Small Cap Core Growth
Portfolio Commentary
2nd Quarter 2019

During second quarter of 2019, the market zig-zagged, changing courses each month. April returns were buoyed by the strong corporate earnings reports. May was marked by intensified trade wars with Mexico and China, and the markets were down sharply. June posted a rebound, reflecting strong consumer spending and the possibility of a future interest rate cut by the Fed. The Russell 2000 Growth Index ended the 2nd quarter up 2.75%. The Granahan Small Cap Core Growth strategy fared well in this environment, outperforming its benchmark with a composite return of 6.97%, net of fees. The six months through June 2019 marked the best half-year start to a year in the last ten years, with the Russell 2000 Growth Index returning 20.36%. The same was true for the GIM Small Cap Core Growth composite, which posted a return of 28.65%, net of fees.

The portfolio's industrial and healthcare stocks led for the quarter, and four of the top five performers represented the Core Growth LifeCycle category: Exact Sciences (healthcare), Enphase Energy (industrials), Repligen (healthcare) and RBC Bearings (industrials). Continuing its strong run, Exact Sciences was the top relative performer in the quarter. The company's co-promotion partnership with Pfizer is succeeding in raising awareness around Cologuard, the company's colorectal cancer early-detection test. They have hired new salespeople, increased market access and expanded media coverage for the product. Even with the rapid growth, the company still has a small share of a very large market; we have trimmed our position to maintain a reasonable weighting. Enphase Energy was up on strong earnings from its residential solar products. The company should continue to gain market share as it is in the process of transforming from a micro-converter supplier to a complete solution provider, which will significantly increase the dollar content per home. The growth prospects in the underpenetrated US residential solar market are strong, and we are adding to the position. Repligen is a leading "picks and shovels" biotechnology company capitalizing on the early stage and expanding market opportunity for consumable bioprocessing products. The company has a compelling strategic approach to this market, which is combined with a strong operating model that includes high profitability and good revenue visibility. We are trimming the position due to valuation. Industrial company, RBC Bearings, reported a strong March quarter. The company has added aerospace capacity that includes 4 new plants, which add incremental production that will drive sales well into 2020. Importantly, RBC's industrial end-markets remain healthy. We have trimmed our position on the recent strength. From the Pioneer LifeCycle category, Kornit Digital (industrials) also landed in the top five for the quarter. Kornit introduced two well-received products this year that have given investors confidence in the company's long-term outlook for taking market share for high quality, on-demand printed garments and fabric. An important side benefit of Kornit's machines is that, unlike traditional printing, the processing does not produce polluted water as a by-product.

The largest detractor this quarter was Ring Energy from the Special Situation category. Ring Energy was down along with most energy stocks, as oil retreated from its earlier rise in the quarter. Many energy investors have grown frustrated as these stocks have underperformed energy prices, both as prices rose and as they fell. We added to the group, as we remain positive on company-specific growth initiatives and very compelling valuations. Three information technology names also detracted this quarter: Cloudera, 2U, and Pure Storage. Pioneer technology company, Cloudera, is struggling with its big merger last year, causing disruption in the marketplace, and its CEO resigned. The company has given disappointing guidance for Q2 and subdued numbers for the second half of the year. There is high demand for Cloudera's alternative types of data storage and analytics tools that can be used to tackle the exponential growth in enterprise unstructured data. We continue to monitor Cloudera's progress and may further add to the position should the company meet certain milestones. Another Pioneer, 2U (online education platform for university graduate-level programs) underperformed as it modestly lowered guidance after many schools tightened admissions standards following a well-publicized U.S. college admissions scandal. We have increased our position as we believe that the market over-reacted given 2U's strong long-term outlook. Core Growth technology company, Pure Storage, has modestly missed the low end of expectations for two quarters. However, the company is still growing its revenues in excess of 25%. As the company continues to develop a moat around its storage array offerings, we have added to the position due to the strong growth and attractive valuation. Pioneer healthcare company, Evolent Health (value-based, technology-enabled healthcare service platforms) underperformed with a slow start to the year and investor pessimism regarding the acquisition of one of its customers. There is an on-going shift to value-based reimbursement, and with Evolent's dominant market share, we believe the company is well-positioned to capitalize on the opportunities in this large addressable market.

Year-to-date, Exact Sciences, Enphase Energy, and Kornit Digital were the top relative performers. Evolent Health, Ring Energy, and Stamps.com (consumer discretionary, Core Growth) were the largest detractors for the six months.

