

Small Cap Growth Quarter-End Review—4Q2023



Stock market investors enjoyed a strong rally over the last two months of the quarter, as the S&P 500 posted a return of 11.7% for the quarter as a whole. Information Technology, Real Estate, and Financials were the strongest performing sectors in the S&P 500, while Energy was the only sector that posted negative returns. Bond prices also exhibited strong gains during the quarter, as the yield on 10-year Treasury bonds declined to 3.89% at quarter-end, compared to 4.57% at the beginning of the quarter. The 10-year Treasury yield ended the quarter at roughly the same level where it started the year, despite rising as high as 5.0% in October.

The immediate impetus for the stock and bond market rallies was dovish commentary by the Federal Reserve, which suggested that interest rates are likely to be reduced over the course of 2024 and beyond. However, it is doubtful that the Fed would suggest future cuts in interest rates if it weren't for the significant improvement in inflation that occurred over the past year and a half. After peaking at close to 9% in mid-year 2022, the annualized change in the Consumer Price Index (CPI) declined to 3.1% through November—a remarkable drop over such a short period—and continues to move closer to the Fed's stated 2% inflation target. The Fed's preferred measure of inflation, the Personal Consumption Expenditures (PCE) Index, has declined to 2.6%, with the annualized rate over the past six months ending November falling even further to 1.9%.

In December 2022, a story in *The Economist* stated that 85% of economists polled said that they expected a recession to occur over the next 12 months (i.e., 2023). The fact that the

SECTOR WEIGHTS & PORTFOLIO CHANGES⁽¹⁾

Sector	Ending Weight ⁽²⁾	Change from 9/30/2023	Small Cap Growth Additions & (Small Cap Growth Deletions) ⁽³⁾
Information Technology	27.4%	-1.0%	Sprinklr (Engagemart, Perficient)
Industrials	24.4%	+0.2%	
Health Care	16.5%	+1.1%	HealthEquity
Consumer Discretionary	12.9%	-1.2%	(Lithia Motors)
Consumer Staples	6.9%	+2.8%	e.l.f. Beauty
Financials	4.3%	-0.8%	
Energy	3.2%	-0.8%	
Real Estate	2.0%	0.0%	
Materials	1.6%	-0.2%	
Cash	1.0%	-0.1%	
Utilities	0.0%	0.0%	
Communication Services	0.0%	0.0%	

⁽¹⁾Based on a representative account of the strategy discussed. Portfolio characteristics (e.g., sector weights, valuation, growth rate) are based on a representative account that we believe is illustrative of the strategy. All accounts in the strategy are invested identically in the same securities unless a client has imposed restrictions. Characteristics and/or holdings on a given date may vary due to pending trades.

⁽²⁾Weights as of the end of the presentation period. Cumulative total weighting may not add up to 100% due to rounding of percentages to the nearest decimal place.

⁽³⁾Any securities referenced should not be considered a recommendation to purchase or sell a particular security. These securities represent a portion of the companies held in a representative account in this strategy as of the date stated and are intended for informational purposes only. The reader should not assume that investments in the securities identified or discussed were or will prove to be profitable. The past performance of these securities is no guarantee of future results. The specific securities identified and described may not represent all of the securities purchased, sold, or recommended for this strategy. To request a complete list of holdings recommendations for this strategy over the past year or a list showing the contribution of every holding to the performance of the representative account for the time period stated, please contact Renaissance at compliance@reninv.com.

Source: Renaissance Research, FactSet

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CONTRIBUTORS TO RETURN⁽¹⁾⁽²⁾

Ticker	Company Name	Average Weight ⁽³⁾	Contribution to Return
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TOP FIVE CONTRIBUTORS—SMALL CAP GROWTH

BLD	TopBuild	2.31%	1.07%
MTH	Meritage Homes	2.28%	0.94%
AMPH	Amphastar Pharmaceuticals	2.59%	0.87%
ELF	e.l.f. Beauty	2.02%	0.87%
DECK	Deckers Outdoor	2.86%	0.86%

BOTTOM FIVE CONTRIBUTORS—SMALL CAP GROWTH

XPEL	XPEL	1.49%	-0.74%
KNSL	Kinsale Capital Group	2.85%	-0.71%
FOXF	Fox Factory	1.07%	-0.55%
LSCC	Lattice Semiconductor	1.54%	-0.50%
PTEN	Patterson-UTI Energy	1.74%	-0.48%

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⁽³⁾Average weights over the presentation period.

Sources: Renaissance Research, FactSet

majority of economists proved to be wrong should serve as a cautionary tale to anyone who makes economic projections. In 2023, the financial markets weathered the Federal Reserve's raising of interest rates 11 times over the preceding 18 months to their highest level in over 20 years, weakness in regional banks and a significant bank failure (Silicon Valley Bank), the ongoing war in Ukraine, and the renewed war in the Middle East. Few would have expected that these events would be associated with a 20%+ gain in the stock market, but these results have nonetheless occurred, lending credence to the adage that "the stock market tends to climb a wall of worry".

We continue to focus our efforts on identifying high-quality companies with good growth opportunities that are selling at reasonable valuations. While the market outlook for 2024 is just as difficult to predict as it was in 2023, we believe that our disciplined investment approach will continue to reward patient investors with good long-term returns.

