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EMERALD DIVERSIFIED SMALL CAP GROWTH

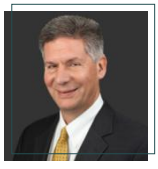
HIGHER ENERGY COSTS AND RATES FORCE A SMALL CAP CORRECTION

SURGING TREASURY YIELDS, rising energy prices, persistent inflation, competition for credit, geopolitics and another bout of AI angst dominated the market narrative in the third quarter. Rates were at the forefront, as the Treasury sell-off that began in the second quarter accelerated. Pressure was most acute at the long end of the curve: the 10-year yield rose 79 bps, from 4.48% to 5.27%, and the 30-year yield rose 65 bps, from 4.97% to 5.62%, both reaching their highest levels in more than two decades. This step-change in yields reflects three forces: strengthening domestic growth, upward pressure on oil, diesel and gasoline prices, and concern that faster growth combined with higher input costs will require more Fed tightening to return inflation to the 2% target. The aggressive repricing across the curve weighed on equities, narrowing market breadth and shifting market leadership.

Leadership moved decisively up in market cap during the quarter. The Russell 1000 and S&P 500 gained +1.80% and +2.30%, respectively, while the Russell 2000 fell (-7.23%). According to an October 1, 2026 report from Steven DeSanctis at Jefferies, the Russell 2000's roughly 900 bps of underperformance versus the Russell 1000 was the third-worst third-quarter gap in Russell data going back to 1979, and its roughly 950 bps shortfall versus the S&P 500 was the widest since

KEY POINTS:

- ***The narrowing of market returns, and the leadership of value factors described above were a headwind to Emerald's investment style, and the Emerald Small Cap Diversified Growth portfolio which underperformed the Russell 2000 Growth Index for the period.***
- ***From an attribution perspective, stock selection was the largest detractor from relative performance. At the sector level, results were most challenged in the industrials, technology, consumer discretionary, financials and energy sectors.***
- ***Encouragingly, after lagging in July and August, the portfolio's relative performance improved significantly in September, led by stock selection in technology, energy, basic materials and healthcare.***
- ***As we enter the fourth quarter of 2026 the portfolio currently holds the most noteworthy active exposures in the technology, consumer discretionary and financials sectors.***



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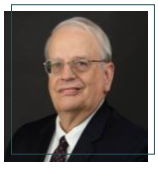

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the first quarter of 2020.

Weak breadth was not confined to small caps. Even within large caps, leadership narrowed: the S&P 500 Equal Weight Index fell (-1.87%) while the cap-weighted index rose. Further down the cap spectrum, the Russell Midcap Index declined (-3.00%) and the Russell Microcap Index fell (-7.20%). Beneath the index level, the damage was deeper still. Roughly 54% of Russell 3000 constituents have fallen more than 20% from their June levels, according to an October 5, 2026 report from Morgan Stanley equity strategist Michael Wilson.

Growth also ceded leadership to value, with growth indices lagging their value counterparts across the capitalization spectrum. The Russell 2000 Growth Index declined (-9.39%), compared with a more modest (-4.91%) decline for the Russell 2000 Value Index. The preference for value and quality was evident within the Russell 2000 Growth itself. Per the same Jefferies report, the lowest-P/E quintile outperformed the Index by 1,206 bps, while the highest-P/E quintile underperformed by 873 bps. Low-beta stocks outperformed by 330 bps, while the highest-beta stocks lagged by 418 bps. The highest-yielding stocks outperformed by 253 bps and the highest-ROE stocks by 212 bps, while the fastest sales growers modestly underperformed, by 30 bps.

PORTFOLIO REVIEW

The narrowing of market returns, and the leadership of value factors described above were a headwind to Emerald's investment style, and the Emerald Small Cap Diversified Growth portfolio which underperformed the Russell 2000 Growth Index for the period. From an attribution perspective, stock selection was the largest detractor from relative performance. At the sector level, results were most challenged in the industrials, technology, consumer discretionary, financials and energy sectors. Encouragingly, after lagging in July and August, the portfolio's relative performance improved significantly in September, led by stock selection in technology, energy, basic materials and healthcare.

