Emerald Advisers, LLC
Diversified Small Cap Growth

Q4 2020 | Economic & Portfolio Commentary

Small Caps Dominate 4th Quarter Rally

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Market Update

2020 was an extraordinary year from start to finish and remarkably, despite the COVID-19 induced anguish and consternation, all of the major asset classes posted gains for the year, led by Gold which gained 24.6%. The Russell 2000 (+19.96%) slightly edged out the S&P (+18.4%) but trailed the Russell 1000 (+20.96%). U.S. equities outpaced the MSCI AC World Index ex-US (+6.46%) and MSCI EAFE (+1.28%) indices and growth stocks across the capitalization spectrum posted record setting relative outperformance to their value counterparts.

Extreme market movements proved to be more the norm rather than the exception, as the market navigated the onset of COVID-19, nationwide business closures and government imposed operating restrictions, a second quarter GDP that fell by -31% (Q/Q annualized) and then rebounded by +33% (Q/Q annualized) during the third quarter, unprecedented fiscal and monetary stimulus, the historic mobilization of research and development resources to bring to market a COVID vaccine in record setting time and a resourcefulness and resiliency of both businesses and consumers that have collectively driven what is likely to be the fastest and most aggressive economic/market recovery in modern times. This frenetic series of events amidst a rapidly adjusting risk backdrop drove more than 25 outsized (> than four standard deviation) style rotations during the course of 2020, the most ever recorded according to a recent report from B of A Securities Equity and Quant Strategist Savita Subramanian.

One of the larger standard deviation moves of the year occurred during the fourth quarter with the massive rotation into value and small capitalization stocks. The Russell 2000 gained +31.4%, the best quarterly performance in the history of the index and handily outpacing the Russell 1000 index which advanced by +13.69%. Within the Russell 2000, value stocks led with the Russell 2000 Value gaining a whopping +33.36% and outpacing the Russell 2000 Growth which gained a more modest +29.61%. For the full year, the Russell 2000 Growth beat the Russell 2000 Value by the widest margin since 1999, with the Russell 2000 Growth gaining +34.63% and substantially outpacing the Russell 2000 Value which gained +4.63%.

Catalyzing the aggressive rotation into small capitalization stocks was $13 billion in inflows into small capitalization exchange traded funds during the fourth

Key Points:

- The Russell 2000 gained +31.4%, the best quarterly performance in the history of the index and handily outpacing the Russell 1000 index which advanced by +13.69%. Within the Russell 2000, value stocks led with the Russell 2000 Value gaining a whopping +33.36% and outpacing the Russell 2000 Growth which gained a more modest +29.61%.

- At the sector level within the Russell 2000 Growth only four of the eleven economic sectors outperformed the index overall, led by the Energy sector which gained +124.6%. Also contributing to the strong index performance strength within the technology, healthcare and telecommunications sectors which gained +36.64%, +32.18% and +36.64%, respectively.

- Entering 2021, the portfolio held the largest active exposures in the financial services, consumer discretionary, consumer staples, technology, and industrial sectors.

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quarter. While fund flows helped drive strong index level performance, the rotation manifested itself in a way that proved moved challenging to active managers as fund flows disproportionately benefitted the smallest companies within the Russell 2000 benchmark. This resulted in returns within the smallest end of the market capitalization spectrum meaningfully outpacing the larger capitalization companies within the index. Specifically, when decomposing the index by market capitalization, according to a January 5, 2021 report from Steve DeSanctis of Jeffries, those companies within the Russell 2000 with market capitalizations that range from $500 million to $1 billion and less than $500 million returned +36.99% and +34.58%, outpacing those capitalizations greater than $1 billion which returned a more modest +30.0%. The relative underperformance of the greater than $1 billion market capitalization stocks marked a substantial deviation from the performance witnessed throughout the bulk of 2020, with this subset of stocks posting a total return for 2020 of +21.28% substantially outpacing the +9.04% and +17.31% returns achieved by the $500 million to $1 billion and <$500 million market capitalization stocks, respectively. Among the Russell 2000 Growth and Russell 2000 Value sub-indices, the dispersion in performance between the >$1 billion and the $500 million to $1 billion market cap performance was greatest within the Russell 2000 Growth at 761 bps (+28.97% vs. +36.58%), with spread within the Russell 2000 Value at 559 bps (+37.24% and +37.61%). Performance of the smaller end of the Russell coincided with a meaningful acceleration in the performance of the lowest ROE companies. According the same report cited above from Steve DeSanctis, when decomposing the Russell 2000 Growth index by ROE quintiles those companies in the lowest quintiles, quintile 4 and 5 gained +44.79% and +31.21% respectively, whereas those companies within highest ROE quintile, quintiles 1 and 2, gained a more modest +23.31% and +22.32%, respectively.

