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EMERALD DIVERSIFIED SMALL CAP GROWTH

STRONG YEAR ENDS WEAK

THE BROAD MARKET EQUITY INDICES finished the fourth quarter in positive territory despite a challenging December, to close out what was another solid year of performance. Large capitalization stocks continued their streak of outperformance with the S&P 500 advancing +2.39% in Q4, and +25.0% for the full year 2024, marking the index's second consecutive year of 20%+ gains, and the best two-year stretch since 1997-1998, according to the Wall Street Journal and Dow Jones market data. The Russell 1000 demonstrated similar strength, gaining +2.75% for the fourth quarter and +24.51% for the full year 2024. Resilient domestic economic growth, a strong artificial intelligence (AI) investment cycle, and solid large cap corporate earnings continued to underly the advance. The growth in AI related spending and strength in the Mega cap technology stocks had a halo effect throughout the equity market, with the technology heavy NASDAQ Composite Index, gaining +28.64% for the full year, lapping a more than +43% gain in 2023.

For the Russell 2000, it was again a story of two steps forward, one step back. After posting the third strongest November return in the history of the index at +10.97%, the Russell 2000 fell (-8.26%) during the month of December. The

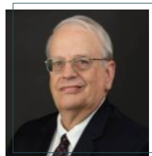
KEY POINTS:

- ***The Emerald Small Cap Diversified Growth portfolio outperformed the Russell 2000 Growth Index in the fourth quarter driven by a combination of allocation, selection and interaction effect.***

- ***At the sector level, relative outperformance within the healthcare, telecommunications and technology sectors more than offset relative underperformance within the industrial and consumer discretionary sectors.***

- ***As we enter 2025 the portfolio currently holds the largest active exposures in the financial, telecommunications, consumer staples and technology 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

strong post-election November small capitalization rally was upended in December by hawkish takeaways from Federal Reserve Chairman Powell's post December Federal Open Market Committee meeting press conference and the published Summary of Economic Projections. The new outlook ratcheted back the number of rate cuts now expected in 2025 to two versus the pre-meeting expectation of approximately three, and unexpectedly, reflected a tick-up in inflation expectations from a target of 2.3% to 2.5% at the end of 2025. The more hawkish tenor, particularly on inflation, took the market off guard, sending the 10-year yield higher (from 4.15% on December 6 to 4.57% December 31), and abruptly stunted the equity market advance. Over the last two years, these step function moves higher in the 10-year treasury yield have been most inversely correlated with the performance of the Russell 2000, and that proved true again in December with the Russell 2000 posting its second worst December in the history of the Russell index, and the worst performance since December of 2018. On a relative basis, performance for the month of December was also the worst relative performance for the Russell 2000 Index versus the S&P 500 (-2.40%) on record, with the Russell 2000 underperforming by 590 bps, according to a January 6, 2025 report from Furey Research Partners. The weaker December performance all but erased the November rally, resulting in a total return of +0.33% for the fourth quarter, and +11.54% for 2024. The annual return looks meager in comparison to the gains posted by the large capitalization indices, and at a delta of (-1300 bps) to the Russell 1000 Index total return of +24.5% was the fourth worst relative performance year ever, according to a January 1, 2025 report from Steve DeSanctis of Jefferies.

The Growth component of the Russell 2000 Index faired meaningfully better, for both the fourth quarter and full year 2024, with the Russell 2000 Growth gaining +1.70% and +15.15%, respectively and outpacing the Russell 2000 Value, which fell (-1.06%) during the fourth quarter and gained +8.05% for the full year. The technology sector of the Russell 2000 Growth was the largest contributor to the benchmark return gaining +11.26% for the quarter, contributing 162 bps to the Russell 2000 Growth's +1.70% total return for the quarter, and +28.72% for the year, contributing more than 500 bps to annual return of +15.15%. Conversely, the healthcare sector of the Russell 2000 Growth was the largest detractor to the Index return during the fourth quarter, falling (-7.38%) and detracting ~170 bps from the Russell 2000 Growth's total return for the quarter. For the full year, while performance for the sector was positive at +4.60%, the healthcare sector substantially lagged the overall performance of the benchmark.