For the full quarter the industrials sector was the portfolio's largest detractor to return for the period. While the portfolio's holdings within AI infrastructure exposure were a headwind to performance, it was the portfolio's underperformance in the non-AI areas of the portfolio including defense and aerospace that were the most disappointing as concerns surrounding surging energy prices, rising rates and the outcome of upcoming midterm elections weighted on multiples despite better-than-expected earnings, growing backlogs and constructive forward commentary. The portfolio also suffered from idiosyncratic stock specific headwinds.

The technology sector was the second largest detractor to return for the period, reflecting headwinds to both stock selection and allocation. The significant derating across the semiconductor and production technology industries weighed on portfolio performance. Although stock selection within these two industries was modestly positive, the portfolio's sizeable relative overweight to these industries was a headwind. Also detracting from performance was stock selection within the software industry. The software industry was the strongest industry with the Russell 2000 Growth technology sector, gaining +9.63%, materially outperforming broader technology sector which declined (-11.38%) for the period. After outperforming through the first half of the year, the portfolio's software holdings lagged, as fears over AI disintermediation eased, flows improved and valuations across the industry expanded from oversold levels.

Stock selection within the consumer discretionary sector also detracted from performance. Upward pressure on energy prices, and rising rates created a challenging backdrop for stock selection, as multiples compressed across the broader consumer sector, despite generally solid fundamental financial performance. While overall sector performance was challenging, performance was more bifurcated beneath the surface with the portfolio experiencing relative outperformance within the entertainment industry, while performance within the airlines, apparel, casinos, and restaurant industries was more challenging.

Holdings and positioning within the financial and energy sectors also detracted from performance, largely as a result of the relative underperformance within the banking and oil equipment and services industries.

The healthcare sector was neutral to portfolio performance for the quarter as underperformance in the biotechnology industry was offset by relative outperformance within the pharmaceutical and health care services industries. It was an unusual quarter for the biotechnology industry and Emerald's relative performance. The underperformance within the biotechnology industry resulted from a combination of idiosyncratic headwinds, positioning and flow dynamics within the broader industry. This was particularly true in the weeks in August surrounding the sharp single-day rally in the shares of Moderna following positive interim phase 3 trial results in melanoma where hedge fund positioning dynamics created significant distortions in returns amongst the biotechnology industry constituents. On a fundamental basis, the level of innovation across the sector remains encouraging as exemplified by the robust clinical catalyst pipeline, encouraging clinical progress, a solid pace of novel drug approvals by the FDA, and the ongoing successful commercialization of recently approved drugs. Although aggregate performance was neutral, holdings within the healthcare sector dominated the portfolio's top 10 contributors to return for the quarter.

Modestly offsetting the aforementioned headwinds was the positive contribution from both stock selection and allocation effect within the basic materials sector for the quarter.

As we enter the fourth quarter of 2026 the portfolio currently holds the most noteworthy active exposures in the technology, consumer discretionary and financials 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 spanning the semiconductor, production technology, electronic components, computer services, software, and consumer digital services industries. Of these, the semiconductor, production technology, and software industries represent the largest absolute weights. We have continued to reposition our exposures within the semiconductor industry including increased exposure to novel optical networking technology, novel power-related semiconductor architectures for 800V datacenters, and edge AI semiconductors. We also believe that the supply/demand situation in semiconductor capital equipment is historic in nature and that despite the significant increase in stock prices in the 1H, they should be poised for a rebound after weak Q3 performance. 2027 estimates for wafer fabrication equipment spending have risen from $140bn to $210bn since the beginning of the year, and we believe that expenditures in 2028 will be over $250bn. Based on current forecasts for compute growth, we believe the supply/demand imbalance is likely to persist for the next several years as leading foundry, IDMs, OSATs, and memory vendors scramble to add capacity to meet unabated demand. Within software, we expect typical seasonal strength in enterprise software spending through the fourth quarter, with the strongest areas of demand increasingly centered on establishing and scaling AI infrastructure, securing the data that powers AI, and preparing enterprise architectures for a more agentic environment. Within this environment, we remain particularly focused on security, where protecting enterprise data, identities, and other critical assets is becoming increasingly important as AI models and autonomous agents gain broader access to corporate systems. Additionally, we believe that the proliferation of agentic AI will become an increasingly prominent investment theme into 2027 and 2028, expanding the addressable opportunity across data security, identity, governance, observability, and infrastructure. We also continue to favor select

vertical SaaS businesses, where deep domain expertise, proprietary workflows and data, regulatory knowledge, and embedded customer relationships can create defensible niches that are more difficult for generalized LLMs to replicate. We remain selective in our software investments, given the accelerating pace of AI innovation and our belief that early adoption of AI will continue to meaningfully change the software industry.

