EMERALD DIVERSIFIED SMALL CAP GROWTH

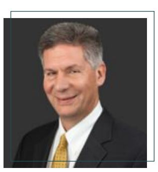
FED PIVOT GIVES SMALL CAPS A BOOST

SMALL CAPITALIZATION STOCKS notched a win during the third quarter with the Russell 2000 (+9.27%) significantly outpacing the larger capitalization Russell 1000 (+6.08%). While the results for the full quarter favored small capitalization stocks, the relative outperformance was largely concentrated in the month of July, as persistent concerns over the health of the domestic economy, a massive unwind of the Yen carry trade that had been supporting risk assets, manufacturing issues with Nvidia's next generation Blackwell series of GPUs utilized in artificial intelligence (AI) servers and rising turmoil in the Middle East created a tremendous amount of intra-quarter volatility. Ultimately, the September triad of firming high frequency economic indicators, a 50-bps cut in the Federal Funds rate, and a coordinated package of stimulus measures from the People's Bank of China reignited growth optimism. From a style perspective, value stocks led with the Russell 2000 Value (+10.15%) outpacing the Russell 2000 Growth (+8.41%).

Within the Russell 2000 Growth, the interest rate sensitive sectors of real estate (+21.12%) and financials (+18.66%) led, whereas the energy (-9.38%) and technology (+2.13%) sectors lagged. Performance amongst the Russell 2000

KEY POINTS:

- ***The Emerald Small Cap Diversified Growth portfolio lagged the Russell 2000 Growth Index in the third quarter driven by stock selection.***
- ***At the sector level, relative underperformance within the consumer discretionary, industrials, healthcare and technology sectors more than offset relative outperformance within the telecommunications, basic materials and financials sectors.***
- ***As we enter the fourth quarter of 2024 the portfolio currently holds the largest active exposures in the financial, technology, telecommunications and consumer staples sectors.***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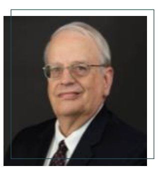
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Growth constituents by characteristics appeared somewhat more random in nature relative to recent history as outperforming companies included those with the highest return on equity (outperforming by 160 bps), $500 million - $1 billion market capitalization companies (343 bps), the top quintile as measured by sales growth (106 bps) and the non-revenue generating companies (385 bps), the highest leverage (103 bps) and the lowest beta companies(257 bps), according an October 1, 2024 report from Steven DeSantis, Equity Strategist at Jefferies.

PORTFOLIO REVIEW

The surge in performance within the Russell 2000 in July and subsequent macroeconomic volatility through the balance of the third quarter created a challenging backdrop for active management. Emerald was not immune to these challenges with the Emerald Small Cap Diversified Growth portfolio lagging the Russell 2000 Growth Index in the third quarter driven by stock selection. At the sector level, relative underperformance within the consumer discretionary, industrials, healthcare and technology sectors more than offset relative outperformance within the telecommunications, basic materials and financials sectors.

The consumer discretionary sector was the largest detractor to return for the period, driven by stock selection. While stock selection was the largest detractor to return, the portfolio's relative underweight to industries that experienced outsized relative performance including the homebuilders, clothing and accessories, footwear, commercial services, and entertainment industries was a sizeable headwind. This was compounded by relative underperformance of the portfolio's holdings particularly within the home furnishings industry.

Performance within the industrials sector also detracted from performance as the positive contribution from holdings within the commercial vehicle-equipment, defense, and climate control industries was offset by stock selection driven relative underperformance within the professional business services, control and filter equipment, and industrial machinery industries, resulting from stock selection related headwinds.

The portfolio also experienced challenging relative performance within the technology sector, as challenging relative performance within the semiconductor industry more than offset the positive contribution to return from holdings within the production technology equipment and software industries.

Also detracting from relative performance during the third quarter was positioning and stock selection within the healthcare sector, and more specifically the biotechnology industry. The biotechnology industry of the Russell 2000 Growth Index was the largest contributor to the index's return for the quarter, driven by the combination of a better than Index return (+11.61% vs. the Russell 2000 Growth +8.41%) and the sizeable benchmark weight, which averaged 14.28% for the quarter. Although Emerald's holdings within the industry outperformed that of the benchmark and stock selection was modestly positive, the portfolio's relative underweight of approximately 230 basis points proved to be a headwind.

Partially offsetting the previously discussed sources of relative underperformance was stock selection driven relative outperformance within the telecommunications, basic materials and financials sectors. At the industry level performance was most noteworthy within the iron and steel, full line insurance, and telecommunications equipment industries.

As we enter the fourth quarter of 2024 the portfolio currently holds the largest active exposures in the financial, technology, telecommunications and consumer staples sectors. Thoughts on those sectors are highlighted below.

- The portfolio entered 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 positions in the semiconductors and semiconductor capital equipment/production technology equipment industries as the companies in these industries possess many of the strongest secular growth themes in the broader market, such as AI infrastructure. In addition, we believe the relative maturity of the semiconductor industry will also lead to strong earnings and cash flow generation. We enter the fourth quarter 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.

- The portfolio also held an overweight position within the consumer staples sector, as we remain positive on the fundamental outlook for growth-oriented consumer packaged goods companies. We see mounting evidence that the broad-based cost inflation and supply chain issues that plagued the industry in recent years are abating, which should continue to drive higher levels of profitability. We continue to focus on companies generating industry leading revenue and earnings growth rates driven by disruptive brands, category leadership positions, strong secular growth opportunities, and improving profit margins.

