Emerald Advisers, LLC
Diversified Small Cap Growth

Q3 2021 | Economic & Portfolio Commentary

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The Economy and Stock Market Take a Breather

Market Update

The domestic economy hit a speed bump during the third quarter as the spread of the Delta variant, concerns about vaccine efficacy and supply constraints (labor and materials) led to a slowing in the rate of domestic economic growth and downward revisions to third quarter GDP growth forecasts. The weakening economic backdrop and uncertainty regarding the Delta variant weighed on yields with the 10-year yield bottoming near 1.19% during July and August. The market downdraft accelerated in September, in response to more hawkish than expected commentary from Fed Chair Powell indicating the Fed could move ahead with the taper as soon as the next meeting. This language catalyzed a surge in treasury yields, and a rotation toward cyclicals, value and small-capitalization stocks.

Despite the relative outperformance of small caps during the month of September, small capitalization stocks underperformed for the quarter with the Russell 2000 declining (4.4%) and lagging the Russell 1000 and S&P 500 which gained +0.21% and +0.58%, respectively. For the year-to-date period the Russell 2000 now trails the Russell 1000 by 278 bps and the S&P 500 by 321 bps. This divergence in performance is noteworthy. According to an October 5, 2021 report from Furey Research Partners the S&P 500 hit its 54^{th} new all-time high of the year on September 2^{nd}, which is the fourth highest total of new all-time highs in a year going back to 1928. Conversely, the Russell 2000 has achieved only 13 new all-time highs this year (last accomplished on 3/15/21) marking the largest divergence between the number of R2000 and S&P 500 new all-time highs since 2014 when the S&P 500 hit 53 new highs and the R2000 made only ten. According to the same report, if this pattern holds, this would make the third consecutive year that the Russell 2000 is posting fewer new all-time highs than the S&P 500, which would be unprecedented in the over 40-year history of the index.

Portfolio Review

The Emerald Diversified Small Cap Growth portfolio outperformed the benchmark for the quarter driven by stock selection within the healthcare, financials, industrials, and technology sectors which offset modest relative underperformance within the consumer staples sector.

Key Points:

- Despite the relative outperformance of small caps during the month of September, small capitalization stocks underperformed for the quarter with the Russell 2000 declining (4.4%) and lagging the Russell 1000 and S&P 500 which gained +0.21% and +0.58%, respectively.
- The Emerald Diversified Small Cap Growth portfolio outperformed the benchmark for the quarter driven by stock selection within the healthcare, financials, industrials, and technology sectors which offset modest relative underperformance within the consumer staples sector.
- Looking to the balance of the year and beyond, Emerald remains confident that above trend domestic economic growth is poised to continue into 2022.
- 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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DRIVEN BY RESEARCH

After a challenging first six months of 2021, relative performance within the healthcare sector improved during the third quarter. Stock selection and allocation effect within the biotechnology, medical services and healthcare services industries were the largest contributors to return. At the index level, performance of the healthcare sector has continued to struggle, trailing the Russell 2000 Growth benchmark by more than 640 basis points for the quarter. The biotechnology industry, remained a particular source of ongoing weakness returning approximately (14%). From a portfolio specific perspective, the biotechnology industry was the largest source of the portfolio's relative outperformance resulting from a combination of stock selection and the portfolio's average underweight to the biotechnology industry of approximately 330 basis points. At the stock level, Gossamer Bio was the most noteworthy contributor to return. Shares of Gossamer Bio appreciated meaningfully during the quarter as the market began to price in the opportunity associated with GB-002, the company's drug in development to treat pulmonary arterial hypertension (PAH). Gossamer will have critical phase 2 data reading out in the first half of 2022. In addition to the market's showing recognition of the PAH opportunity, shares of the company appreciated further in response to the $11.5 billion acquisition of competitor, Acceleron by Merck. We believe the majority of the $11.5 billion valuation Merck ascribed to Acceleron is attributable to sotatercept for PAH. Acceleron added $4B in market cap on the release of the positive phase 2 data from that trial, which was nearly identical to Gossamer's GB-002 that we expect to read out next year. Gossamer Bio, in comparison is valued at only $1 billion in market capitalization today, we therefore continue to believe there remains meaningful upside to the shares of Gossamer Bio.

