Emerald Advisers, Inc.
Diversified Small Cap Growth

Q1 2018 | Economic & Portfolio Commentary

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Volatility Returns

Market Update

What a difference three months makes. After a strong start to January with the S&P 500 advancing 7.5% in the first 18 days of trading, the S&P 500 over the proceeding weeks retraced erasing early gains and finishing the quarter down 0.8% as uncertainty and volatility rose in tandem. While the absolute change in volatility has been dramatic, the factors driving the market's volatility have varied from month to month with inverse volatility ETF's, inflationary fears, Fed concerns, weakening economic surprise indices, downward revisions to first quarter GDP expectations, the specter of a trade war with China, fear of regulatory backlash against internet leaders, a flattening yield curve, the surge in LIBOR (London Interbank Offered Rate) and the widening TED spread (the spread between 3-month LIBOR and 3-month Treasury Bill) all contributing to spiking volatility and the market's rising wall of worry.

Interestingly, market leadership (large capitalization, growth, and technology) stayed largely intact until the month of March when growing concerns regarding tariffs, global trade and fear of regulation in the technology sector began to alter the narrative. The most notable shift in leadership occurred during the month of March with small capitalization showing notable outperformance relative to their large capitalization peers. Small capitalization stocks as measured by the Russell 2000 appreciated by 1.29% during the month of March and (0.08%) for the first quarter outperforming the Russell 1000 which returned a (2.27%) in the month and (0.69%) for the quarter.

Although large capitalization stocks lost their early quarter lead, growth stocks were able to hold on to their first quarter outperformance despite a choppier March. Small capitalization growth stocks as measured by the Russell 2000 Growth posted solid absolute performance for the month of March gaining 1.35% narrowly outperforming the Russell 2000 Value index which gained 1.24% for the same period. Conversely, the month of March was more challenging for large capitalization growth stocks, as measured by the Russell 1000 Growth which returned (2.74%) for the month vs. the Russell 1000 Value which returned (1.76%). For the quarter, however, both small and large capitalization growth stocks

Key Points:

- Although large capitalization stocks lost their early quarter lead, growth stocks were able to hold on to their first quarter outperformance despite a choppier March.
- On a relative basis, Emerald underperformed the benchmark for the quarter as challenging stock selection within the healthcare, materials, producer durables, and consumer discretionary sectors more than offset relative outperformance within the technology sector.
- Entering the second quarter of 2018, the portfolio held the largest active exposures in the financial services, technology, materials, and utilities sectors..
- As we look to the second quarter, while the market narrative has been altered by the uncertainty related to global trade and peaking rates of global growth, the fundamental underpinnings of our optimism entering 2018 remain firmly intact.

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outperformed their value counterparts with the Russell 2000 Growth and Russell 1000 Growth gaining 2.30% and 1.42% respectively as compared to the Russell 2000 Value and Russell 1000 Value which returned (2.64%) and (2.83%) respectively.

Within the Russell 2000 Growth index the fastest growing companies maintained their dominance for both the month and quarter gaining 3.50% and 10.38% respectively. At the sector level within the Russell 2000 Growth index, the technology sector was the best performing sector for the month and quarter returning 2.22% and 9.40% respectively. The energy, consumer staples and materials sectors posted the weakest returns for the quarter at (14.15%), (6.17%) and (4.33%) respectively.

Portfolio Review

On a relative basis, Emerald underperformed the benchmark for the quarter as challenging stock selection within the healthcare, materials, producer durables, and consumer discretionary sectors more than offset relative outperformance within the technology sector.

