

Emerald Advisers, Inc.

Diversified Small Cap Growth

Q1 2017 | Economic & Portfolio Commentary



Optimism Recedes

Market Update

The broad based post-election market optimism that dominated the fourth quarter receded somewhat during the first quarter as domestic economic growth decelerated, the yield curve flattened and uncertainty grew regarding the timing and implementation of fiscal policy changes. Although the market continued to advance, the complexion of the first quarter market performance marked a fairly significant departure from that of the fourth quarter from a size and style perspective. Small capitalization stocks, after leading during the fourth quarter, have lagged large caps with the Russell 1000 gaining 6.02% and substantially outpacing the Russell 2000 which appreciated by 2.47%. From a style perspective, growth was able to recapture a portion of the last twelve months of underperformance with the Russell 2000 Growth gaining 5.35% and outpacing the Russell 2000 Value which returned -0.13% for the quarter. Within the Russell 2000 Growth, performance of the fastest growing companies rebounded after a challenging fourth quarter and full year 2016. This rebound was most apparent in the strong relative performance of the healthcare and technology sectors which gained 13.23% and 7.03%, respectively.

Portfolio Review

On a relative basis, Emerald's performance slightly trailed that of the benchmark for the quarter, driven largely by allocation effect as stock selection was neutral. At the sector level, the most notable positive contributors to return included performance within the technology, consumer discretionary and materials sectors. These areas of positive contribution were more than offset by challenged relative performance within the healthcare, energy, financial services, and producer durables sectors. The negative allocation effect in the quarter resulted from the portfolio's relative underweight position to the healthcare sector, which as a sector significantly outperformed the Russell 2000 Growth index.

The technology sector served as the portfolio's greatest source of relative outperformance this quarter driven by stock selection within the software industry and the relative outperformance of optical communications suppliers Applied

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Key Points:

- Within the Russell 2000 Growth, performance of the fastest growing companies rebounded after a challenging fourth quarter and full year 2016.
- Within the Russell 2000 Growth, performance of the fastest growing companies rebounded after a challenging fourth quarter and full year 2016. This rebound was most apparent in the strong relative performance of the healthcare and technology sectors which gained 13.23% and 7.03%, respectively.
- If economic growth remains intact, as we believe it will, Emerald believes that small capitalization growth stocks remain relatively well positioned as growth and valuation relative to their value counterpart remains particularly attractive.



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Optoelectronics and Lumentum Holdings Inc. The shares of Applied Optoelectronics, a leading provider of intra-datacenter optical modules, appreciated after a significantly positive pre-announcement of fourth quarter financial results and a subsequent material increase in guidance for the first calendar quarter of 2017. Emerald believes that the company remains well positioned with three leading datacenter operators in their ongoing transition to 40G and 100G datacenter networking. In the case of Lumentum, a diversified optical component and module provider, shares appreciated in response to growing optimism related to the company's positioning and opportunity for market share gains within the emerging but sizeable \$1 billion market for 3-D sensing technology. Emerald remains encouraged by the growth outlook for the shares of Lumentum.

Relative outperformance within the consumer discretionary and materials sectors also contributed positively to return, driven largely by stock selection within the consumer services and building materials industries. Within the consumer discretionary sector, shares of Nutrisystem, a leading commercial weight loss company, was the top contributor to return. Strength in new customer volumes, reactivation revenues from prior customers, and higher uptake of premium offerings led to significantly better than expected fourth quarter financial performance with EPS growing 55% year-over-year. The positive trends have continued into the first quarter diet season, leading management to provide better than expected financial guidance for 2017. In addition, the early results appear promising for the commercial launch of the recently acquired South Beach Diet weight loss program, bolstering our view that South Beach can be a meaningful growth driver for the company in the future. The combination of the strong performance of the flagship Nutrisystem product line, the meaningful growth potential of the South Beach Diet brand, and the company's highly profitable, asset-light business model lead us to remain positive on Nutrisystem shares. Within the materials sector, Installed Building Products, the nation's second largest installer of insulation and other peripheral products, was the

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most notable contributor to return. The outlook for the company continues to improve as the housing market transitions from smaller, multifamily units to more single family homes, which consume more insulation and therefore require more of the company's installation services. Installed Building Products has been growing sales organically at a 10% rate and already in 2017 the company has made acquisitions representing 10% of 2016 full year sales, solidifying yet another year of double digit top line sales growth. Emerald continues to believe that Installed Building Products can grow earnings in excess of 20% annually over the next three years.

Offsetting the aforementioned was relative underperformance within the healthcare, producer durables, financial services and energy sectors. Amongst this group, the healthcare sector was the largest detractor to return resulting from the portfolio's relative underweight position to the sector and specifically to the pharmaceutical, biotechnology and equipment industries as well as stock selection within the biotechnology industry. These industries were collectively the largest contributor to the rebound in Russell 2000 Growth healthcare sector performance, as discussed above, and as a result the combination of Emerald's underweight position to these industries and the subsequent relative underperformance of the holdings that comprised that underweight position in the biotechnology industry led to the underperformance. From a stock selection perspective, although the portfolio did have a few stocks pressured due to fundamental disappointments, including Albany Molecular and NantHealth, these stock specific issues were minor in the context of the aggregate sector underperformance. Specific to Albany Molecular, a manufacturer of drug raw materials, shares were pressured during the quarter as the company reported disappointing fourth quarter results as product delays limited sales growth. 2017 guidance was also modestly below expectations as a result of a customer loss and less visibility on a prior royalty stream. While disappointed with the short-term financial results, Emerald continues to believe that growth will

reaccelerate during the second half of 2017.

