

# Emerald Advisers, Inc.

## Diversified Small Cap Growth

Q3 2016 | Economic & Portfolio Commentary



## Small Caps Outperform

### Market Update

Small capitalization stocks continued their move higher during the third quarter, as global economic growth concerns subsided and risk aversion rose. This shift in risk aversion was most evident in not only the outperformance of small capitalization stocks, but in the relative outperformance of growth stocks that spanned the market capitalization spectrum. The third quarter marked the second consecutive quarter that small capitalization stocks, as measured by the Russell 2000, outperformed on a relative basis by advancing 9.05%, significantly outpacing the 4.03% gain posted by the Russell 1000. From a style perspective, growth stocks outperformed relative to their value counterparts. Within the Russell 2000, the Russell 2000 Growth gained 9.22% for the quarter, outpacing the 8.87% gain posted by the Russell 2000 Value index.

Within the Russell 2000 Growth, performance was led by the energy, technology and health care sectors which gained 18.04%, 17.65% and 13.45% respectively. Conversely, performance within the consumer staples and utilities sectors lagged declining by 5.05% and 3.71%, respectively. Further decomposing the performance of the benchmark the fastest growing companies outperformed, as did non-yield, higher beta, lower return on equity and companies with market capitalizations under \$1 billion.

### Portfolio Review

On a relative basis, Emerald's performance outpaced that of the benchmark for the quarter. Stock selection contributed positively to performance within the healthcare, technology, consumer discretionary and utility sectors, offsetting relative underperformance within the materials and producer durables sectors.

At the sector level, the healthcare sector was the most significant contributor to

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### Key Points:

- Emerald's performance outpaced that of the benchmark for the quarter.
- Stock selection contributed positively to performance within the healthcare, technology, consumer discretionary and utility sectors, offsetting relative underperformance within the materials and producer durables sectors.
- Entering the fourth quarter of 2016, the portfolio remains positioned in the best growth opportunities which are reflected at the sector level in overweight positions in the Technology, Financial Services Consumer Discretionary and Utility sectors.

return. Behind the sector's strong relative outperformance was stock selection within the biotechnology and healthcare services industries. Notably, performance benefitted from the acquisitions of two portfolio holdings at meaningful premiums. The holdings included Cepheid, a molecular diagnostics company (a 54% premium over the previous days' close) and Imprivata Inc., a healthcare authentication management solution provider (a 33% premium over the prior days' closing price). In addition the portfolio also benefitted from the strong fundamentally driven outperformance in the shares of biotechnology company Sarepta Therapeutics and life sciences software provider Veeva Systems, Inc. Sarepta Therapeutics shares advanced significantly during the quarter in response to the FDA approval of the company's lead compound, eteplirsen (trade name Exondys 51) for treatment of a genetically defined subset of patients with Duchenne Muscular Dystrophy (DMD). Emerald continues to be optimistic regarding the outlook for the shares of Sarepta as we believe that patient demand will be quite strong, and that the average weight per patient on drug will be much higher than what the company used to forecast an annual net cost per patient of \$300k/patient/year. As it relates to Veeva Systems, shares of the company appreciated in response to better than expected second quarter financial results, which highlighted the company's ongoing new customer and subscription growth. These factors served to further support Emerald's investment thesis regarding Veeva's market leading position and growth opportunity. Emerald continues to be optimistic regarding the outlook for Veeva Systems.

Partially offsetting the positive contribution from the healthcare sector discussed above was the relative underperformance of the shares of medical device company, Integer Holdings. Shares of Integer came under pressure during the quarter in response to the company's report of weakness in both the cardiac rhythm management and energy business segments which led the company to reduce full year guidance. While disappointed with the near-term trajectory of the business, we believe one of Integer's largest customers will launch a new product category

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in early 2017 which we believe will benefit Integer later this year and into early next year. Further we continue to expect that the company will ultimately recognize significant synergies related to the recent acquisition of Lake Region Medical which we expect will be accretive to earnings over time. Emerald has maintained its position in the shares of the Integer Holdings.