The healthcare sector was the largest detractor to return for the period due predominantly to stock selection within the biotechnology, medical and dental instruments and pharmaceutical industries which weighed on relative performance. Amongst these, performance within the biotechnology industry was the most impactful as the subset of the portfolio's biotechnology holdings meaningfully underperformed the otherwise strong index level biotechnology industry performance. The underperformance was driven largely by idiosyncratic factors that unfortunately impacted a disproportionate number of the portfolio's holdings as measured by number of stocks and aggregate weighting. The largest of these detractors included Puma Biotechnology Inc., Portola Pharmaceuticals Inc., Dermira Inc., Insmed Incorporated and Adamas Pharmaceuticals. The details underlying each position's performance during the quarter are highlighted below:

- Puma Biotechnology is a biotechnology company with an approved product (Nerlynx) on the market in the U.S. for the treatment of breast cancer. Shares of Puma declined during the quarter in response to European regulators rejection of the company's application to market Nerlynx in Europe. Although the company is appealing the ruling, we do not expect them to gain clearance in Europe before the release of the 5 year survival data from the company's ongoing breast cancer trial which is expected in late 2019. While disappointed with the setback in Europe, as this geography represents approximately 30% of the commercial opportunity for Nerlynx, Emerald has maintained its position in Puma. We continue to believe that the U.S. uptake of Nerlynx is progressing better than planned and as a result we see upside to 2018 guidance of $175-$200M of U.S. sales.
- Portola Pharmaceuticals is a pharmaceutical company engaged in the development of two primary products: Betrixaban, an oral Factor Xa for preventative treatment of venous thromboembolism in acute medically-ill patients currently on the market in the U.S., and Andexanet, which is an antidote in development for all approved Factor Xa inhibitors. Shares of Portola came under pressure during the quarter in response to an announced delay in the company's FDA action date on Andexanet. The company, on their fourth quarter conference call, mentioned that the FDA had sent them a written correspondence questioning if the company might need another clinical trial prior to approval. Portola had met with FDA several times dating back to mid-2016 when the FDA rejected their initial application without mention of another clinical trial. With the risk of the FDA now mandating a pre-approval study now elevated in our view, Emerald believes the risk/reward to the valuation is skewed to the downside and as a result have opted to exit our position.

- Shares of biotechnology company Dermira came under pressure in the quarter as the company's lead compound in phase 3 clinical trials for the treatment of acne failed to meet its primary endpoint. This was a disappointment as the results of the phase 3 trial deviated meaningfully from that of the phase 2 data. The company's phase 2 data looked strong and we were confident that the drug would have strong uptake based on our conversations with physicians, given the drug's combined benefit of reducing acne and skin oil production. Cosmetic dermatologists were especially enthusiastic on the drug as an option for patients who wanted to reduce the appearance of an "oily sheen" on their face. Given the failure of the acne program, which was expected to be the largest value driver for the company, Emerald opted to exit its position.
- Insmed Incorporated is a biotechnology company that is developing a specially formulated inhaled antibiotic to treat a chronic lung infection called non-tuberculosis mycobacterium (NTM). The company submitted their NDA for FDA approval during the quarter, but stated that the FDA is planning to hold an advisory committee meeting to discuss the drug prior to approval. While the shares came under pressure in response to the upcoming advisory committee review, we do not believe the review presents a risk as it is likely that the FDA wants to discuss the state of the NTM market. There are no drugs currently approved for this indication and with Insmed's success, there are a host of potential competitors emerging. In addition, the company issued convertible debt in January which we believe has also been a contributing factor to the relative underperformance of the shares. Despite this underperformance Emerald has maintained its position as we continue to have a favorable view on the approvability of the drug and believe that the risk/reward for Insmed remains very attractive.
- Adamas Pharmaceuticals markets Gocovri, a drug that releases the active ingredient amantadine at specific time intervals to prevent side effects typically seen when amantadine is taken by patients with Parkinson's disease. Shares came under pressure during the quarter in response to private competitor Osmotica receiving approval for their formulation of a delayed release amantadine (albeit with a different release profile). Emerald has tracked the Osmotica progress for years and believed the threat to be behind us once Adamas gained approval and received orphan drug exclusivity which would prevent Osmotica from gaining approval for the same indication. Osmotica, however, circumvented this barrier by filing their drug as an alternative to generic amantadine, without specific data related to Parkinson's (or any other data). While in the near-term Osmotica's filing has added some uncertainty to the trajectory of Gocovri's uptake we remain confident in Gocovri's strong clinical profile and ultimate market opportunity. Emerald has maintained its position in the shares of Adamas Pharmaceuticals.

