



# EMERALD DIVERSIFIED SMALL CAP GROWTH

## A YEAR OF STOCK PICKING

### POSITIVE FOURTH QUARTER EQUITY MARKET RETURNS

capped off what was ultimately a double-digit return year for the majority of the broad market Indices. The S&P 500 gained +2.66% in the fourth quarter, bringing gains for the year to +17.88%, marking the S&P's third consecutive year of double-digit gains. The Russell 1000 similarly showed strong gains, advancing +2.41% for the fourth quarter and +17.37% for the full year. While large capitalization stocks maintained their streak of market leadership, small capitalization stocks demonstrated solidly improved relative performance. The Russell 2000 gained +2.19% for the fourth quarter and +12.81% for the year, and while that may have lagged large capitalization performance, the gap of underperformance has narrowed considerably. The laggard in 2025 was the Russell MidCap Index which gained only +0.16% in the fourth quarter and +10.60% for the year. Rarely do we see a barbell of performance within the equity universe with Russell 2000 and Russell 1000 simultaneously outperforming the Russell MidCap Index. The majority of the time, mid caps finish exactly where they are, right in the middle of the pack. The underperformance of the Russell Midcap Index wasn't the only anomaly. The Russell Microcap Index posted the strongest performance amongst the Russell Core Indices, gaining +6.25% for the

### KEY POINTS:

- ***The Emerald Small Cap Diversified Growth portfolio posted strong relative fourth quarter performance results, capping off one of the best relative performance years in recent history for the strategy.***
- ***Stock selection was the largest driver of performance, with the Emerald portfolio holding nine of the top ten contributors to the Russell 2000 Growth benchmark total return for the calendar year.***
- ***At the sector level, performance was diversified across the major economic sectors, with the portfolio exhibiting strong relative outperformance from holdings within the technology, healthcare, industrials, consumer discretionary, telecommunications and financial sectors.***
- ***As we enter 2026 the portfolio currently holds the largest active exposures in the technology, financial, and consumer discretionary sectors.***



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fourth quarter and +22.98% for the full year. Again, it is highly unusual for the MicroCap Index to outperform the Russell 2000 Index by that magnitude. From a style perspective, growth stocks squeezed out another year of relative outperformance, although the gap of outperformance narrowed relative to 2024. The Russell 2000 Growth (+13.01%) modestly outperformed the Russell 2000 Value (+12.59%) for the year, but it lagged for the fourth quarter gaining +1.21% as compared the Russell 2000 Value at +3.26%.

Resilient and forward looking is the only way to characterize the performance of the equity market over the course of 2025. While equity performance for the year was strong, the path was anything but linear with episodic spikes in volatility, a breathtaking market drawdown and an equally breathtaking recovery. The rapidly evolving macro narrative kept investors on their toes as tariffs, inflation, recession, the Fed rate path, Fed Independence, AI Bubble fears, consumer weakness, the labor market, the prospect demise of American exceptionalism, and persistent geopolitical turmoil added to the building wall of worry. While these factors created undeniable risks to the trajectory of the domestic economy and the equity market, the risks ultimately proved overstated and the market pushed higher, powered by 75 bps of rate cuts, a paradigm shift in innovation, a resurgence in merger and acquisition activity, and a broad reacceleration in corporate earnings growth.

The veracity of the V-shaped market recovery off the April 8<sup>th</sup> Liberation Day market bottom is reflective of this changing backdrop. We believe this is particularly true within the small capitalization universe, where the Russell 2000 and the Russell 2000 Growth Indices notched gains of +42.38% and +45.01% respectively, from the market bottom. The composition of the Russell 2000 Growth Index performance over the last nine months has garnered much attention given the significant outperformance of the non-earners, low return on equity, and the smaller market capitalization companies, as both the pace and magnitude of the recovery has created sizeable headwinds to broader small capitalization growth active managers' performance.

While it is indisputable that "low quality" - defined by non-earners, low return on equity, and, as a corollary, the smaller market capitalization companies outperformed, it was inevitable. The performance of this segment of the benchmark has been inversely correlated with interest rates and as a result has exhibited material underperformance since the Federal Reserve aggressively embarked on the hiking cycle in 2021. The Federal Reserve has now reduced the Fed Funds rates by 175 bps, turning this headwind to a tailwind. Recession fears have also been receding from the elevated levels reached in early 2025, financial conditions are easing, and M&A activity is percolating: a perfect recipe for a recovery in the long duration constituents within the benchmark that have been underperforming for the last five years.