Also noteworthy was the shift in relative outperformance of those companies with greater than 20% of their sales coming from foreign sources. According to the same report referenced above from Steve DeSanctis, within the Russell 2000 Growth those companies with greater than 20% of sales from foreign sources gained +36.24% vs. companies with largely domestic revenue (<20%) which gained a more modest +26.52%. Further, the dispersion in performance by sales growth continued to be more bifurcated with the tails demonstrating the strongest performance. In this regard the top quintile of the fastest growing companies gained +34.96% modestly underperforming the bottom quintile or slowest growing companies which gained +35.46% for the quarter.

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Portfolio Review

The Emerald Diversified Small Cap Growth portfolio trailed the benchmark for the quarter driven by a combination of stock selection and allocation effect. At the sector level, challenging performance within the healthcare, energy, real estate and telecommunications sectors more than offset relative outperformance within the consumer staples, technology and consumer discretionary sectors.

The healthcare sector proved to be the greatest source of relative underperformance for the quarter as the portfolio was challenged by both the portfolio's relative underweight positon and stock selection. These headwinds were particularly acute within the biotechnology industry. The Russell 2000 Growth biotechnology industry returned +36.67% during the fourth quarter. Given the industry's average index weight of 19.36%, it was the largest contributor to the healthcare sector's aggregate contribution to return for the period. The strong industry performance coupled with

Emerald's average underweight of approximately 597 basis points proved insurmountable from a performance perspective. Adding further to the pressure was the incremental headwind to performance resulting from stock selection as the composition of Emerald holdings from a total return basis lagged that of the benchmark.

The portfolio's relative underweight position and stock selection within the energy and real estate sectors also negatively impacted relative returns for the period. Stock selection within the energy sector, proved to be a noteworthy headwind to performance as the energy sector was the best performing sector within the Russell 2000 Growth for the period, surging 124%. At the industry level the portfolio was most challenged by the relative underweight position and stock selection within the renewable energy equipment industry which gained a staggering 140% as enthusiasm surged post-election on hopes of a Green New Deal in the US. Similarly within the real estate sector, portfolio performance was challenged as a result of the negative contribution from stock selection. While there was no meaningful detractor to performance at the stock level, the portfolio's holdings within the infrastructure REIT industry lagged the strong rebound in those industries that had trailed year to date and were most exposed to the reopening, like hotel and lodging REITs for example, which surged as investors looked forward to a vaccine driven reopening of the broad economy.

Partially offsetting the aforementioned headwinds to performance was the positive contribution to return achieved within the consumer staples, technology and consumer discretionary sectors. Amongst these sectors, the consumer staples sector was the largest positive contributor to return driven primarily by stock selection. Emerald continues to focus on 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. The portfolio's outperformance in sector in the fourth quarter was led by holdings in the pet food and nutritional snacking spaces.

Performance within the technology and consumer discretionary sectors also contributed positively to performance. At the industry level, the portfolio experienced the most noteworthy outperformance within the semiconductor and education services industries.

Entering 2021, the portfolio held the largest active exposures in the financial services, consumer discretionary, consumer staples, technology, and industrial 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 primarily 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, and active nutrition and personal care products.
- Emerald also held an overweight position within the consumer discretionary sector at quarter-end. The overweight is comprised of a diverse subset of holdings within the educational services, specialty retail, recreational services, recreational products, restaurants, casinos and gambling, and auto parts industries among others. With the economy poised for a full reopening upon the successful distribution and uptake of COVID-19 vaccines, we believe the outlook for consumer spending in 2021 remains particularly attractive and believe there remain meaningful opportunities for share gains for those companies offering differentiated products/services with strong value propositions amidst a consolidating retail, restaurant and leisure backdrop.