Performance within the financial sector also contributed positively to performance driven by a combination of stock selection, allocation and interaction effect. At the industry level, the portfolio experienced the greatest relative outperformance within the full line insurance and investment services industries. Amongst these industries, the most noteworthy contributor to return was insurance broker BRP Group Inc. The company reported outstanding second quarter earnings results that were well above consensus estimates. New business wins, prior investments in technology and people, and improving market conditions drove broad-based strength across the company's business segments, which resulted in organic growth of 32.3%, and far surpassed consensus expectations for high-teens growth. EBITDA margins were similarly better than expected and we remain confident that both organic growth and margins remain biased to the upside as we move through the balance of this year. Emerald has maintained its position in the shares of BRP Group.

Also contributing to the portfolio's relative outperformance was stock selection within the industrials and technology sectors. Within the industrials sector, the portfolio benefitted from the positive contribution to return achieved within the professional business support services, transportation services, and industrial machinery industries. At the stock level the most noteworthy contributors to return included: Chart Industries, Echo Logistics, and TriNet Group.

- In the case of Chart Industries, a provider and manufacturer of cryogenic tank solutions, heat transfer systems, specialty products and services to the industrial gas, energy and biomedical industries, shares appreciated during the quarter reflecting the market's growing confidence in the growth outlook for the business. Management has been aggressive in broadening its product portfolio through niche acquisitions including investing in a turboexpander business, LA Turbine, a critical component in process refrigeration that aids in converting gases to liquids and AdEdge, a rapidly growing and high margin water treatment company that provides solutions for a broad range of contaminant removal options. These added to other recent acquisitions that have largely focused on growing the company's specialty platform. In addition to the broadening of the product portfolio, Chart's position as the premier provider of energy infrastructure products for LNG, hydrogen, and helium has positioned the company to benefit as projects in these areas gain traction. Emerald continues to be optimistic regarding the outlook for Chart as we believe there remains significant opportunity for upward revisions to earnings and the company's valuation over the foreseeable future.

- Also contributing positively to performance for the quarter were the shares of Echo Global Logistics, a leading technology-enabled third-party logistics services provider. The company's shares appreciated during the quarter after the company agreed to be acquired by the private equity firm The Jordan Company in an all-cash transaction representing a 54% premium to the company's share price prior to the announcement. We believe the transaction premium is demonstrative of the strength and perceived durability of the current freight cycle, which provides incremental support to Emerald's underlying investment thesis for other holdings within the transportation/trucking industries.

- Over and above the aforementioned, shares of TriNet Group were also a top contributor to performance. TriNet is a leading provider of outsourced human resources solutions to small- and medium-sized business, including payroll processing, benefits enrollment and administration, and regulatory compliance services. The company reported significantly better than expected Q2 financial results with revenues and adjusted EBITDA coming in more than 65% above the sell-side consensus estimates. TriNet is emerging from a multi-year turnaround and repositioning initiative with an integrated technology platform, enhanced product offerings, and streamlined cost structure. This combined with market share gains and a robust hiring environment resulted in strong upper single digit growth in worksite employees covered, outpacing analyst expectations and the growth rate achieved by many of its industry peers. We continue to believe that TriNet is early in realizing its growth potential and we continue to hold a position in the company's shares.

Stock selection within the technology sector and specifically within the software and computer services industries also contributed to the portfolio's relative outperformance. At the stock level, the top contributors to return included cybersecurity company Rapid7 and digital services provider Perficient. In the case of Rapid7 a leading provider of vulnerability management software for large- and medium-sized enterprises, the company's stock appreciated +19.5% during the quarter after they reported better-than-expected quarterly results and raised guidance for 2021 due to 1) strong end market demand, 2) new customer adds, and 3) increased success in cross-selling the company's product portfolio to a larger installed customer base. Emerald continues to believe that Rapid7's solutions will become increasingly relevant due to a heightened threat environment and an increased number of high-profile attacks such as Solarwinds and the recent Colonial Pipeline hack. As it relates to Perficient, a leading IT services and digital consulting firm, the company's shares appreciated in response to the company's release of better-than-expected results for its second quarter and raised guidance for fiscal year 2021 due to strong customer demand. The company attributed this to a spike in large digital transformation projects and the increased use of offshore and near-shore labor. We continue to believe that the company will benefit from strong demand as the economy reopens and enterprise customers increase their investments in customer-facing technology solutions.