Performance within the technology sector also contributed positively to performance driven largely by strong relative outperformance within the communications technology, semiconductor and telecommunications industries. Within these industries the largest contributors to return included: Lumentum Holdings, Inc., Cavium, Inc., Gigamon, Inc., Microsemi Corporation and Applied Optoelectronics. Applied Optoelectronics, an optical components manufacturer, continued its strong bounce back from early 2016 driven by improving management execution and an improving market outlook for optical components. The improving market outlook for optical components and strong second quarter financial performance also benefitted shares of optical components supplier Lumentum Holdings, which is similarly well positioned to benefit from the ongoing 100G optical upgrade cycle. Gigamon, a network traffic visibility and control solution provider, was also a positive contributor to performance during the quarter as the company posted strong results and guidance, due to continued penetration into the security segment of the market. As security requirements evolve from protecting the perimeter of networks to a more comprehensive view of data security, Gigamon remains ideally positioned to grow its market presence. The portfolio also benefitted from holdings within the semiconductor industry as the market appeared to become more comfortable with the recent acquisitions made by both Cavium and Microsemi, driving the shares of both companies higher.

Performance within the consumer discretionary and utilities sectors also contributed positively to return. Relative outperformance within the consumer discretionary and utilities

sectors was driven by stock selection within the education, specialty retail and telecommunications industries. Top contributors within these sectors included: Burlington Stores, Chegg Inc., and Vonage Holdings Corp.

The positive contribution to performance from the aforementioned sectors was partially offset by relative underperformance within the materials and producer durables sectors. Stock selection proved to be a headwind to performance in each of the aforementioned, as the portfolio's relative underweight position and the composition of holdings within the relative underweight collectively underperformed the benchmark.

Entering the fourth quarter of 2016, the portfolio held the largest active exposures to the technology, financial services, consumer discretionary and utility sectors. Thoughts on those sectors and other areas of notable opportunity/ portfolio exposure are highlighted below:

The technology sector represents the portfolio's largest overweight position. The portfolio has exposure to emerging trends in optical network infrastructure as significant technology transitions are underway to support increased bandwidth across multiple networks: within and between datacenters, within core and metro telecommunications networks, cable operators, and submarine. The next few years represent the first time in over a decade that these disparate networks are all undergoing shifts in technology and network architecture, which should bode well for optical suppliers, equipment manufacturers, and electronic component suppliers across the supply chain. The portfolio also remains exposed to software companies that are benefitting from strong secular growth in areas such as cybersecurity and digital marketing. More importantly, we believe both the software and semiconductor industries will continue to benefit from consolidation as both larger vendors and private equity groups continue their activity in the technology industry. Emerald continues to be optimistic regarding the outlook for the holdings in the portfolio.

Although the relative overweight to financial services has declined on an absolute basis, the portfolio remains meaningfully overweight. The aggregate exposure is comprised of overweight positions to the banking, commercial finance, consumer lending, and real estate investment trust industries with the largest relative overweight position remaining in the banking industry. Emerald continues to believe that small capitalization banks are particularly well positioned to continue to gain market share from their larger capitalization peers and in that regard anticipates that holdings within the portfolio will generate loan growth of 10% or better this year.

The portfolio also maintains an overweight position to the consumer discretionary and utilities sectors. The overweight to the consumer discretionary sector is comprised of a diverse subset of companies within the casino and gambling, consumer services, education services, leisure time, diversified retail, restaurant, specialty retail and apparel industries. Emerald believes that each of these companies is positioned to benefit from company specific initiatives and opportunities. Within the utilities sector, Emerald continues to believe that adoption of unified communications among mid-market and enterprise customers is in the very early stages and that the segment will continue to expand, shifting market leadership from traditional telephony equipment providers to a new group of software/network centric companies, which includes 8x8 Inc. and Vonage Holdings.