- The portfolio exited the quarter with an overweight position to the technology sector. Within the sector, the computer software industry remains the portfolio's largest total and active exposure as we continue to believe that secular themes such as digital transformation, which has been pulled forward by the pandemic, and cybersecurity, only further reinforced by recent high profile attacks, will remain spending priorities. Outside of software, we also continue to be optimistic regarding select opportunities within the semiconductor industry in those companies poised to benefit from the rebound in industrial and automotive production, and the growing penetration of 5G and industrial IoT (internet of things).
- Emerald also exited the quarter with an overweight position to the industrial sector. The overweight was comprised of a diverse subset of holdings with the building materials, professional business support services, defense, industrial machinery, engineering and contracting services, and transaction processing services industries, among others that at are poised to benefit from a combination of the cyclical recovery in the economy and company specific business initiatives that we believe will collectively translate to industry leading growth in revenue and earnings.
- The financial services sector, comprised of holdings within the bank, full line insurance, investment services, property and casualty insurance and life industries, was also overweight relative the positioning of the benchmark at quarter-end. Emerald has been adding to its exposure to holdings within the banking industry as we anticipate the steepening of the yield curve and a better credit backdrop with the aid of stimulus should be beneficial to earnings growth. In addition, Emerald has placed specific emphasis on those banks that are positioned to drive a meaningful improvement in their efficiency ratios.
- The healthcare sector, while underweight relative to the benchmark, also remains an area of considerable 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, driven by their unequivocal clinical data. Rounding out the portfolio's healthcare sector exposure are niche opportunities within the pharmaceutical, medical equipment, medical services, health care services and medical supplies industries. There were 13 drugs approved during the quarter, bringing the total approvals for 2020 to 53. On average, there have been 13 new drugs approved per quarter dating back to 2017.

Market Outlook

As we look to 2021, we remain optimistic that the rollout of a COVID-19 vaccine, the rapidly recovering corporate earnings outlook, incremental stimulus initiatives and the forthcoming broad reopening of global economies are setting the stage for a significant acceleration in economic growth as we progress through 2021. Within this backdrop, Emerald continues to believe that small capitalization stocks remain particularly well positioned for further mean reverting outperformance. Earnings growth in 2021 is set to improve meaningfully for the Russell 2000, expanding by approximately 48% year over year based on current consensus according to a January 4, 2021 report from Steve DeSanctis of Jeffries. This compares favorably to 21.6% earnings growth currently projected for large capitalization stocks, and is even more attractive when you consider that small capitalization earnings are now projected to grow 5.5% (8.4% when excluding energy) over the their 2019 base. Valuations, while admittedly in less of an extreme undervalued position on a relative basis than they were at the end of the third quarter, continue to remain attractive relative to their large capitalization peers. As of year-end the Russell 2000 was still trading at a double digit discount to the Russell 1000 on three out of six metrics. Additionally, we believe merger and acquisition activity, which accelerated to close out 2020, is poised for further acceleration in 2021 which we believe should add further support to valuations.

As enthusiastic as we are about the economic backdrop as outlined above we remain mindful of looming risks on the horizon. In this regard, while the prospect of incremental stimulus and accelerating growth has been a catalyst for market performance in recent weeks, it has also been raising concern that inflation may finally emerge from its more than decade's long slumber. Inflation expectations have been rising, with 2-year forward inflation break-evens breaching 2.3% for the first time since 2013. Forecasts for the 10-year yield have been moving higher as well, with the strategists at Morgan Stanley, Goldman Sachs and JPMorgan each now anticipating the 10-year yield to push toward 1.4% to 1.5% by year-end 2021. While we are currently not operating under the assumption that the economy will see a step-function move higher in inflation, we cannot dismiss the possibility given the unprecedented levels of monetary and fiscal stimulus that have been unleashed to date and see this as one of the key risks to the market's advance as we progress through 2021. The upcoming transition of power in the White House also remains a point of uncertainty as key facets of the Biden agenda, specifically the timing of tax policy could have meaningful implications to corporate earnings. We continue to monitor the path of the virus. While the availability of the vaccine is certainly helping to mitigate the tail risk to COVID, in the near-term distribution and administration challenges remain. The market is not embedding any further closures or current closures extending beyond early 2021 and with a new administration set to take office, there remains uncertainty as to the whether there will be meaningful change in the approach taken to manage the spread of the virus or the distribution of the vaccine.

While every year presents its own set on opportunities and risks, 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.

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