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EMERALD DIVERSIFIED SMALL CAP GROWTH

SMALL CAP INVESTING IS BACK

THE TUG OF WAR between the bulls (soft landing) and the bears (hard landing) that has dominated the market narrative throughout 2023, convincingly shifted in favor of the bulls over the course of the fourth quarter. Inflationary pressures receded, domestic economic growth powered by the consumer remained resilient, and in December Chairman Powell and the Federal Reserve Open Market Committee adopted a significantly more dovish posture, declaring that the risks between inflation and employment were now balanced. Assets rallied across the board with the S&P 500 (+11.69%), the S&P 500 - equal weighted (+11.87%), MSCI World Ex USA (+10.51%) and the Bloomberg US Aggregate Government Treasury Long (+12.70%).

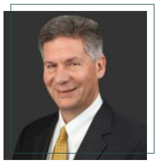
The inflection in performance was particularly pronounced within small caps, with the Russell 2000 surging more than 24% off the October low, up +14.03% in the fourth quarter and +12.22% in the month of December, marking the Russell 2000's best ever December return, according to a December 31, 2023 report from Steve DeSanctis, equity strategist at Jefferies. Despite the strong exit to the year, the Russell 2000 (+16.93%) trailed the Russell 1000 (+26.53%) by 960 bps for the calendar year 2023, the 9th widest gap ever, according to the

KEY POINTS:

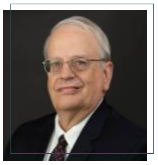
- ***The Emerald Small Cap Diversified Growth portfolio outperformed the Russell 2000 Growth Index for the fourth quarter driven by the positive contribution to return from selection effect.***

- ***At the sector level, outperformance within the healthcare, technology, and consumer staples sectors more than offset relative underperformance within the industrials, consumer discretionary, energy and basic materials sectors.***

- ***As we enter 2024, 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

same report. From a style perspective, within the Russell 2000, value led for the quarter with the Russell 2000 Value (+15.26%) outpacing the Russell Growth (+12.75%), as falling yields drove a meaningful bounce within the financial sector, which represents more than 26% of the Russell 2000 Value Index. Although growth lagged for the quarter, the style led for the year, with the Russell 2000 Growth (+18.66%) outpacing the Russell 2000 Value (+14.65%) during 2023, the first time the Russell 2000 Growth has outpaced the Russell 2000 Value since 2020.

Beneath the surface, the Federal Reserve pivot and reversal in yields changed the complexion of index leadership over the course of the fourth quarter. Specifically, according to the same report from Steve DeSanctis of Jefferies cited above, strength within the Russell 2000 Growth index was driven by the relative outperformance of the lowest return on equity quintile (+811 basis points), the sub-$500 million market capitalization companies (+252 basis points), and high yield (+197 basis points). When viewing performance by sales growth, while the fastest growers in the top quintile outperformed (+99 bps), the best relative performance was derived from the slowest growers in quintile 5 (+318 bps). Performance by P/E quintile was similarly bifurcated with both the lowest P/E cohort (+45 bps) and the non-earners (+600 bps) demonstrating relative strength. Despite the strong performance to close the year, each of these constituent cohorts: the fastest growers (-241 basis points), slowest growers (-745 bps), lowest P/E (-255 bps), non-earners (-121 basis points), and the sub-$500 million market cap companies (-2001 basis points) lagged the Russell 2000 Growth index for the full calendar year.

PORTFOLIO REVIEW

The Emerald Small Cap Diversified Growth portfolio outperformed the Russell 2000 Growth Index for the fourth quarter driven by the positive contribution to return from selection effect. The headwinds that constrained the portfolio's relative outperformance in the third quarter turned to tailwinds, as the healthcare sector, fastest-growers, and non-earners turned to leaders from laggards. At the sector level, outperformance within the healthcare, technology, and consumer staples sectors more than offset relative underperformance within the industrials, consumer discretionary, energy and basic materials sectors.

The healthcare sector was the portfolio's largest contributor to return for the quarter. Performance of the Russell 2000 Growth healthcare sector rebounded significantly gaining 15.84% during the fourth quarter as interest rates retreated and perceived threats to future demand resulting from the adoption of anti-obesity medications receded. Specific to the Emerald portfolio, as those headwinds turned to tailwinds, both absolute and relative portfolio performance improved driven by stock selection within the biotechnology, pharmaceuticals, medical services, and medical equipment industries.

The technology sector was also a positive contributor to performance driven by stock selection within the semiconductor and production technology equipment industries, and specifically holdings that are benefitting or are poised to benefit from secular tailwinds in artificial intelligence, automotive and advanced packaging. Although relative performance within the software industry was more neutral to the benchmark, the contribution from stock selection was solidly positive.

Emerald also realized solid outperformance within the consumer staples sector driven by stock selection within the food products industry.

Partially offsetting the positive contributors outlined above was relative underperformance within the industrials, consumer discretionary, energy and basic materials industries. The industrials sector was the largest detractor to return for the period as a result of both challenging stock selection within the industrial machinery, specialty machinery, and engineering and contracting services industries as well as the portfolio's relative underweight to the building materials and building related industries given their outperformance relative to the sector and Russell 2000 Growth Index overall.