While in aggregate holdings within the biotechnology industry weighed on relative performance there were a few bright spots as both Sarepta Therapeutics and G1 Therapeutics were top-ten contributors for the quarter.

Stock selection within the materials sector also detracted from performance due largely to relative underperformance within the roofing wallboard, cement and steel industries. At the stock level the largest detractors to return included: U.S. Concrete Inc. and Installed Building Products. US Concrete, Inc. is the largest domestic provider of ready mixed concrete. The company operates mostly in Northern California, Texas, and the New York City metropolitan area, with small, growing operations in Philadelphia and Northern Virginia. In four of the past five quarters, US Concrete's locations have experienced unusually heavy rain which has impaired its customers' ability to perform projects particularly in California and Texas. Unfortunately, the weather in the first quarter similarly presented headwinds, resulting in earnings estimates being revised lower and the shares underperforming. While the weather has created a significant amount of volatility short-term we believe the backdrop remains favorable. Non-residential construction activity continues to grow year over year, institutional is accelerating and residential building is up 4 – 6%. Therefore assuming a return to normal weather patterns, new projects coming online, as well as the accruing earnings from acquired aggregates and ready mix operations, Emerald believes US Concrete remains well positioned to demonstrate accelerating earnings growth as the year progresses and have maintained the position in the shares. In the case of Installed Building Products, the nation's second largest installer of residential insulation, shares have come under pressure in response to negative revisions to earnings resulting from higher than anticipated material and labor inflation. Although disappointed by the short-term impact that both factors have had on profitability, this management team has operated in inflationary environments in the past and we believe the company will recapture the lost margin over the coming quarters. Emerald remains confident that Installed Building Products remains well positioned to grow annual sales at 15% and earnings at 30% through 2020.

Performance within the producer durables and consumer discretionary sectors were also negative contributors to performance as stock selection within the machinery, truckers and consumer services industries proved to be a headwind to relative performance. At the stock level the shares of equipment company Manitowoc Company, Inc., metal-working tool company Kennametal Inc., and commercial weight-loss company Nutrisystem Inc. were the most notable detractors to performance. Nutrisystem was the portfolio's largest negative contributor for the quarter. Nutrisystem provided lower than expected guidance for the first quarter and full year 2018 financial results, based on the company's disappointing performance during the first quarter diet season. The first quarter represents the strongest seasonal period for commercial weight loss companies as consumers embark on diet-focused New Year's resolutions. Nutrisystem's first quarter advertising campaign failed to resonate with consumers, offering an oft times crowded and tired message with little innovation in an increasingly competitive weight loss market. In addition, the company's efforts to branch out beyond its core cable TV network focused advertising strategy into the broadcast network and syndication markets proved unsuccessful, particularly combined with an ineffective advertising campaign. As a result, management provided guidance of EPS growth of only 4% to 9% in 2018, which was below the sell-side consensus estimate of 22.5%. After significant due diligence, we believe the issues impacting Nutrisystem in early 2018 are fixable within a reasonable timeframe. In addition, there is an emerging bright spot with the South Beach Diet program that was formally launched in 2017 and is expected to grow by more than 150% in 2018. Nutrisystem also employs a highly efficient direct-to-consumer business model that should generate meaningful levels of profitability and cash flow, even in what appears to be a disappointing year for the company. We believe that Nutrisystem is on a path toward improved financial performance as the year progresses, which combined with the stock's attractive valuation, should lead to improved share price performance. As a result, we continue to hold a position in the stock.

The aforementioned weakness was partially offset by relative outperformance within the technology sector. Stock selection within the communications technology, electronic entertainment and semiconductor industries were the primary sources of strength. At the stock level, the portfolio's top two contributors were security software holdings: Proofpoint Inc. and Varonis Systems. Varonis is a leading provider of software to the rapidly emerging category of data and file security. Shares of the company appreciated during the quarter in response to the company's better than expected fourth quarter financial performance in which revenue and license growth increased 35% year over year. Strength was driven by strong execution internationally with revenue increasing 52% year over year and increased penetration at existing clients. Shares of Proofpoint, a leading provider of email security for large enterprise, also appreciated during the quarter in response to better than expected financial results and guidance. Proofpoint continues to experience strong demand resulting from the growth of new customers and better cross-selling efforts to existing customers. Emerald remains optimistic regarding the outlook for security spending and specifically the opportunity for growth for both the shares of Varonis Systems and Proofpoint Inc.