The aforementioned positive contributors to return were modestly offset by the slight relative underperformance of holdings within the consumer staples sector. The consumer staples sector within the Russell 2000 Growth was a notable laggard for the quarter, returning (11.53%) and trailing the benchmark's total return by nearly 600 bps. At the portfolio level, while stock selection was modestly positive for the consumer staples sector in aggregate, this positive contribution to return was more than offset by the headwind to allocation effect as a result of Emerald's relative overweight position to the sector and specifically the food industry. At the stock level within the food industry, shares of Freshpet, the leading provider of fresh, cooked, meat-based pet foods and one of the fastest growing pet food providers overall, were one of the portfolio's largest detractors for the period. Freshpet reported better than expected revenue growth of 36% for Q2-21, driven by rising household penetration rates and distribution gains. However, the company's share price came under pressure as retail sales growth slowed late in the quarter and into the beginning of Q3-21, due to supply chain disruptions with a third party logistics services provider, production constraints, and more challenging year-over-year comparisons. We view these issues as transitory and we have witnessed a re-acceleration in retail sales growth in recent weeks as the supply chain issues have improved, production volumes have continued to ramp, and year-over-year comparisons have become easier. We continue to believe that Freshpet is a highly disruptive brand in the $37 billion U.S. pet food market that is well positioned for continued rapid market share gains. As such, we continue to hold Freshpet shares as a core position in the portfolio.

Exiting the third quarter of 2021, the portfolio held the largest active exposures in the financial services, consumer discretionary and consumer staples sectors. Thoughts on those sectors and other notable areas of exposure are highlighted below.

- The financial services sector, comprised of holdings within the bank, full line insurance, investment services, property and casualty insurance and life industries, was the portfolio's largest relative overweight position at quarter-end. Emerald has maintained its exposure to holdings within the banking industry as we anticipate a resumption in 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.

- 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 now open, vaccines widely distributed, the labor market recovering and consumer net worth continuing to rise, we believe the outlook for consumer spending remains attractive and believe there remains meaningful opportunity for share gains for those companies offering differentiated products/services with strong value propositions.

- As it relates to the technology sector, the portfolio exited the quarter with technology sector positioning largely in-line with the benchmark. The technology sector weighting on an absolute basis remains the second largest nominal portfolio weight behind the healthcare sector. Within the technology sector, the computer software industry remains the portfolio's largest total and active exposure. The global pandemic accelerated the adoption of ecommerce, digital forms of entertainment (video games, streaming, etc…), technology infrastructure upgrades, and a diverse array of cybersecurity and cloud-related software opportunities that are enabling digital transformation. We also believe that industry fundamentals for both hardware and software will continue to benefit from a number of tailwinds including 1) an improving economic environment, 2) healthy IT spending by corporations and 3) investment in large digital transformation projects by medium and large enterprises. In addition, we continue to see a strong rebound in industrial and automotive production, though significant supply constraints are now manifest in the global tech supply chain. With demand still significantly outstripping supply, we continue to monitor the nuanced supply side dynamics including geopolitical and supply chain risk.

- 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, active nutrition and "better-for-you" beverages.

- The healthcare sector, while underweight relative to the benchmark, also remains an area of considerable nominal exposure within the portfolio. The portfolio's underweight to the healthcare sector is driven largely by the portfolio's relative underweight position to the biotechnology industry. Emerald believes performance within the biotech industry has been challenged on a year-to-date basis for a number of reasons including: rare disease niches getting crowded with competition, risks around governments recognizing intellectual property, record setting IPO and secondary offerings, fear of rising interest rates, lack of leadership at the FDA, uncertainty regarding the FDA's willingness to approve new drugs given the agency's recent issuance of several high profile complete response letters or delayed regulatory actions, less M&A activity possibly driven by a tougher FTC, and the seemingly never ending discussion of drug pricing. In addition to the issue of so much supply, we believe that the small cap biotech industry has surpassed peak return on investment. Further, we continue to look for differentiated opportunities with moats to protect the business from competition. We believe M&A is required to get the sector moving in the right direction. While all of these factors have been gating factors to the portfolio's relative positioning, the biotechnology industry remains an area of considerable nominal exposure within the portfolio. We continue to look for innovative therapeutics that can command premium pricing, driven by their unequivocal clinical data, and we are seeing opportunities in innovative therapeutic areas including cell therapy and gene editing. 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.