Decomposing the Russell 2000 Growth Index further, performance amongst the Russell 2000 Growth constituents exhibited a growth bias with the fastest growing (top quartile) companies, as measured by sales growth, outperforming for both the fourth quarter (+616 bps) and the full year (+1720 bps), as did the top quintile of companies measured by beta, which outperformed by +1132 bps and +2020 bps for the fourth quarter and full year, respectively. There was also a notable broadening of performance amongst the Index constituents during the fourth quarter. Specifically, the improved relative performance of the $500 million to $1 billion and sub-$500 million market cap companies, which outperformed by +379 bps and +841 bps respectively for the fourth quarter, though underperformed for the full year by (-878 bps) and (-460 bps) respectively. Similarly, the lowest quintile of companies measured by return on equity, also exhibited improved relative performance with quintile 5 outperforming the Russell 2000 Growth Index overall by +236 bps respectively for the quarter, after underperforming by (-1062 bps) for the full year, according to a January 1, 2025 report from Steven DeSantis, Equity Strategist at Jefferies.

PORTFOLIO REVIEW

The relative outperformance of the fastest growing companies as measured by sales growth was a tailwind to Emerald's performance for the quarter, with the Emerald Small Cap Diversified Growth portfolio outperforming the Russell 2000 Growth Index in the fourth quarter driven by a combination of allocation, selection and interaction effect. At the sector level, relative outperformance within the healthcare, telecommunications and technology sectors more than offset

relative underperformance within the industrial and consumer discretionary sectors.

The healthcare sector was the portfolio's largest positive contributor to return for the quarter, as the positive contribution from stock selection more than offset the negative contribution from allocation effect. The healthcare sector of the Russell 2000 Growth Index declined (-7.38%), significantly underperforming the Index which returned +1.70%, as policy uncertainty related to the incoming Presidential administration and rising treasury yields weighed on sector performance. The relative underperformance of the sector was a headwind to portfolio performance given the portfolio's average overweight to the sector of approximately 150 bps for the quarter and total nominal exposure of more than 25%, representing the largest sector exposure within the portfolio. Despite these headwinds the portfolio's holdings benefitted from stock selection driven by clinical advancement and merger and acquisition activity within the biotechnology industry, and a combination of innovation, market share gains and higher levels of healthcare utilization within the healthcare and medical services industries.

Performance within the telecommunications and technology sectors also contributed positively to performance. Within these sectors, holdings within the semiconductor and telecommunications equipment industries were the most noteworthy contributors to return. From a thematic perspective, the portfolio's exposure to those companies positioned to benefit from the acceleration in AI related capital spending was a tailwind to performance.

Partially offsetting the relative outperformance discussed above was the portfolio's relative underperformance within the industrial and consumer discretionary sectors. Performance within the industrial sector was the largest detractor to return for the period. While stock selection was the largest driver of underperformance, it is more reflective of the portfolio's relative underweight and positioning within the aerospace, professional business services, construction and specialty machinery industries.

The consumer discretionary sector also detracted from performance for the period, driven by stock selection and the portfolio's relative underweight to sector. At the industry level relative outperformance within the airlines and diversified retail industries was more than offset by relative underperformance within the restaurant, recreational services and household furnishing industries.

For the full calendar year 2024, Emerald also demonstrated solid relative outperformance to the Russell 2000 Growth benchmark driven by stock selection. At the sector level, relative outperformance within the technology, basic materials, financials, telecommunications, consumer staples and industrials sectors more than offset the relative underperformance within the consumer discretionary and healthcare sectors. Thematically, the portfolio benefitted from the acceleration in artificial intelligence related capital spending, secular spending tailwinds within the aerospace and defense end markets, strong written premium growth and pricing with the insurance industry, niche opportunities within consumer packaged goods, as well as clinical advancement and merger and acquisition activity within the biotechnology industry and innovation, market share gains and higher levels of healthcare utilization within the healthcare services and medical equipment industry.