Although we agree that much has changed versus the market backdrop of 2024, what has been persistent has been the market's proclivity towards growth. According to a January 2, 2025 report from Steve DeSanctis at Jefferies, within the Russell 2000 Growth the top two quintiles of companies as measured by sales growth outperformed by +1360 bps and +411 bps, respectively in 2025. It is interesting from our perspective that this was similarly true for the full year 2024, although the magnitude of outperformance varied. The difference appears to be where that growth is being realized. In 2024, the fastest growth came almost exclusively from the largest market cap quintile and the highest ROE companies in the benchmark. In 2025, given the emerging secular tailwinds across the domestic economy and lower interest rates, the growth opportunities have broadened beyond the largest market capitalization and highest return on equity companies within the benchmark (although the highest ROE companies did outperform for the full year) to include the early stage innovators that are positioned to capitalize on these new and rapidly developing market opportunities. This market behavior feels very characteristic of the early stages of an emerging small cap cycle.

## PORTFOLIO REVIEW

The Emerald Small Cap Diversified Growth portfolio posted strong relative fourth quarter performance results, capping off



one of the best relative performance years in recent history for the strategy. In what proved to be a broadly challenging year for our active management peers, Emerald's emphasis on fundamental bottom-up stock selection, identifying the innovators, and our long-term commitment and adherence to our small capitalization and growth mandates was a tailwind to performance for the fourth quarter and full year 2025.

For the full year 2025, the Emerald Small Cap Diversified Growth portfolio significantly outpaced the benchmark, posting a total return that more than doubled that of the Russell 2000 Growth index. Stock selection was the largest driver of performance, with the Emerald portfolio holding nine of the top ten contributors to the Russell 2000 Growth benchmark total return for the calendar year. At the sector level, performance was diversified across the major economic sectors, with the portfolio exhibiting strong relative outperformance from holdings within the technology, healthcare, industrials, consumer discretionary, telecommunications and financial sectors. The positive contribution from the aforementioned more than offset relative underperformance resulting from stock selection and allocation effect headwinds within the real estate, basic materials, energy, and consumer staples sectors. At the stock level, it is important to highlight, given the discussion above regarding the composition of index returns, that seven of the portfolio's top ten contributors for the year are profitable companies within the industrials, technology and healthcare sectors. The three remaining positions are biotechnology companies, an industry in which Emerald has historically invested, and from a positioning perspective was approximately equal-weight to average for the year.

Specific to the fourth quarter, stock selection remained at the core of strong outperformance relative to the Russell 2000 Growth benchmark. At the sector level, relative outperformance within the healthcare, telecommunications, technology, consumer discretionary, utilities and industrials sectors were the largest positive contributors to return. Partially offsetting this strength was modest relative underperformance of the portfolio's holdings within the energy and consumer staples sectors.

The healthcare sector was one of the portfolio's largest positive contributors to return for the fourth quarter. After a multi-year run of underperformance, the healthcare sector of the Russell 2000 Growth Index broke the streak, outpacing the benchmark for the fourth quarter and year. The Federal Reserve's return to policy accommodation, an improving M&A backdrop, improved sentiment regarding the new Administration's priorities and policy initiatives, and demonstrative clinical progress and commercialization success collectively contributed to the improving sentiment. The healthcare sector was the best performing sector of the Russell 2000 Growth Index for the quarter, gaining +17.79%, driven by outsized strength within the biotechnology industry which gained +28.11%. Although the Emerald portfolio was underweight the sector and essentially neutral weight in the biotechnology industry on an average basis for the period, stock selection was the largest source of the portfolio's relative outperformance. Performance was particularly noteworthy from holdings within biotechnology and pharmaceutical industries where Emerald's portfolio holdings again benefitted from a combination of innovation, clinical advancement, and commercialization success.

Emerald's holdings and positioning within the telecommunications sector, and more specifically the telecommunications equipment industry, contributed positively to performance.

The technology sector was also a top contributor to performance for the quarter driven by stock selection within the electronic components, semiconductors, computer services, and production technology industries. Thematically, those companies positioned to benefit from AI and defense-related capital spending were a tailwind to relative performance.

