Emerald Advisers, LLC
Diversified Small Cap Growth

Q1 2020 | Economic & Portfolio Commentary

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Global Pandemic

Market Update

The aggressive global spread of the COVID-19 virus during the month of March dramatically altered the "return to growth" narrative that had propelled the market through the early part of the first quarter. Public health took precedence over economic growth, as virus containment became a top priority and shelter in place and social distancing guidelines were rolled out across the U.S. and abroad. Volatility surged as the market began rapidly repricing both equities and credit to reflect the economic reality of the global demand shock. Virus fears were compounded by OPEC's reluctance to cut supply in the face of a deteriorating global economic backdrop which triggered a significant weakening in the price of oil (Brent crude fell by 64% in the quarter). The collapse in crude prices added fuel to the liquidity concerns already building within the credit markets in the face of a dramatically deteriorating economic backdrop. All of these factors contributed to sizeable cross-asset class movements in the market. The CBOE VIX Index spiked to 82.69, equity prices succumbed to significant pressure with the S&P 500 declining by (-30.4%) at trough, U.S. Treasury prices rallied (10-year +10.1%), forcing U.S. 10 year yields to decline by (-120 bps), the most since the fourth quarter of 2008. U.S. Corporate bond spreads blew out with high yield (+544 bps) experiencing the largest widening since the fourth quarter of 2008 and U.S. investment grade spreads (+179 bps) widening more than what was experienced during 2008. Aggressive actions from the Federal Reserve to add the necessary liquidity to keep the funding markets functioning appropriately, and growing visibility to a meaningful fiscal policy response helped reduce the market's perception of the tail risk from the crisis, alleviating the near-term pressure and allowing the market to rebound from the intra-quarter panic lows.

When it was all said and done, the S&P 500 finished the first quarter down (-19.60%), while a far cry from its intra-quarter low, the first quarter of 2020 still marked the worst quarter for the performance of the index since the financial crisis and the worst first quarter going to back to 1937 (Savita Subramanian of BofA Securities 4/2/2020).

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Key Points:

- Small capitalization stocks suffered the greatest losses, with the Russell 2000 falling (-30.61%), marking that indices worst quarter in its history.
- The Emerald Diversified Small Cap Growth portfolio outpaced the benchmark for the quarter driven by a combination of allocation and stock selection effect.
- At the sector level the portfolio realized relative outperformance within the materials & processing, producer durables, healthcare and utilities sectors which offset more challenged performance within the consumer discretionary, technology and energy sectors.
- While near-term visibility remains limited, market dislocations create opportunities and Emerald, as always, remains focused on utilizing our fundamental bottom-up research process to identify the most attractive growth opportunities within the small capitalization universe.

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performance challenged, the Russell 2000's underperformance to the S&P 500 was similarly record setting at (-1100 bps), (Furey Research).

From a style perspective, within the Russell 2000 universe, growth stocks demonstrated strong relative outperformance on the downside, with the Russell 2000 Growth Index (-25.76%) meaningfully outpacing the Russell 2000 Value Index (-35.66%). At the sector level, the consumer discretionary sector led to the downside declining by (-41.15%), followed closely by the energy and materials sectors which declined by (-36.98%) and (-32.26%) respectively. The utilities (-6.63%) and healthcare (-18.66%) sectors were the only sectors to decline by less than (-20%).

Decomposing the Russell 2000 Growth Index performance one-step further, with data from an April 2, 2020 report from Jeffries Equity Strategist, Steve DeSanctis, there were several notable observations. First given the relative outperformance of growth as a style, it is not surprising that the highest P/E (-14.55%) and non-earnings (-21.05%) companies were the best performers. That being said the spread of performance between the lowest P/E quintile (-46.78%) and the highest P/E quintile (-14.55%) was a staggering (-3200 bps). There was a directionally similar, but not as stark of a spread (-1435 bps) between performance of the fastest growing companies measured by sales growth which returned (-15.02%) and the slowest growing companies measured by sales growth which returned (-29.37%). Further again and not unexpected given the volatility in the credit markets as discussed above, leverage was sold aggressively with the highest leverage stocks (-27.13%) within the Russell 2000 Growth meaningfully underperforming the lowest leverage stocks (-15.11%). What was unexpected and somewhat counterintuitive however was the underperformance of highest return on equity quintile (-31.38%) vs. the lowest return on equity quintile (-24.70%) as well as high yield (-32.73%) vs zero yield (-24.11%) stocks given the elevated risk aversion in the market.

Portfolio Review

The Emerald Diversified Small Cap Growth portfolio outpaced the benchmark for the quarter driven by a combination of allocation and stock selection effect. At the sector level the portfolio realized relative outperformance within the materials & processing, producer durables, healthcare and utilities sectors which offset more challenged performance within the consumer discretionary, technology and energy sectors.

The materials & processing sector was the portfolio's largest positive contributor to return. Stock selection and allocation effect contributed positively to return reflecting both the portfolio's relative underweight position and solid stock selection. At the industry level, performance within the building materials industry was the largest positive contributor to return.

Performance within the producer durables sector was also a positive contributor to return driven largely by the portfolio's underweight position relative to the benchmark. Outside of the aforementioned, holdings within the healthcare and utilities sectors also contributed positively to performance. Within the healthcare sector, performance within the medical & dental instrument, healthcare management and healthcare services industries were the largest sources of relative outperformance. Also contributing to performance for the quarter were holdings within the utilities sector.