The consumer discretionary sector also detracted from return for the period driven largely by portfolio positioning as there were no material stock level detractors to return. Contrary to the third quarter where consumer resiliency was a source of uncertainty as consumer spending waned, the recovery in consumer spending in November, rebounding confidence, and a solid start to holiday spending despite the resumption in student loans payments drove a meaningful rebound across the industries within the consumer sector. In this regard, while stock selection within the diversified retail industry was a modest detractor to relative performance, the more significant headwind resulted from the portfolio's relative underweight to industries within the sector that demonstrated significant relative outperformance including the education services, cosmetics, apparel retailers, clothing and accessories, and home construction industries.

Relative performance within the basic materials and energy sector also proved challenging this quarter as a result of both portfolio positioning and stock selection. The oil equipment and services industry was a particular source of weakness.

As we enter 2024, 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. Emerald also remains optimistic regarding the outlook for potential M&A within the sector. Merger and acquisition activity was robust in 2023 with 18 deals of publicly traded biotech companies announced with a total value >$1 billion. This is the highest in our database going back to 2018 and compares favorably to 11 deals in 2022.

- The portfolio also exited the fourth 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 in recent years are abating, which should continue to drive higher levels of profitability. We continue to focus on companies generating industry leading revenue and earnings growth rates driven by disruptive brands, category leadership positions, strong secular growth opportunities, and improving profit margins.

- 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.

MARKET OUTLOOK

Calendar year 2024 is starting out on much different footing then 2023. Inflationary pressures are moderating, Goldilocks is dominating the economic narrative, and the Federal Reserve, with the acknowledgement that risks are now more balanced between employment and inflation, appears at the ready to lower rates to support that dual mandate. The revised Federal Open Market Committee summary of economic projections supports this position, indicating that a majority of the committee members expect multiple cuts in 2024, although economic growth is projected to be only modestly below trend.

While we expect there will continue to be some handwringing by the market as to the timing, pace and ultimate levels of cuts, we believe the dovish pivot by Chairman Powell and the FOMC members has in and of itself substantially narrowed the range of potential outcomes from an economic perspective.

The end of a Federal Reserve hiking cycle has historically been favorable for small capitalization forward returns. We believe the sizeable fourth quarter rally provided a glimpse of that opportunity. While the aggressive move off the bottom has certainly been encouraging, if history is a guide the recovery could be just getting started. Historically, according to January 3, 2024 research report from Furey Research Partners, quarters as strong as the fourth quarter for the Russell 2000 are followed by positive performance with median returns of 6.3%, 8.5%, and 13.3% for the forward one quarter, two quarters and four quarters approximately 72%, 79%, and 69% of the time respectively.

Further when you consider, that despite the significant rally off the October low, the Russell 2000's CY2023 gain of 16.92% pales in comparison to the 26.53% CY2023 return posted by the Russell 1000. As a matter of fact, according to the December 31, 2023 report from Steve DeSanctis of Jefferies cited above, the spread of 9.6% is still the 9th widest in history. When comparing the Russell 2000 to the Nasdaq 100, that gap is more extreme at 38.0%, the third widest in history, with only 1998 and 1999, recording a wider performance gap. 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 9.97% vs. 15.51% for the Russell 1000, a differential of 5.6% which falls in the 12th percentile relative to history, according to that same report.

The sizeable underperformance of the Russel 2000 combined with the substantial outperformance of the Magnificent 7 has pushed concentration within the equity market to historically high levels with the aggregate weight of the Top 7 S&P 500 stocks at approximately 29%. Prior to this cycle, the last time the market was this concentrated was 1973, according to research from Furey Research Partners. According to the same report and looking at the equity market concentration from a different angle, the Russell 2000 market cap as a percentage of the Russell 1000 market capitalization is currently hovering around the lowest level ever. We believe this extreme level of equity concentration will normalize as it has historically, with small caps playing catch-up.

> **WITH THE FEDERAL RESERVE HIKING CYCLE NOW SEEMINGLY IN THE REARVIEW, WE ARE INCREASINGLY OPTIMISTIC THAT SMALL CAPITALIZATION STOCKS ARE POISED TO BUILD ON THE RELATIVE MOMENTUM THAT BEGAN DURING THE FOURTH QUARTER.**

In that regard, small capitalization stocks continue to trade at a discount to their large capitalization peers with the Russell 2000 relative next twelve-month P/E (R2000 ex. Biopharma/S&P 500) near multi-decade lows, according to the Furey Research Partner report cited above. Similarly, the relative valuation of the Russell 2000 to the Russell 1000 also remains historically attractive, residing in the 10th percentile, 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, and P/E to growth according to the January 3, 2024 research report from Steve DeSanctis of Jefferies.

With the Federal Reserve hiking cycle now seemingly in the rearview, we are increasingly optimistic that small capitalization stocks are poised to build on the relative momentum that began during the fourth quarter. Corporate earnings growth is poised to reaccelerate in 2024 and we believe that small capitalization stocks are well positioned to benefit from the relative strength of the U.S. economy, supported by domestic consumption, initiatives to onshore critical elements of supply chain, secular investment in artificial intelligence, and a resurgence in productivity. No outlook is without risks and in this regard geopolitical risks remain ever-present, with tension in the Middle East continuing to percolate and no end to the war between Russia and Ukraine. The U.S. Presidential Election will start to come into view as the year progresses and carries with it its own unique set of risks and opportunities. Treasury funding, which contributed to the third quarter tantrum in interest rates, also adds an element of risk to the outlook as the Government must continue to fund the burgeoning national debt which currently stands at $34 trillion.

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:

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