### **Market Outlook**

Slowing global and domestic recession fears continued to recede during the third quarter as the market and Federal Reserve appear to be coalescing around lower for longer economic growth and a shallower trajectory of interest rate increases. While there have been numerous periods of moderating quarter to quarter growth throughout the post-recession economic recovery that revived recessionary concerns, in each instance these episodes of slow growth

have been followed by a reacceleration in U.S. domestic growth from slow growth to moderate growth. The most recent episode of rising concern and slowing economic growth at the end of 2015 and into early 2016 has been met yet again with a return to moderate growth. As of October 7, 2016 the Atlanta Fed GDPNow forecast is currently projecting third quarter domestic GDP growth of 2.1%. Although the 2.1% forecast represents a significant deceleration from the Atlanta Fed's original forecast of 3.6%, the path of moderate growth appears poised to continue. Emerald, as we have all year, continues to believe that 2016 has the potential to look a lot like 2015 from a growth perspective. We believe services will continue to expand, manufacturing will stabilize and consumption will expand with the potential to serve as a source of upside. Consumer confidence remains encouraging, minimum wages are rising, unemployment remains low, the savings rate is high and home prices are rising and should continue to do so (increasing equity).

With growth remaining relatively elusive in this slow but stable economic backdrop, Emerald believes that small capitalization stocks and more specifically small capitalization growth stocks look increasingly attractive. First from an earnings perspective small capitalization stocks and particularly small capitalization growth stocks remain the greatest source of earnings growth in the domestic universe. In a recently released report from Lori Calvasina, Chief US Equity Strategist at Credit Suisse the 2016 consensus anticipated earnings growth of 5.5% for the S&P 500, 6.8% for the Russell Mid-Cap and 7.1% for the Russell 2000. The outlook for 2017 looks even more favorable with consensus anticipated earnings growth of 10.2% for the S&P 500, 10.4% for the Russell Mid-Cap and 13.1% for the Russell 2000. Further we believe that small capitalization stocks, given the faster growth profile, look even more attractive when we consider the relative valuation of small capitalization stocks to their larger capitalization brethren. On a median LTM P/E, excluding negative earnings companies, the Russell 2000 is as cheap as its been relative to the S&P 500 since 2003, according to a recent research report from Furey Research page 4

Partners. Taking this a step further, Dubravko Lakos-Bujas, Chief Strategist at J.P. Morgan argues that in a "low but stable economic growth with reduced risk of a recession should demand a premium for growth stocks". Merger and acquisition activity, which is closing in on a new high in small caps, seemingly supports this valuation argument, as acquirers are continuing to find attractive opportunities to make accretive strategic acquisitions at double-digit premiums to their public market valuations.

As we move into the final quarter of 2016, while optimistic regarding the outlook for small capitalization stocks, the market/economy is not without risk. Concerns include the upcoming U.S. Presidential Election, Deutsche Bank and its impact to global financial markets, the durability of consumer spending and the direction and rhetoric of the Federal Reserve. Given this backdrop, we expect periods of heightened global volatility to continue adversely affecting the U.S. market. Offsetting these risks, Emerald's research team continues to find innovators, consolidators, and market share gainers in our domestic universe.

Entering the fourth quarter of 2016, the portfolio remains positioned in the best growth opportunities which are reflected at the sector level in overweight positions in the Technology, Financial Services Consumer Discretionary and Utility sectors. The most significant underweight positions are within the Producer Durables, Healthcare, Consumer Staples and Materials sectors.

#### **Top 5 Contributors**

Cepheid  
Sarepta Therapeutics, Inc.  
Veeva Systems, Inc.  
Trex Company, Inc.  
Relypsa, Inc.

#### **Top 5 Detractors**

Integer Holdings Corp.  
Five Below, Inc.  
Chuy's Holdings, Inc.  
CyrusOne, Inc.  
Tile Shop Holdings, Inc.

## DRIVEN BY RESEARCH

Emerald is an asset management firm providing research-based portfolio management. We provide growth-oriented and income-producing portfolios for institutions and individuals.



To learn more about Emerald Advisers, please visit us at [teamemerald.com](http://teamemerald.com).

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