The Russell 2000 Growth Index posted a strong rally in the fourth quarter led by falling U.S. Treasury yields and the expectation the Federal Reserve will begin cutting interest rates sometime in 2024. The Renaissance Small Cap Growth Strategy lagged the index in the fourth quarter but finished ahead of the benchmark on a year-to-date basis. Index performance was led by the Real Estate and Health Care sectors, while the Energy sector was the only sector that declined and the defensive Utilities sector trailed sector performance in the index. Contributing the most to relative performance in the quarter was stock selection in the Consumer Staples and Consumer Discretionary sectors. The largest detractors to our relative performance were our stock selection in the Health Care and Financials sectors.

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TopBuild (BLD) contributed the most to performance during the quarter. The installer and distributor of insulation and other building products is seen as benefitting from lower interest rates. Housing starts improved in November and increased 15% from October levels. Moreover, the backlog of both single-family and multi-family residences remains above historical averages, which should support demand for building products in the near term. With interest rates declining, home affordability should also improve and drive a broader recovery in the home building industry.

XPEL (XPEL) detracted the most from performance, as the company reported disappointing revenues and earnings for the third quarter. China revenues declined during the quarter, and the company expects to see revenue growth for the year at the lower end of its forecasted range. Additionally, the company took an inventory write down which impacted its profitability. Management believes that its China business is bottoming and margins could rebound as the inventory charge is a one-time event. Management also believes it can continue to grow revenues in the 15-20% range going forward.

Trading and stock movements during the quarter led to several changes in sector weights. The Consumer Staples, Health Care, and Industrials sectors saw their weights increase during the quarter, whereas the Consumer Discretionary, Information Technology, Financials, Energy, and Materials sectors had decreasing weights.

One new position added during the quarter was **e.l.f. Beauty** (ELF), a designer, manufacturer, and distributor of cosmetics. The company differentiates itself through products that are competitively priced, innovative, socially responsible, and inclusive. The company has significantly outgrown the industry for years but has only a 4% market share in mass cosmetics versus legacy brands, which boast 15%. The company has also recently entered Western European markets, creating an additional avenue for growth. We believe the company is well-positioned for continued growth by gaining additional shelf space at mass market retailers in the U.S. and abroad, as its products resonate with younger consumers.

We sold our position in **EngageSmart** (ESMT) as the company agreed to be acquired by Vista Equity Partners in an all-cash transaction.

After the Federal Reserve's Open Market Committee (FOMC) meeting in early November, Fed Chairman Powell stated, "The fact is, the Committee is not thinking about rate cuts right now at all." However, just six weeks later in mid-December, Fed officials forecast a series of interest rate cuts in 2024, with the majority of FOMC officials expecting the Fed Funds rate to fall to 4.6% by the end of 2024. The "real" Fed Funds rate (the Fed Funds rate minus inflation) is at the high end of its range over the past 20 years, which suggests room for rate declines, especially if inflation continues to recede.

Our Small Cap Growth Strategy's investable Universe is approximately equivalent to the profitable companies of the Russell 2000 Growth Index, and there are several observations that can be made with respect to where we are today and what we may see in 2024.

First of all, the earnings of profitable companies in the Russell 2000 Growth Index have grown at an annualized rate of 11.0% since the beginning of the century. Earnings growth is highly correlated with stock returns, as the average return for this group has been 9.3% over the same time period. Earnings contracted in 2023, and expectations are that they will increase 18.8% in 2024.

In terms of price-to-earnings (P/E), as of December 31, 2023, the P/E of our market of small cap growth stocks stood at 21.3x earnings. This is only slightly elevated versus the historical average of 20.6x earnings. If we end 2024 at this historical average P/E and if earnings do, in fact, grow by 18.8%, this could imply that our small cap growth universe may gain 18.3% for the year. We consider this scenario optimistic.

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Weighing on the potential returns are earnings estimate revisions which, during the last 90 days, were -2.7%. We anticipate that estimates will continue to drift downward, at least through the first quarter of 2024 as company management teams provide additional guidance for 2024 expectations. In addition, revisions may continue to be negative if inflation and interest rates remain sticky at elevated levels.

One concern that deserves mention is the U.S. national debt, which is approaching \$34 trillion. Service on the debt, or interest expense, for the U.S. government is close to \$1 trillion per year, while the annual deficit continues to hover close to \$2 trillion. This trajectory is not sustainable. If the U.S. government does not find solutions to change the trend, the economy may face structurally higher interest rates that are driven by insufficient demand for the ever-increasing supply of Treasury bills, notes, and bonds.

On balance, we are cautiously optimistic for the economy and the market as a whole. We continue to believe that there are plenty of opportunities in high-quality small growth companies that will offer favorable rewards to patient and disciplined investors.

DISCLOSURES

The opinions stated in this presentation are those of Renaissance as of December 31, 2023 and are subject to change at any time due to changes in market or economic conditions.

GICS SECTOR INFORMATION

Sector Listing according to MSCI and S&P Dow Jones data: MSCI and S&P Dow Jones do not make any express or implied warranties or representations and shall have no liability whatsoever with respect to any GICS data contained herein.

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REFERENCED INDICES

(Indices are unmanaged and are not available for direct investment.)

Consumer Price Index—The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. It is calculated by taking price changes for each item.

Personal Consumption Expenditures Index—The Personal Consumption Expenditures (or "PCE") Index Personal Consumption Expenditures (PCE) includes a measure of consumer spending on goods and services among households in the U.S.

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Russell 2000 Growth Index—The Russell 2000 Growth Index is composed of the smallest 2,000 of the 3,000 largest U.S. companies based on total market capitalization with higher price-to-book ratios and higher forecast growth values.

S&P 500 Index—The S&P 500 Stock Index is a market capitalization weighted index and consists of 500 stocks chosen for market size, liquidity and industry group representation.

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