Stock selection within the producer durables, financial services and energy sectors also detracted from relative performance for the period. Within the producer durables sector the portfolio lagged predominantly due to the portfolio's relative underweight position to the stronger performing industries within the producer durables sector, including back office support which consequently weighed on stock selection. There were no material detractors to return at the holdings level.

This was not the case, however, within the energy and financial services sector, as the relative performance of each of these sectors was challenged by stock specific issues. Within the energy sector, the most notable detractor to return was the shares of Keane Group, Inc., a high growth pressure pumping servicer based in Houston, TX. After a successful initial public offering at the start of the year, shares were pressured in February due to rising concern regarding the potential oversupply of pressure pumping horse power. Although Keane reported very strong earnings in mid-March and provided a much better than consensus guide for revenues for the next several quarters, oversupply fears remain, as do concerns about pressure pumpers being able to recoup costs in a timely manner for highly inflationary completion materials such as sand and to a lesser extent labor. Despite some short-term headwinds, Emerald remains optimistic that Keane is positioned to outperform its peers given the company's quality equipment, management team and leverage to some of America's best oil basins. Emerald believes the company will be able to pass on sand and labor costs to customers over the next two quarters and be in a position to deliver strong revenue and earnings growth for the remainder of 2017.

Within the financial services sector, Opus Bank was the largest detractor to the portfolio's relative performance. Shares were pressured during the quarter as a result of ongoing deterioration of credit within the company's specialty loan portfolio. In this regard, Opus Bank reported a quarterly loss for the third quarter that was larger than what the bank had

previously preannounced resulting from an increase in the loan-loss allowance related to one technology credit. Management subsequently announced that additional losses would be taken in the fourth quarter in response to further deterioration in the bank's commercial and industrial loan portfolio. While management is working aggressively to right the ship through changes to its underwriting standards, approvals and controls process, etc. Emerald remains concerned regarding the potential for the realization of further losses as well as the implications to growth as management works to refine its lending practices. Emerald has reduced its exposure in the shares of Opus Bank.

Entering 2017, the portfolio held the largest active exposures to the technology, utility and materials 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. Looking forward within networking and communications, Emerald believes that the strategic imperative from both telecom service providers and datacenter operators to deliver high-speed bandwidth will drive continued demand for optical components, modules, and systems. Additionally, spending on telecommunication infrastructure across China remains a significant driver of optical component demand, and although spending in this geography is currently in a state of flux, we believe China will ultimately remain a significant growth driver for the optical industry. Security spending continues to be a priority for enterprises and as such an attractive theme within the software industry. Additionally, Emerald also remains interested in the capital/consumer spending cycles associated with DOCSIS 3.1, Intel's Purley/Skylake processor, Apple's 10-year anniversary iPhone 8, and next-gen gaming consoles (both VR and standard).

The portfolio also maintains an overweight position to the

utilities sectors. 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.

The portfolio's exposure to the materials sector has grown as Emerald has become increasingly confident regarding the durability of the recovery in the residential and commercial construction markets, as well as the broadening opportunity set resulting from potential increases in infrastructure and construction spending that we expect to come to fruition under the new administration.

Market Outlook

As we look to the second quarter of 2017, there appear to be some short-term headwinds in the making. The yield curve has been flattening and the market is growing increasingly concerned that there may be something larger at play as the gap between the increasingly optimistic surveys/sentiment data and the "hard economic data" is widening, raising fears that improving confidence isn't translating into stronger economic growth. Case in point is the projection for first quarter domestic economic growth which as measured by the Atlanta Fed's GDPNOW forecast has been decelerating. The forecast had been projecting 2.7% GDP growth for the first quarter at its peak in early February and now sits at a much more modest gain of 0.6% for the first quarter driven largely by what appears to be weakening expectations for personal consumption expenditures, related at least in part to the delay in tax refunds stemming from a change in IRS policy regarding the earned income tax credit and declining inventory levels. At this point, with first quarter GDP performance over the last several years showing little correlation to the direction of the economic growth for the year, the market is looking for a solid first quarter earnings season, optimistic forward looking management commentary and a sequential acceleration in GDP growth as a

confirmation that growth remains on track. Direction from Washington would be an added benefit, but given the challenges with the repeal of the Affordable Care Act there does not appear to be any visibility or certainty regarding the timeline to accomplish the initial fiscal policy objectives of the new administration. Given recent events in Syria, geopolitical uncertainty presents a new wrinkle, and is something we believe the market will continue to monitor.

The Federal Reserve is complicating the situation to some degree as it continues to progress on its path of policy normalization, with the rate hike in March, and the most recent commentary from the March meeting minutes that suggest that the Federal Reserve could be leaning toward normalization of its balance sheet as well, as early as the second half of this year. Any further adjustment to the baseline expectation of three rate hikes in 2017 could add additional volatility to the market.

If economic growth remains intact, as we believe it will, Emerald believes that small capitalization growth stocks remain relatively well positioned as growth and valuation relative to their value counterpart remains particularly attractive. At the close of March the portfolio held the largest relative overweight positions in the technology, utilities, and materials sectors. The portfolio had the most significant underweight positions within the healthcare, producer durables and consumer staples sectors. Please note that as a fundamental bottom-up manager the aforementioned sector weights are a fall-out of the stock selection process.

Top 5 Contributors

Applied Optoelectronics
Nutrisystem, Inc.
Veeva Systems Inc.
Lumentum Holdings Inc.
Exelexis, Inc.

Top 5 Detractors

Opus Bank
Keane Group Inc.
comScore Inc.
GTT Communications Inc.
Gigamon Inc.

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