- Emerald also held an overweight position within the financials sector driven by holdings within the banking, full line insurance, investment services, and property and casualty insurance industries. Most property and casualty insurers are seeing premium increases due to a more benign regulatory environment in many states and the resurgence of social inflation risk. Personal lines such as home and auto are experiencing a hard market with carriers benefiting from successive rate increases and rising investment income resulting from higher interest rates. We still view the specialty Excess & Surplus (E&S) market as very attractive and expect continued robust growth in both property and casualty lines.

- The portfolio also entered the fourth quarter with 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.

MARKET OUTLOOK

After three years of running in place, with the Russell 2000 returning a modest +1.84% on a trailing 3-year annualized basis through September, the foundation is being laid for an improvement in small capitalization relative performance. Emerald has been vocal in our belief that the market would need to see the trifecta of easing interest rates, falling recession risk and a reacceleration in corporate earnings growth before small capitalization stocks are positioned for a durable outperformance cycle. As of the writing of this letter, we believe the first two criteria have been met. The Federal Reserve at the September FOMC meeting cut the Federal Funds rate by 50 bps and outlined the path for an additional 50 bps of cuts in 2024, followed by an additional 100 bps of cuts in 2025. This path reflects the desire of the Federal Reserve to return to its long-run estimated neutral rate of approximately 2.9%, as inflation moves toward the committee's 2% long-run target. While the market was initially pricing a more front-end loaded path given the weakness in the economic data over the summer, expectations have been recast in recent weeks as economic data have been better than expected with the Fed Funds Futures, at least at present, currently aligned with the Federal Reserve's summary of economic projections.

In this regard, the early October release of the September payroll data renewed market confidence in the prospect for a soft landing. September nonfarm payroll grew by 254,000 jobs, well above expectations for 140,000-150,000 in job gains, with positive upward revisions to July and August, translating into an unemployment rate of 4.1%, ticking down from the 4.2% level in the August report. The firming labor market statistics combined with the recently revised data from the Bureau of Economic Analysis (BEA), reflecting meaningful upward revisions to gross domestic income (GDI), personal income and personal savings, have also contributed to this shifting narrative. The personal savings rate, which has been a particular source of consternation given its historically low level at 3.3% as of Q2 2024, was revised higher by 1.9% to 5.2%, which puts the consumer in a position that is considerably less dire relative to history and should at a minimum mitigate downside risk. The breadth of firming datapoints is reflected in the meaningful improvement in the Citi Economic Surprise Index which has moved back into positive territory, after being in negative territory since May. High yield spreads are confirming this narrative, with spreads tightening through September. The solid economic backdrop is also being born out in the Atlanta Fed GDPNow forecast for the third quarter which stood at 3.2% as of October 8, 2024. Outside of our borders, China appears to have embraced the need for stimulus to reinvigorate growth in its stagnating economy, which should only serve to further support this improved economic growth narrative. The revisions to gross domestic income coupled with the reacceleration in jobs growth has resulted in a ratcheting down of recession probabilities with even the most entrenched economists kicking the "inevitable recession" can down the road.

The combination of falling recession risk and an easing cycle in interest rates has historically been favorable for small capitalization stocks absolute and relative performance in the first three, six, nine and twelve months post the first rate cut. In the history of the Index, the Russell 2000 Index has posted an average return of +26.6% in the 12-months post the first rate cut as compared to the +15.6% average return for large capitalization stocks, according to a September 22, 2024 research report from Steve DeSanctis, Equity Strategist at Jefferies.

With recession risk falling and an interest rate easing cycle underway the last obstacle to a durable improvement in relative performance, in our view, remains a reacceleration in small capitalization corporate earnings growth. In this regard, we remain optimistic that small capitalization earnings growth is poised to reaccelerate exiting 2024 and into 2025, as the economic expansion remains intact, investment in artificial intelligence infrastructure and services broadens, automation continues to take hold, investments in onshoring persist, the consumer remains steadfast, housing rebounds, inflationary pressures lessen, the corporate interest expense burden eases, and productivity continues to improve. 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 an October 2, 2024 report from Steve DeSanctis of Jefferies, the relative value of the Russell 2000 to the Russell 1000 remains historically attractive, falling in the 11th percentile, with the trailing P/E (non-negative), forward P/E, price to book, price to sales and P/E Growth trading at double-digit discounts to their historical average.

Therefore, as we look forward, the relative outperformance of small capitalization stocks during the third quarter was an encouraging start. 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 as a percentage of the large capitalization market value to less than 4%, the lowest level on record outside of the Depression era, according to an October 8, 2024 report from Furey Research. According to the same report, in the prior four periods (1933, 1958, 1973 and 2000), when the market cap ratio has approached this level, small caps have outperformed large capitalization stocks in each period on a forward three-year, five-year and ten-year basis.

This outlook is not without risk, October is a historically challenging month in the market, and this has been particularly true in front of a U.S. Presidential Elections. Evolving election probabilities, congressional split, and policy uncertainty also carries with it its own unique set of risks and opportunities, as does the geopolitical landscape. The tensions have ratcheted up in the Middle East in recent weeks, there remains little progress on a resolution between Russia and Ukraine, and China has been stepping up its level of aggression in the South China Sea.

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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