Partially offsetting the aforementioned was relative underperformance within the consumer discretionary, technology and energy sectors. Of these, the consumer sector was the most challenging from a performance perspective, as the underperformance of holdings within the leisure, home building and specialty retail industries weighed most heavily on relative performance. Virus containment policies and voluntary nationwide store/entertainment venue closures have presented these businesses with unprecedented challenges that raised concerns regarding business liquidity. Emerald has opted to reduce exposure to the consumer discretionary sector in the near-term to reflect significantly diminished earnings as a result of the evolving COVID19 situation, the lack of visibility to path of the recovery in consumer spending, as well as account for what we believe will likely be a reprioritizing of spending as we emerge from the downturn.

Performance within the technology sector also proved challenging as the stock selection within the software industry weighed on relative performance.

As we enter the second quarter of 2020, the portfolio held the largest active exposures in the consumer staples and technology sectors. Thoughts on those sectors and other notable areas of exposure are highlighted below.

- The portfolio exited the quarter with an overweight position to the consumer staples sector. The overweight consists of select niche opportunities in disruptive category leaders with innovative product offerings and above average growth prospects that are aligned with emerging consumer trends in the food and beverage industries. Specific areas include pet food, nutritional snacking, active nutrition products, and adult beverages. While our portfolio holdings have benefitted from the pantry-loading phase in the early days of the COVID-19 crisis, the longer term opportunity will be realized through continued category growth and market share gains, along with expanding profit margins.

- The technology sector remains an overweight position. Within the sector, the computer software and services industry remains the portfolio's largest total and active exposure. While secular growth tailwinds like digital transformation continue to be a top of mind priority for most large enterprise customers, we believe that the magnitude of this shift may slow in the near-term as companies are forced to deal with more tactical issues such as workforce relocation, supply chain issues and tightening technology budgets in response to the COVID-19 induced macroeconomic slowdown. As such, Emerald has reduced its exposure to companies that are more discretionary-centric and increased our exposure in areas such as cybersecurity where spending has the potential to be more resilient. Outside of software, we also continue to be optimistic regarding select opportunities within network infrastructure spending, as demand for bandwidth continues to drive network upgrades, and at this point, multiple segments (datacenter, telecom and cable companies) are in the early stages of network expansion/evolution. Secular trends such as 5G and industrial IoT (internet of things) continue to build momentum and are expected to see meaningful growth throughout the next several years, with early deployments happening now. Further defense spending is expected to continue to grow, with bi-partisan support of an expanded budget to address current threats from peer and near-peer adversaries such as Russia and China and other areas of potential tension including Iran and North Korea.

- The healthcare sector, while underweight relative to the benchmark, also remains an area of meaningful exposure within the portfolio. At the industry level, the biotechnology industry remains the largest aggregate exposure. We continue to look for innovative therapeutics that can command premium pricing. Rounding out the portfolio's healthcare sector exposure are niche opportunities within the healthcare services, medical equipment, medical & dental instruments and pharmaceutical industries. Political headwinds appear to have diminished somewhat in the near-term as a result of Joe Biden securing the democratic nomination and the goodwill we believe is being amassed by the healthcare industry in its very public efforts to mitigate the impact from COVID-19.

Market Outlook

The market's view on the near-term economic consequences of the coronavirus have become increasingly dire as the economy has transitioned to a suspended animation of sorts, as we are all sheltering in place and commerce has ground to a halt.

Economists currently expect somewhere between a mid-single to high-single digit decline in the first quarter domestic GDP growth and a 20%-50% decline in the second quarter GDP, with a similarly wide range of expectations for a paced recovery thereafter. Given this framework, the market is prepared for the economic data to get much worse (unemployment, consumer confidence, ISM manufacturing and non-manufacturing data, retail sales, etc.) in the coming weeks as the effects of the shutdown roll through the system. Earnings estimates have been coming down and we expect to see further downward revisions as earnings season progresses. That being said, we believe 2020 earnings have become less relevant, given the unprecedented levels of liquidity being provided to businesses and consumers by the Federal Reserve, the U.S. Treasury and the U.S. Government.

The liquidity programs provided the Federal Reserve, U.S. Treasury and U.S. Government and incrementally less negative data points on the progression of the virus collectively catalyzed the S&P 500 to rally more than 20% from its low two weeks ago. While certainly encouraging, Emerald continues to believe the path forward will not be linear. Market direction from this point forward will be determined by the day to day assessment of the path of the virus, the efficacy and availability of a healthcare solution (therapeutic or vaccine), the duration of the government mandated shelter in place orders, the pace at which business activity resumes, and how the unemployed and furloughed return to work. Beyond the pure economic transition, we are in unchartered territory with limited historical precedent as to the broader residual/behavioral ramifications from the pandemic which further adds to the uncertainty.

While near-term visibility remains limited, market dislocations create opportunities and Emerald, as always, remains focused on utilizing our fundamental bottom-up research process to identify the most attractive growth opportunities within the small capitalization universe. As of quarter-end, the portfolio held the largest relative overweight positions in the consumer staples and technology sectors. The portfolio had the most significant underweight positions within the producer durables, healthcare and materials sectors. Please note that as a fundamental bottom-up manager the aforementioned sector weights are a fall-out of the stock selection process.

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