Attribution

In the quarter, stock selection drove the outperformance, and the effect of the sector weightings was slightly positive. The quarter showed strong relative stock selection in the industrials, healthcare, information technology, and financial sectors. Selection in communication services, real estate, materials and consumer staples also assisted. Stock selection in energy was a slight negative to performance, and our overweight position in the sector also hurt relative performance. Stock selection in the remaining sectors was neutral to performance. The portfolio's underweight position in consumer discretionary assisted relative performance, as did our overweight positions in industrials, healthcare and information technology.

Holdings in the Core Growth LifeCycle category drove the outperformance for the quarter, while the portfolio's Special Situation holdings also outperformed the benchmark. The Pioneer names slightly lagged the benchmark return this quarter.

For the year-to-date, stock selection again drove performance, and the sector weightings were also a positive. The portfolio showed positive stock selection in all sectors except consumer discretionary, though our underweight position in this sector partially offset the poor selection.

Weightings

Weightings in the LifeCycle categories have not changed from last quarter. Since the end of last year, Pioneers have increased from 21% to 24% of the portfolio. Core Growth and Special Situation weightings have both decreased; Core Growth from 48% to 46%, and Special Situations from 32% to 29%. We have been trimming winners in both categories due to the relative outperformance.

GIM's bottom-up process leads us to continue our significant overweight in information technology, and we are also overweight versus the benchmark in the energy, healthcare, and industrial sectors. Our large underweight in consumer discretionary continues, and we are also underweighted versus the Index in financials, consumer staples, materials, communication services, real estate, and utilities.

Themes

About 10 years ago, investors were excited about the growth prospects for the solar industry. They were soon disappointed as the solar market became propped up by unsustainable foreign government subsidies that were then victims of the financial crisis. However, the underlying problem was that solar was not economical compared to traditional electrical generation. Today, thanks to continuous cost reductions over the last decade, solar is now cost competitive in many environments. There are still subsidies in place, but the market is nowhere near as dependent on them as in the past.

We expect the solar market to grow more than 10% annually for the next few years. According to EnergySage, in several important states (including New Jersey, Massachusetts and California) the payback period for installing a solar system is now less than six years. Furthermore, the state of California has mandated that, starting in 2020, all new homes must be equipped with solar panels. Goldman Sachs recently estimated that this alone could increase the US solar residential volumes by 15-30%. In the GIM portfolio, Enphase Energy is rapidly gaining market share in this growing market with its superior product line and leading technology position.

In May 2018, Europe implemented new data privacy rules – General Data Protection Regulation (GDPR). Under GDPR, data breaches can be severely punished with fines that seriously impact the financials of a company. Recently, British Airways was fined $229 million for exposing the personal information of 500,000 customers in September 2018. The largest fine before the GDPR regulations was a $626,000 penalty on Facebook. Many US companies sell into Europe, and many are also preparing for similar legislation to be implemented in the US. Companies in our portfolio that help to mitigate these security risks include Cyberark, Radware, Okta, Qualys, Proofpoint, Mimecast, and Zscaler.

Macro

A slowing global economy, the Fed's position on interest rates, the current and potentially expanding tariffs, and brewing presidential-election rhetoric have many on edge about the US economy's growth trajectory. The global slowdown may explain low inflation rates and provide an argument for lower interest rates. Though at this time, investors appear to be taking the positive view that robust US consumer spending, the possibility of an interest rate cut, and the current trade-war truces with China and Mexico will sustain the economic expansion.

Outlook

While growth is generally scarce across the economy, we believe the outlook for the companies in the Small Cap Core Growth portfolio is very good. We noted in the last two quarterly commentaries that we may see difficult earnings growth rate comparisons for 2019 against the strength of 2018 earnings. And as anticipated, the earnings growth rates for some portfolio companies have slowed from the very high growth rates experienced last year, particularly for those that benefited from the US tax cuts. Though overall, the portfolio companies continue to experience excellent growth that we believe can be sustained for the foreseeable future, as many are poised to capitalize on substantial long-term opportunities and/or company-specific dynamics. Many of these companies are leaders in terms of innovation and market disruption.

According to Steve DeSanctis, a SMID-Cap Strategist at Jefferies, small cap stocks are now much cheaper overall than their large cap brethren. However within the small cap arena, in comparison to small cap value stocks, some small cap growth stocks are trading at premium valuations (based on *current* earnings), and we believe this may persist for some time given the dynamic opportunities available to many of these companies. Company fundamentals drive our bottom-up excellent stock analysis and decision making, and diversification across the three LifeCycle categories – each with distinct performance drivers – balances the portfolio. Both are important to the long-term consistent performance of the Small Cap Core Growth strategy.