- Emerald continues to hold a modest overweight position in the financial sector driven by the portfolio's relative overweight position within the banking industry. We believe loan growth continued to expand at a high single digit year-over-year rate in Q3-26, and our expectation for continued growth is supported by bank management reporting strong to very strong loan pipelines across key categories. At the same time, credit quality remains robust, highlighted by seven consecutive quarters of declining credit card delinquency rates and five consecutive quarters of falling net charge-offs. Together, these strong operational fundamentals position banks for both tangible book value growth and EPS multiple expansion across the sector.

- The portfolio also ended the quarter with a modest overweight position in the consumer discretionary sector. Absolute exposure to the consumer discretionary sector has been stable over the last few quarters, reflecting a diverse opportunity set across airlines, apparel, auto, casinos, consumer electronics, home furnishings, retail, entertainment, restaurants, and recreational services. The sector remains highly sensitive to both the volatility in energy prices related to the Iran conflict and interest rates, which has created a challenging backdrop year to date. That said, although inflation has continued to weigh on consumer sentiment, consumer spending has remained resilient. We continue to remain optimistic regarding the idiosyncratic opportunity for each of the individual holdings that comprise the sector exposure.

- The healthcare sector remains a large nominal exposure within the portfolio, 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 industry and the largest nominal exposure within the biotechnology industry. Approximately 47% of the portfolio's therapeutics exposure is in companies that are generating revenue, with four additional holdings positioned to launch drugs in the fourth quarter of 2026. Within the medical device and diagnostic companies, we remain focused on the innovators that are driving growth through accelerating utilization and market share gains. As we look forward, we continue to be encouraged by the accessibility of financing for those biotechnology and pharmaceutical industries that are achieving clinical success as well as the pace of new drug approvals. There were 22 novel drugs approved in the third quarter which brings the total to 45 for the year-to-date period. This compares favorably to the 46 approvals in calendar 2025. M&A continues as big pharma companies still have a $300B patent cliff by the end of the decade, although the third quarter saw the pace of M&A slow with only four transactions of public biotech companies for >$1B announced bringing the total for the year to 18. 2025 was a strong year for M&A and had only 18 such deals for the entire year. We believe pharmaceutical companies are likely to continue along this path, looking to pursue a larger number of bolt-on transactions which we believe will provide a favorable tailwind to the small capitalization biotechnology industry and Emerald's small cap biotechnology exposure.

MARKET OUTLOOK

Treasury yields have been on an unrelenting climb. There were hopes that the Fed's 25 bp hike in September and its hawkish rhetoric would halt the Treasury sell-off. Instead, continued upward pressure on energy prices (oil, diesel and gasoline) is complicating the Federal Reserve's path to 2% inflation, while strengthening domestic growth (the Atlanta Fed's GDPNow estimate for the third quarter stood at 3.7% as of October 6) and seemingly insatiable demand for capital are pushing the neutral rate higher. Competition for credit and volatility in global bond markets have added further uncertainty. Market pricing has been adjusting in real time to these shifting crosscurrents and now reflects an aggressive recalibration, with 75–100 bps of additional hikes expected between now and the end of 2027. That stands in stark contrast to the Fed's own Summary of Economic Projections, released after the September FOMC meeting, which projects only 25 bps of additional hikes before the end of 2026 and none in 2027. In our view, the gap between these two scenarios is too wide. While we do not claim to be Fed experts, we believe the "removal of accommodation" Fed Chair Warsh has described is unlikely to follow the aggressive path the market now expects, or to unfold in a way that disrupts AI-related investment, the broadening capex cycle or the trajectory of earnings growth.

