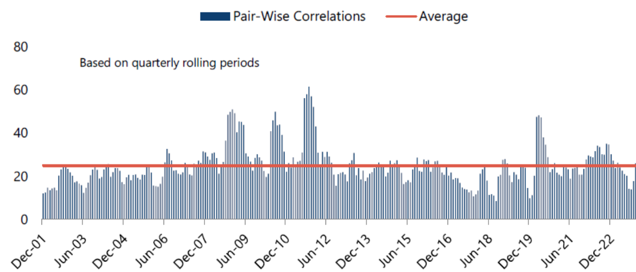
Beyond the market's slowing-inflation-related euphoria, investors – us included – clearly underestimated the prospects of a soft landing. Investors overestimated the interest rate sensitivity of the economy focusing too much on more interest rate sensitive areas of the market like manufacturing and housing (which we could argue were in recession) vs. what some folks call the "Ed, med and hotel bed," areas of the economy, which are less interest rate sensitive. Investors failed to recognize that consumers and businesses exited the Covid economy with better balance sheets and that the Federal government continues to spend. Lasty, investors and the Fed underestimated the loosening of supply side constraints serving to push inflation back towards the Fed's 2% goal.

For the quarter, mid-cap growth stocks led, followed by multi-cap growth, with small growth returns strong, but trailing. Growth beat value, with the Russell 3000 Growth Index exceeding the Russell 3000 Value Index return by almost 30 percentage points – an astounding outperformance led by the returns of the "Magnificent Seven" which made up approximately one-half of the S&P 500 return for the year.



Source: FRP, FactSet; as of 12/29/23; *Magnificent 7 is Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta, Tesla

Using the Russell 1000 Growth as a proxy for our Russell 3000 Growth Index, for the 4th quarter the smallest names in the index performed best, as did low ROE, non-earners, and companies with higher foreign sales. Pair wise correlations spiked on the "Everything Rally" making it no surprise that we, like many active managers, trailed on a relative basis during the 4th quarter.



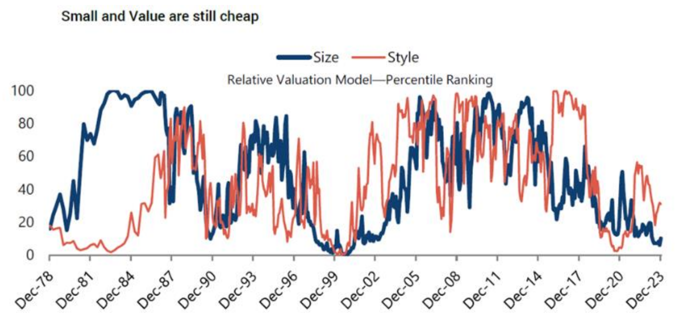
Source: FactSet; Lipper Analytical Services; FTSE Russell; Jefferies

PORTFOLIO REVIEW

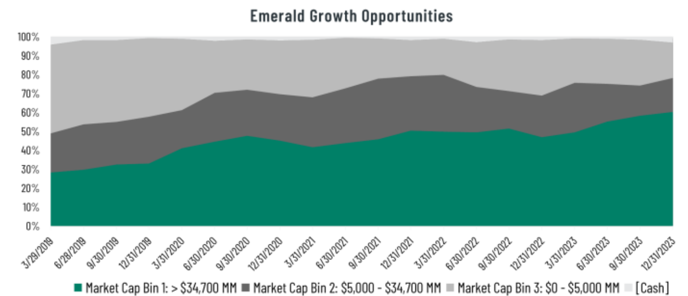
As noted, Emerald Growth Opportunities portfolios experienced positive absolute quarterly returns in the 4th quarter, but negative relative returns vs. our benchmark. Portfolios experienced positive attribution in the Consumer Discretionary, Staples, Healthcare and Financials sectors while our overweight to Energy – the quarter's worst performing sector - hurt performance, as did stock selection in Technology and Industrials.