The consumer discretionary sector also contributed positively to performance driven by stock selection and specifically the relative outperformance of holdings within the airline and restaurant industries.



The utilities and industrial sectors also contributed to return for the quarter driven by the portfolio's relative underweight position and stock selection. Within the industrials sector, the positive contribution to return from positioning and stock selection within the aerospace, specialty machinery, electronic equipment, professional business support, and electronic equipment industries more than offset the relative underperformance of holdings within the defense industry. Within the utilities sector, relative outperformance was driven by a combination of the portfolio's relative underweight position and stock selection.

Partially offsetting the above was relative underperformance within the energy and consumer staples sectors. Within the energy sector, the portfolio's relative underperformance was driven by stock selection, as relative outperformance within the oil equipment and services industry was more than offset by relative underperformance within the integrated oil & gas and renewable energy equipment industries.

As we enter 2026 the portfolio currently holds the largest active exposures in the technology, financial, and consumer discretionary sectors. Thoughts on those sectors and other notable areas of exposure are highlighted below.

- The technology sector, as of quarter-end, was the portfolio's largest relative overweight position. The composition of the sector exposure remains diversified 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 continues to hold the largest overweight position in the semiconductor industry with an emphasis on companies participating in the growth in AI infrastructure, defense modernization and replenishment, quantum computing and the expanding market opportunity for RFID, as well as those companies positioned to take advantage of a broader cyclical recovery in the industrial and

consumer end markets. Further, although sentiment surrounding software stocks is being pressured by concerns over the commoditization of point solutions and subscale platforms, we remained focused on niche opportunities within cybersecurity, and vertical software where domain expertise, first-party data, and the ability to build embedded workflows create defensible positions over time.

- Emerald continues to hold an overweight position in the financials sector driven by holdings within the banking, insurance, asset management, investment services and consumer lending industries. The portfolio has the largest nominal exposure to the banking industry. We are particularly optimistic regarding the outlook for the banking industry. In 2025, the number of U.S. bank M&A deal announcements reached 182 deals announced, up about 37% from the 133 announced in 2024, and the highest annual total since 2021, according to data from S&P Global Market Intelligence, when the number of deals recorded reached 200. We expect announcement momentum to continue through 2026, resulting in multiple expansion across the industry. At the same time we believe greater than expected loan growth, a positive sloping yield curve resulting in further rate cuts from the Federal Reserve, and an easing regulatory burden will have positive implications for earnings growth and bank performance.
- The portfolio also ended the quarter with an overweight position in the consumer discretionary sector. Exposure to the consumer sector has grown in recent quarters, reflecting an expanding opportunity set across airlines, apparel, auto, casinos, consumer electronics, home furnishings, retail, entertainment, restaurants and recreational services.
- The healthcare sector represents the portfolio's largest nominal exposure, although the portfolio was



underweight relative to the benchmark as of quarter-end. At the industry level, the portfolio currently holds the largest active exposures within the pharmaceuticals and medical equipment industries and the largest nominal exposure within the biotechnology industry. For therapeutics, more than 80% of the portfolio's healthcare sector holdings are companies that are generating revenue. Within the medical device and diagnostic companies, we remain focused on the innovators that are driving growth through accelerating utilization and market share gains, and that are profitable or approaching profitability with a strong balance sheet. After a multi-year run of underperformance, the healthcare sector of the Russell 2000 Growth broke the streak, outpacing the benchmark for the fourth quarter and year. The Federal Reserve's return to policy accommodation, an improving M&A backdrop, improved sentiment regarding the new Administration's priorities and policy initiatives and demonstrative clinical progress and commercialization success collectively contributed to the improving sentiment. The financing window is open to biotechnology companies that report positive data. M&A activity is also showing signs of improving momentum, with the announced acquisitions of two additional biotechnology companies for more than \$4 billion during the quarter. There were twelve new drugs approved in the fourth quarter, bringing the total for the year to 44. Since 2021, there have been 48 new drugs approved annually on average.