Notably, corporate earnings expectations have continued to rise. Earnings revision ratios have remained above 1 (more upward than downward revisions) for 17 consecutive months, supported by strong upward revisions to sales growth, according to the Jefferies report cited above. Breadth is improving as well: more than 40% of Russell 2000 companies are delivering earnings growth of 20% or more, versus an average of 37.7%, according to an October 6, 2026 Jefferies report. These revisions have lifted estimated Russell 2000 earnings growth to 14.7% on 8.1% sales growth, up from estimates of 14.1% and 6.8% at the end of the second quarter. Estimates for calendar 2027 have also moved higher, with small-cap revenue and earnings growth expected at approximately 4.9% and 15.8%, respectively, according to the same report.

The combination of rising earnings estimates and falling share prices has compressed the Index's forward P/E to 19.7x, from 21.9x on June 30, 2026 and roughly 26x before the annual Russell reconstitution, according to an October 5, 2026 report from Steven DeSanctis at Jefferies. The valuation gap with large caps has also widened: the Russell 2000 now trades at a double-digit discount to the Russell 1000 on trailing P/E, forward P/E, price-to-book and price-to-sales, according to the same report. Given the sizable multiple reset that has already occurred in the Russell 2000, we believe forward multiples should be relatively well insulated from here, provided the domestic economy and corporate earnings continue to grow above trend.

Third-quarter earnings season will be the next proof point. As we have highlighted previously, innovation has ignited a powerful investment cycle with artificial intelligence at its core. The reindustrialization of the U.S. economy is progressing rapidly, fueled by investment in advanced manufacturing such as semiconductors and pharmaceuticals, efforts to modernize the defense industrial base and initiatives to rebuild depleted stockpiles. There is also a strong push to reshore critical parts of the supply chain, including essential minerals. Together, these trends are driving a significant increase in demand for power generation, which in turn is accelerating investment in domestic power infrastructure. AI is also moving to the edge, as rapid advances in consumer wearables illustrate. Quantum computing continues to reach key development milestones on its path toward commercialization, and space is emerging as a new frontier for exploration, defense, communications and potentially even data centers. Health care continues to innovate as well, particularly in biotechnology, diagnostics and medical devices.

The multiplier effect of accelerating investment across these end markets is broadening economic momentum. Second-quarter 2026 GDP growth was unexpectedly revised up to 2.2% from 1.5%, and nominal growth was revised to 8.5% (q/q SAAR), reflecting stronger consumer spending (3.8% vs. 3.4% previously) and stronger capital spending, with real private fixed investment expanding 9.0% (SAAR, vs. 8.5% previously). The ISM® Manufacturing PMI® has signaled expansion for eight

consecutive months, and the Atlanta Fed's GDPNow estimate for the third quarter is tracking at ~3.7% SAAR. Loan growth remains strong with commercial and industrial loans tracking up high-single digits y/y in the third quarter, and CEO confidence is rising: the Business Roundtable's CEO Economic Outlook Index climbed three points in the third quarter, its fifth consecutive increase, to its highest reading since 2022. This broadening momentum reinforces Emerald's conviction in the outlook for small-cap earnings growth.

Risks to this outlook remain numerous. The forces driving Treasury yield volatility are admittedly something of a Rorschach test, and we may be misreading them, and consequently how much further yields could rise. Fed Chair Warsh continues to refine his and The Federal Reserve's messaging to the market, and as a result we believe the Federal Reserve's path for interest rates and the market's expectations will remain a source of volatility. The conflict with Iran remains unresolved, and refinery capacity constraints are likely to keep prices for refined products such as diesel and gasoline elevated even if crude prices retreat. Inflation, while showing some signs of easing, has been a persistent challenge for both the market and the Fed, and pressure on refined products adds complexity. The midterm elections are also fast approaching. Historically, the period around elections has been challenging for equity performance, and we believe the underperformance of defense stocks, for example, reflects shifting expectations for the election outcome. Finally, the market's love/hate relationship with the AI trade continues to evolve. Political and consumer opposition to data center development is growing louder, AI safety concerns and calls for regulation have moved to the forefront, the cost of capital is rising, and questions linger about the trajectory of AI token consumption and pricing, competition from low-cost Chinese models, and whether returns will ever justify today's extraordinary levels of investment. Given how central this AI cycle is to the broader economic backdrop, the debate will remain a key focus for investors.

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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