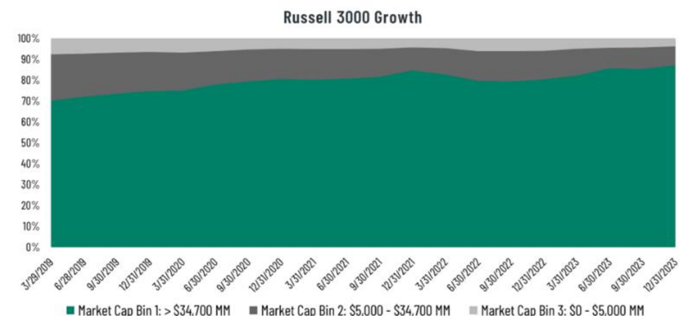
We continue to rely on our barbell portfolio construction framework of dynamically repositioning holdings by market cap, growth, economic sensitivity, geographic exposure, yield, momentum, and many other factors. This Dynamic Barbell approach allowed us to maintain exposure to selected large and mega-caps regardless of valuation, while at the same time allowing positioning in selected smaller cyclical-oriented names and equities with company-specific growth drivers. As has been the case for many quarters, Growth Opportunities portfolios remain overweight small- and mid-cap stocks vs. the benchmark given our thoughts on relative valuation and growth, with small cap relative valuations vs. large trading in the 10th percentile – a level not seen since 2002.

Small and Value are still cheap



Source: FactSet; FTSE Russell; Jefferies





Portfolios continued to maintain their earnings growth advantage vs. the benchmark with estimated weighted average 3-5-year EPS growth of 21.88% vs. 17.38% for the

Russell 3000 Growth index. As has been the case for many quarters, while portfolios have superior estimated EPS growth, valuations are still discounted vs. the benchmark on most major valuation metrics including Price/Earnings, Price/Sales, Price/Cashflow and Price/Book, a set-up we believe is positive for future returns should earnings growth come to fruition.

MARKET OUTLOOK

After 2023's dramatically positive equity performance, most clients would think us crazy and/or delusional to expect strong equity returns in 2024. Well call us crazy, but we do expect positive equity market returns in 2024, but the drivers of those returns will be very different than what drove equity returns for most of 2023. In 2023, as we noted earlier, over 2/3 of large cap equity returns were driven by just a few Mega cap names. As the following Jefferies Chart notes, 70.6% of US large cap (Russell 1000 Growth) returns were driven by just 10 stocks:

Ticker	Company Name	2023's Return	Contribution	Sector
MSFT	Microsoft Corp	58.2	6.4	Info Tech
AAPL	Apple Inc.	49.0	6.2	Info Tech
NVDA	NVIDIA Corp	239.0	5.2	Comm Serv
AMZN	Amazon.com	80.9	3.7	Discretionary
TSLA	Tesla	101.7	2.0	Discretionary
GOOGL	Alphabet A	58.3	1.7	Comm Serv
GOOG	Alphabet C	58.8	1.5	Comm Serv
AVGO	Broadcom Inc.	104.2	1.3	Comm Serv
META	Meta	194.1	1.2	Comm Serv
LLY	Eli Lilly	60.9	0.9	Health Care
Top 10		**73.7**	**30.1**	
Russell 1000 Growth			**42.7**	

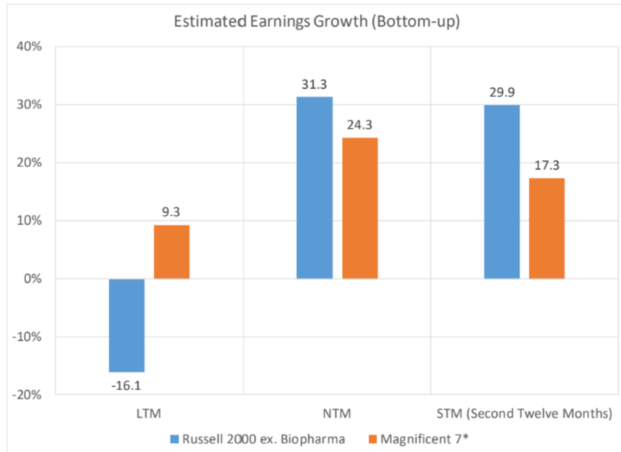
We think 2024 will be different. The market started broadening out in the last two months of 2023 to include small- and mid-caps, selected cyclicals, international-oriented names, highly shorted equities, and many low- and non-earners. Some call this a low-quality rally as it was led by low ROE names – we do not. Yes, lower ROE names bounced the most, but we see the market broadening out to include many names that trade at valuations that are dramatically lower than the Mega caps, with materially greater expected earnings growth.