As we enter 2025 the portfolio currently holds the largest active exposures in the financial, telecommunications, consumer staples and technology sectors. Thoughts on those sectors and other notable areas of exposure are highlighted below.

- Emerald held the largest overweight position within the financials sector driven by holdings within the banking, full line insurance, and property and casualty insurance industries. The portfolio has the largest active and nominal exposure to the banking industry, as we believe the banks are a leveraged play on a steepening yield curve, and we expect a more favorable business climate in 2025. In the insurance industry, we still favor the specialty (E&S) insurers given the secular shift of admitted business

into the E&S market which should support pricing and growth, and the insurance brokers with their resilient high margins and growth profiles.

- The portfolio also held an overweight position in the telecommunications sector. The exposure is largely concentrated within the telecommunications equipment and telecommunications services industries and is comprised of holdings that are benefitting from niche company specific opportunities as well as those that are positioned to benefit from the broadening of AI infrastructure related spending.

- The portfolio also exited the fourth quarter with an overweight position in the technology sector. Exposure is broad based with holdings within the semiconductor, software, production technology, electronic components, computer services and consumer digital services industries. Of these, the semiconductor and software industries represent the largest absolute weights. On a relative basis, the portfolio holds the largest overweight position in the semiconductor industry which possesses many of the strongest secular growth themes in the broader market, such as AI infrastructure. In addition, we believe there is opportunity for a cyclical recovery in many end markets that have been depressed for the last five to six quarters. Further we believe the relative maturity of the semiconductor industry will also lead to strong earnings and cash flow generation. We have also recently adopted a more positive on the outlook for the software industry driven by the increasing role of AI. We believe that segments of the software market will benefit from product expansions leveraging AI in 2025. Additionally, we expect the technical shift to drive demand for enhanced cybersecurity solutions, particularly in areas like data security and vulnerability management.

- Emerald also holds an overweight position within the consumer staples sector. We remain positive on the fundamental outlook for the consumer staples sector with a focus on growth-oriented consumer packaged goods companies with disruptive brands, category leadership positions, strong secular growth opportunities, and improving profit margins.

- The healthcare sector continues to represent the portfolio's largest nominal exposure, and at quarter end was modestly overweight relative to the benchmark. At the industry level, the portfolio currently holds the largest active exposure to the pharmaceutical, medical equipment, medical services and healthcare services industries and the largest nominal exposure within the biotechnology industry. We continue to be primarily focused on medical device and diagnostic companies that are profitable or approaching profitability with a strong balance sheet. In therapeutics, the portfolio has exposure to both revenue generating companies as well as high-quality development stage companies.

MARKET OUTLOOK

Waiting is the hardest part. While equity returns on an absolute basis were strong for calendar 2024, small capitalization stocks struggled to sustain relative momentum, as bursts of strong relative outperformance in the months of July and November were fleeting, with the Russell 2000 finishing 2024 with its fourth-worst relative year to the Russell 1000 in the history of the Index according to the same report from Steve DeSanctis of Jefferies cited above. Lagging relative earnings growth and upside volatility in treasury yields have remained the largest gating factors to relative performance. Although the reemergence of a small capitalization outperformance cycle has taken longer than we anticipated to emerge, our conviction in our outlook remains unwavering.

Over the last twelve months the 10-year treasury yield has traded as high as 4.68% in April to a low of 3.62% in mid-September, and now early January is on the verge of surpassing

those April highs. The recent decoupling of treasury yields from the path of the Federal Funds appears to be reflective of a combination of stronger than expected domestic economic growth, growing concerns regarding policy changes from the incoming Presidential Administration, the size of the fiscal deficit, long-run inflation expectations and supply/demand dynamics within the Treasury market. While it remains difficult to truly pinpoint the source or sources of dislocation in the Treasury market, the most important thing from our perspective is that the Federal Reserve has shifted undisputably to an easing bias. Fed Chairman Powell has explicitly stated that policy remains tight relative to his admittedly opaque view of Neutral, and as a result is poised to support the economy as inflation recedes or employment weakens further (i.e. support economic growth). Therefore, if the path of rate cuts is less steep, then economic growth is stronger than expected, which is positive for corporate earnings growth and the market, not a negative. We continue to believe inflation will remain contained, although we acknowledge some short-term uncertainty related to the proposed policies of the incoming Administration, as highlighted by several Federal Reserve members in the December Summary of Economic Projections.