- The portfolio also has meaningful exposure to the industrials sector, although the sector remains the portfolio's largest underweight at quarter-end. At the industry level the portfolio's largest overweight is in the defense industry. We believe the portfolio's defense holdings are well positioned to benefit from initiatives to replenish and modernize the global defense industrial base. Investment levels are set to accelerate both domestically, as outlined in the Big

Beautiful Bill, and globally, as highlighted at the most recent North Atlantic Treaty Organization (NATO) meeting, as U.S. allies are committed to increasing spending on core defense requirements as well as defense and security spending from approximately 2% of GDP to 5% of GDP by 2035. Beyond defense, the portfolio is exposed to the aerospace industry which continues to benefit from elevated maintenance and repair spending on the existing commercial fleet, while new build activity is starting to accelerate. In addition to the above, AI adjacent themes are proliferating with power infrastructure investments seeing accelerating investment. Reshoring and advanced manufacturing are adding to the demand for power.

## MARKET OUTLOOK

2026 is setting up to be another solid year for the equity markets. The U.S. economy exited 2025 on firm footing. The initial estimate of third quarter GDP growth clocked in at 4.3%, the fastest pace in 2 years. Fourth quarter GDP is currently tracking ~5.4% according to the Atlanta Fed GDPNow Forecast and holiday sales by all accounts have been pacing better than expected. As we look forward to 2026, we believe the current consensus for ~2.3% GDP growth could be biased to the upside. Innovation throughout the economy is accelerating, and we believe that the flow through of benefits from the One Big Beautiful Bill (rising capital expenditures), consumer tax refunds, deregulation, lower interest rates, easing financial conditions, waning tariff pressures, rising productivity, improving CEO confidence and the potential for improved consumer confidence, if inflation eases as we anticipate, collectively are poised to provide incremental upside to current forecasts for economic growth. Corporate earnings growth has tracked at a better-than-expected pace through the second half of 2025 and we believe all of the aforementioned factors will provide a tailwind to 2026. At the same time, while we are optimistic about growth, we believe that easing inflationary pressures as a result of a softer, but stable, labor market and waning tariff pressures are likely to keep the Federal Reserve biased toward normalizing rates.



Small capitalization stocks are particularly well positioned to benefit from these macroeconomic tailwinds, and we believe the recent improvement in small capitalization earnings growth, and relative stock performance off the Liberation Day market low is signaling this forthcoming strength. After more than two years of stagnating revenue growth, declining net margins, and negative year-over-year earnings growth for the Russell 2000, earnings growth inflected positively in the second quarter. This momentum continued through the third quarter reporting season, with small capitalization earnings growing approximately 14% year over year, according to December 1, 2025 report from Jefferies. This was the best year over year rate of earnings growth for small capitalization earnings since the first quarter of 2022 and the first time in 13 reporting seasons that small cap earnings growth outpaced that of large capitalization stocks, according to January 2, 2026 report from Steven DeSanctis, Equity Strategist at Jefferies. The 2026 outlook remains equally encouraging with earnings expected to grow more than 14.6% for small caps, which compares favorably to the 14% expected for mid caps, and the 11.6% currently expected for large capitalization stocks, according to a separate January 5<sup>th</sup> report from Steve DeSanctis at Jefferies. While recent performance and the early outlook for 2026 is encouraging, we continue to believe that we are in the early stages of the earnings upcycle for small caps. Innovation and investment are on the rise, and we believe that both the simultaneous broadening and deepening of multiple secular growth investment opportunities are contributing to this reacceleration. Artificial intelligence investment is crossing the adoption chasm and AI adjacent themes are proliferating. The reindustrialization of the U.S. economy, datacenter, defense, semiconductors, and broader initiatives to reshore aspects of the supply chain, including critical minerals are driving a meaningful acceleration in the demand for construction and engineering and power, which is catalyzing a simultaneous acceleration of investment in the domestic power infrastructure. At the same time, initiatives to modernize the defense industrial base and rebuild depleted stockpiles are expanding globally. Investments in space/aerospace also appear to be gaining steam and we are in the nascent stages of what appears to be the beginning of a more meaningful investment cycle in quantum computing. We also continue to

see meaningful opportunity within the longer-duration of aspects of the healthcare sector, specifically in biotechnology and medical devices where innovation has continued unabated, and headwind from interest rates is receding. Similarly, we believe lower rates and the multiplier effect from the secular growth opportunities above, should also have positive implications for the more cyclically exposed companies within the financial, consumer discretionary and broader industrial sectors. The opportunity set is broad and expanding and that is reflected in Emerald's sector and industry positioning.