In making the case for small caps – where we have been overweight for close to two years – we agree with the following call being made by Furey Research Partners in their year-end letter:

> "Despite a 25% move at year-end there is still a catch-up potential built into small caps - small caps are still behind large caps & the bond market (in returns) overall sentiment is far from exuberant and small sentiment is still negative, a lot of cash on the sidelines and extreme large-cap concentration can provide fuel for small when it cracks."

LAST QUARTER, 3Q23, MARKED THE BEGINNING OF AN EARNINGS RECOVERY, WHICH IS FORECASTED TO REACCELERATE THROUGHOUT 2024, WITH SMALL- AND MID-CAPS AND AREAS OF THE MARKET BEYOND TECHNOLOGY LEADING THE CHARGE.

Small is advantaged in valuation vs. large as we noted above in the commentary and is expected to have materially greater 2024 earnings growth with easy comps (see following Furey Research Partners chart showing expected 2024 small cap earnings growth vs. Magnificent Seven). Small caps also benefit from an easing dollar and potentially soft economic landing.



*Source: FRP, FactSet; as of 12/29/23; *Magnificent 7 is Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta, Tesla*

We highlight that the S&P 500 entered a 3-quarter-long earnings recession in late 2022. Last quarter, 3Q23, marked the beginning of an earnings recovery, which is forecasted to reaccelerate throughout 2024, with small- and mid-caps and areas of the market beyond Technology leading the charge. Earnings revisions, especially for small caps, have been trending higher since March 2023 according to Furey Research Partners and signaled a major bottom earlier this year.

Our expectations for robust 2024 earnings growth – particularly for small- and mid-caps, presupposes that the economy does experience a soft landing and many of the economic indicators we mention above like the LEI, Inverted Yield Curve, and weak money supply growth, that are all flashing recession warnings are false indicators and somehow the economy will slow but not experience a true recession in 2024. We have our doubts, but it is possible that the Fed's tightening will not cause a credit crunch that will inevitably turn into a recession and that the recession we saw last year in earnings, manufacturing, and housing, as well as last year's banking crisis, will be the extent of the economic slowdown.

Our commentary would be incomplete without one paragraph on inflation, the Fed, and rates. Most inflation gauges we follow including core and super core PCE are slowing - dropping towards the Fed's 2% target. In fact, 6-month core inflation is already below the Fed's target. Assuming this softening is sustainable, we believe the Fed could start cutting as early as March of this year, with at least 4 cuts in 2024, more if the economy slows toward recession. The real Fed Funds rate, when adjusted for quantitative tightening, is well over 6% and with inflation dropping it is becoming more important than ever for the Fed to move out of restrictive territory and start cutting. Cuts should weaken the dollar and should serve as fuel towards a broad equity market rally.

Presently, we are underweight Technology, Mega caps, and Industrials and overweight Healthcare and Energy, with other sectors generally equal weight. Our underweight in Technology is made up for by holding some high growth, small cap, higher-beta Technology names. Our overweight to healthcare is more bottom up, as our Lifesciences team has been able to identify many high growth, disruptive biotechnology, pharma and device names, whose earnings are relatively recession resistant. We have been overweight Energy for several years, as we know of few other sectors driving technological change and innovation than Energy. We also think our holdings' earning growth is dramatically above the industry's and that our holdings have many idiosyncratic growth drivers not tied directly to the price of the commodity. We like the reshoring/onshoring theme and are playing this through several Technology, Materials and Energy holdings. We benefited greatly in 2023 from certain AI-oriented holdings, and we maintain that exposure, as well as thematic exposure to cybersecurity, digital leisure, fintech and infrastructure/power to name a few.

We write in most commentaries that at Emerald we believe earnings drives stock prices. We look for companies with high earnings growth, competitive advantages, and most importantly great management teams. We think our portfolios have all the boxes checked related to the above and continue to like the set up for Growth Opportunities portfolios – materially higher expected earnings growth than the benchmark with lower valuations on every significant metric that we track. This does not guarantee outperformance vs. our index, but we think it puts us in an advantageous position.

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