Entering the second quarter of 2018, the portfolio held the largest active exposures in the financial services, technology, materials, and utilities sectors. Thoughts on those sectors and other notable areas of exposure are highlighted below.

The portfolio has maintained its overweight to the financial services sector, with a notable overweight to the banking and consumer lending industries. Emerald continues to believe that the underlying fundamentals of small cap community bank stocks remain attractive and in fact begin to look more attractive when we add in the benefits from reduced corporate tax rates, possible regulatory relief, loan growth that outpaces that of their large cap brethren and continued rate increases from the Fed.

Specific to the technology sector, the portfolio is overweight the communications technology, electronics, computer technology and computer software and services industries. Software remains the portfolio's largest absolute industry exposure with holdings focused on areas of secular growth such as enterprise security and vertical software. We believe that the security spending will continue to be strong given the current fundamental backdrop, which includes a number of high profile attacks (i.e. Wannacry and Equifax) and the implementation of the new General Data Protection Regulation (GDPR) in Europe in 2018. Further we see the potential for enterprise software spending to accelerate in 2018 in response to increased corporate profits, increased investment by the financial services industry (20% of technology spending), deregulation and better spending in Europe.

The portfolio also maintains an overweight position to the utilities sector. 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.

The portfolio also holds a meaningful absolute weighting within the healthcare sector. The healthcare sector also remains an area of meaningful exposure within the portfolio, although the portfolio remains underweight relative to the benchmark. At the industry level, the biotechnology industry remains the largest aggregate exposure. Emerald remains optimistic regarding the ongoing opportunity within the biotechnology industry given the high-level of innovation and the substantive progress being witnessed in drug development amidst what continues to be a very accommodating FDA (46 new drugs were approved over the course of 2017). Further, Emerald also believes that biotechnology industry could be a beneficiary if merger and acquisition activity accelerates during 2018.

Market Outlook

As we look to the second quarter, while the market narrative has been altered by the uncertainty related to global trade and peaking rates of global growth, the fundamental underpinnings of our optimism entering 2018 remain firmly intact. Global economic growth in aggregate remains strong and the earnings outlook has improved thanks to lower taxes and better top-line growth. Further, thanks to rising earnings and more muted first quarter market returns, valuations across the equity universe have gotten more reasonable. All of these factors on a fundamental basis keep us highly encouraged.

While positive on the underlying fundamentals of the marketplace, we remain mindful of the growing list of uncertainties that have driven the acceleration in volatility year to date. Of these, trade tensions have moved to the top of list as a trade war with China could have broad implications to growth and inflation. Although we are more inclined to expect a rational and potentially beneficial outcome to trade discussions, the markets daily handicapping of the vast array of potential outcomes is likely to keep volatility elevated. Further, we continue to monitor inflation, the direction of monetary policy, the shape of the yield curve, credit conditions, and the direction of the dollar. Geopolitical risk similarly remains elevated in our view as is domestic political/policy risk, particularly as it relates to the outcome of mid-term elections and the implications to U.S. congressional control. While the list of risks is long and evolving, each of these issues independently has the potential to be disruptive to the market. That being said with all of these risks acknowledged, Emerald continues to believe that the improving global economic backdrop will be supportive of further positive revisions in forward earnings growth and market returns. Within this backdrop, we believe small capitalization stocks are particularly well positioned as we move through the balance of 2018.

Top 5 Contributors	**Top 5 Detractors**
Chegg Inc.	Nutrisystem Inc.
Sarepta Therapeutics Inc.	Puma Biotechnology Inc.
G1 Therapeutics Inc.	U.S. Concrete, Inc.
Proofpoint Inc.	Portola Pharmaceuticals Inc.
Varonis Systems Inc.	Installed Building Products Inc.

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