Merger and acquisition activity adds another potential catalyst for the asset class. M&A is accelerating. According to January 5, 2025 report from Goldman Sachs, announced global M&A volumes increased 43% to ~\$4.8tn, with deal volume representing 9.6% of the S&P 500 market cap. While better year over year, the level remains well below the 14.5% 10-year average. Strategic and sponsor-backed activity contributed to the growth, with sponsor-backed M&A deal volume growing 47% year over year to ~\$1.2tn as highlighted in that same report. Private-equity dry powder is significant: as of September, U.S. firms were sitting on approximately \$880 billion in undeployed capital according to PricewaterhouseCoopers and the Wall Street Journal on December 28, 2025. Given the cash on corporate balance sheets, improving CEO confidence, easing financial conditions and pent-up demand from private equity, we believe activity is poised to accelerate further in 2026.

In this regard, the improving earnings outlook outlined above combined with historically attractive valuations, should position small caps as attractive take-out candidates. Although the relative valuation gap has narrowed somewhat, the relative valuation of the Russell 2000 to the Russell 1000 remains in the 18<sup>th</sup> percentile, with the Russell 2000 continuing to trade at a double-digit discount to the Russell 1000 on a trailing P/E (non-negative), forward P/E, price to book and price to sales basis. Collectively, historically attractive valuations, the significantly improved earnings outlook, supported by the rekindling of the small cap innovation engine, a solid economic backdrop, forthcoming fiscal stimulus, supportive monetary policy, an easing in growth encumbering and costly regulation, and an



acceleration in M&A activity are coalescing to drive a broadening of market returns and improving relative performance for the Russell 2000. While we admittedly feel like the Firm that has cried wolf, calling for the improved small capitalization relative performance that has continually failed to materialize, 2026 might finally be the year.

2025 marked the fifth consecutive year of small cap vs. large cap underperformance, tying the longest streak of five years ending in 1998, according to a January 5<sup>th</sup> report from the team at Furey Research Partners. Small caps have never lagged for six consecutive years, putting the onus squarely on 2026. The Federal Reserve has now cut rates by 175 bps from the peak in 2024, 75 bps of which has occurred in the last three months. According to Canaccord Genuity portfolio strategist Martin Roberge, “while the relative performance of small caps normally stabilizes after the Fed has cut its policy rate by 50bps and 100bps from peak Fed funds, sustained outperformance usually begins after 150bps in Fed Cuts”. With the December rate cut now on the books, the Fed Funds rate is down 175 bps from the peak and if historical precedent holds, small capitalization stock performance should begin hitting that inflection point as we progress through 2026.

Despite our optimism, there are always risks to the outlook. Post traumatic stress disorder from the 1999’s tech bubble has investors on high alert for any cracks in the AI narrative. The rebalancing that has been taking place between the Federal Reserve’s messaging regarding the path of future rate cuts and the market’s implied path has continued to be a source of market volatility, as evidenced by the significant unwind and rewind of implied probabilities for December rate cut between September and early December. If market expectations were again to diverge and Treasury yields move meaningfully higher, this would present a significant risk to the rally in risk assets. The Supreme Court’s IEEPA Trade Decision is also forthcoming. The outcome of which is difficult to handicap, as is the Administration’s response. We see positive implications for corporate profitability, but at the same time see potential negative ramifications to the outlook for the federal deficit and foreign investment. How the equity and fixed income markets weigh these counterbalancing factors is a source of

uncertainty. The market also remains on high alert for any sign of deterioration in the credit markets, particularly private credit, which has been an area of significant growth over the last few years. A new Federal Reserve Chair will assume the role this year which brings with it its own unique set of potential challenges. 2026 is also a midterm election year. Historically, mid-term election years, particularly in and around the election, have proven more challenging than not. Lastly, the risk of a geopolitical black swan like event remains ever present given the persistence and prevalence of tensions throughout the world. The recent events in Venezuela only add to level of complexity and risk present in the geopolitical landscape.

Emerald as always remains focused on controlling the controllables and utilizing our fundamental bottom-up research process to identify the best growth opportunities within the small capitalization universe.



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