As it relates to the outlook for small capitalization corporate earnings growth, we remain optimistic that small caps, after back-to-back down years in earnings, will emerge from their earnings recession in 2025. The domestic economic expansion remains intact and we believe growth in 2025 will be supported by solid consumer spending, a broadening of business investment driven by improving CEO confidence, as highlighted in the most recent NFIB Survey, lower borrowing costs, secular spending trends in artificial intelligence, which is moving beyond the procurement of GPU's, to the supportive infrastructure (connectivity, power, etc.), onshoring, investments in automation, a more normalized inflationary backdrop, an easing corporate interest expense burden, and gains in productivity.

If we are correct on the path of earnings, we believe small capitalizations stocks should also benefit from a narrowing of the relative valuation gap. According to a January 7, 2025 report from Steve DeSanctis of Jefferies, the relative value of the Russell 2000 to the Russell 1000 remains historically attractive, falling in the 15th percentile with the trailing P/E (non-negative), forward P/E, price to book and price to sales trading at double-digit discounts to their historical average. If history is a guide and small capitalization corporate earnings growth recovers as we anticipate, we believe there remains a meaningful opportunity for the Russell 2000 to embark on an outperformance cycle. We believe this shift in leadership is further supported by the extreme level of large capitalization concentration relative to history, which has pushed the small capitalization market value to less than 4% of the US equity market, and the total market capitalization of the Russell 2000 as a percentage of the S&P 500 total market cap to approximately 6%, more than two standard deviations below average and close to the June 2024 all-time low according to a January 6, 2025 report from Furey Research. At the same time, according to the same report, the S&P 500 Index concentration has also breached historical peaks, with the top 5 stocks' aggregate weight comprising ~28% of the index.

The acceleration of merger and acquisition (M&A) activity could provide an incremental catalyst to those outlined above. With the election now in the rearview mirror, funding costs coming down, $7.5 trillion of cash and equivalents on global non-financial equities balance sheets and the private markets industry with an estimated $4.0 trillion in unleveraged dry powder according to a November 11, 2024 report from Morgan Stanley Strategist Andrew Sheets, global M&A activity could be poised for recovery. 2023, according to the same report, recorded the lowest level of global M&A in at least 30 years, and while 2024 deal announcements are trending up 25% year over year, Morgan Stanley is forecasting an approximate 50% increase in 2025. Accelerating M&A activity has historically been positively correlated with small capitalization relative outperformance.

The risks to this outlook remain numerous. While the U.S Presidential Election is in the rearview mirror, the policy priorities of the incoming Administration and their implications to U.S. economic growth, inflation and the fiscal deficit are still being ascertained. The 10-year Treasury yield has been a

chronic source of consternation over the twelve months and with the recent surge toward its 2024 high has again become a headwind to short-term equity performance. The strong equity market performance over the last two years and the current valuation of the broad market equity indices could also prove to be a headwind, if corporate earnings growth fails to materialize as expected. Lastly, and not insignificantly, the geopolitical landscape remains a significant source of uncertainty. Tensions abroad do not appear to be lessening to any significant degree, with ongoing conflict in the Middle East and Russia/Ukraine. China also continues to demonstrate signs of aggression, and it is yet to be seen whether the new Administration will be successful in its efforts to ease these tensions abroad.

Emerald, as always, remains focused on what we can control and vigilant in our efforts to identify the most attractive growth opportunities within the small capitalization universe through our fundamental bottom- up research process.

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