Market Outlook

Looking to the balance of the year and beyond, Emerald remains confident that above trend domestic economic growth is poised to continue into 2022. Although third quarter GDP growth weakened more meaningfully than anticipated, with the Atlanta Fed GDPNow forecast tracking to 1.3% GDP growth as of October 5, 2021, Delta cases appear to have peaked and high frequency economic indicators have begun to inflect positively. While supply chain bottlenecks are likely to continue to present headwinds to growth, with inventory to sales ratios tracking at near historic lows we believe the rebuilding of inventory levels will ultimately contribute to GDP growth as supply chain pressures ease throughout 2022.

Further, while there have been some concerns regarding the sustainability of consumer spending as the benefits from stimulus subside, we believe consumer spending should remain supportive of above trend economic growth throughout 2022. Consumer net worth is surging, wages are on the rise, unemployment continues to trend lower, U.S job openings are tracking at historical highs and cumulative excess savings stands at approximately $2.4 trillion, according to a September 15, 2021 report from Dubravko Lakos-Bujas of JP Morgan, leaving the consumer with plenty of dry powder to support further spending growth. The outlook for business investment remains similarly encouraging given the strong growth in corporate earnings and profitability, rising cash levels and easy lending conditions, all of which should be supportive of ongoing strength in capital expenditures.

The underlying sources of economic strength outlined above remain evident in forecasted earnings growth. Estimates for Russell 2000 earnings growth relative to the 2019 earnings base have continued to move higher and now stand at 42%, according to an October 5, 2021 report from Steve DeSanctis of Jefferies. The outlook for 2022 remains similarly encouraging with small capitalization earnings projected to grow by 17.7% year over year, substantially better than the 9.6% and 9.3% growth projected for mid-cap and large capitalization stocks respectively.

Earnings growth is not only more attractive in small capitalization stocks, so is valuation. On a relative basis, the valuation of the Russell 2000 stands in the 25th percentile relative to Russell 1000, and trades at a discount to the long-term averages when measuring trailing P/E and price to book. The relative valuation of the Russell 2000 looks even more attractive when compared to the S&P 500. According to an October 5, 2021 research report from Furey Research Partners, small-cap relative P/E had only been less expensive in 1999, which was followed by strong small-cap relative P/E expansion.

Further, while there continues to be much discussion around the level of absolute valuations there has been no slowdown in M&A activity. According to an October 4, 2021 report from Goldman Sachs, the year to date strength in merger and acquisition activity continued through the third quarter with more than $1.11 trillion of combined strategic and sponsor M&A announced by North American and European acquirers. Notably, this was the most active quarter since the second quarter of 2007. On a year-to-date basis, with more than $3.24 trillion of M&A announced, 2021 has already exceeded the post-Global Financial Crisis full-year record set in 2015 of $2.9 trillion, and appears to be on track to surpass the record high $3.4 trillion in M&A volume set in 2007. We expect a robust M&A backdrop to remain supportive of valuations.

That being said, while we continue to be optimistic regarding the durability of above trend growth and the opportunity we are seeing in the small capitalization universe, risks to this outlook remain. Specifically, we believe there remains residual uncertainty in the market as it relates to the evolution of COVID, the pace and durability of price inflation, the path of monetary policy, the resolution of the debt ceiling extension, the ultimate size and scope of infrastructure spend and related tax policy, the steady stream of initial public offerings, slowing economic momentum in China as well rising geopolitical uncertainty across the globe.

Notwithstanding the risk outlined above, Emerald remains vigilant and focused on utilizing our fundamental bottom up research process to identify the most attractive growth opportunities within the small capitalization universe.

Top 10 Contributors	Top 10 Detractors
Perficient, Inc.	MediaAlpha Inc.
Chart Industries, Inc.	Reata Pharmaceuticals, Inc.
Rapid7 Inc.	Chegg, Inc.
Echo Global Logistics, Inc.	Kratos Defense & Security Solutions, Inc.
TriNet Group, Inc.	EverQuote, Inc.
Churchill Downs Incorporated	Latham Group Inc.
BRP Group Inc.	Freshpet Inc.
Dick's Sporting Goods, Inc.	Replimune Group, Inc.
Tetra Tech, Inc.	Dicerna Pharmaceuticals, Inc.
Gossamer Bio, Inc.	Visteon Corporation

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