GIM Small Cap Discoveries Strategy
Portfolio Manager Commentary
June 30,2019

"*Clearly, sustained low inflation implies less uncertainty about the future, and lower risk premiums imply higher prices of stocks and other earning assets. We can see that in the inverse relationship exhibited by price/earnings ratios and the rate of inflation in the past. But how do we know when **irrational exuberance** has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade? And how do we factor that assessment into monetary policy?*" –

Federal Reserve Chairman Alan Greenspan, in a December 1996 speech given at the American Enterprise Institute

It was in late 1996 when Alan Greenspan made those comments, but it was a full 3 years later that the dot.com bubble burst. Greenspan was directionally correct, but his timing was a bit off. At GIM, we try to directionally know where we are in a cycle and where we are going, but it is our investment process that handles the impossibility of correctly timing any market peak or correction.

We are frequently asked about our view on where we are in the cycle, and as always, we resist any attempt to be precise; however, we feel an obligation to have a sense of where we are and let that influence our actions on the margin.

So where are we in the cycle?

The economic expansion has gone on for longer than "normal." Our interactions with portfolio companies as well as personal experiences suggest it continues. Interest rates are low and recently have gone lower. Stocks have performed well – larger company stocks have done better than smaller company stocks, and growth stocks have trounced value. Technology stocks have dominated everything, though have been closely followed by financial services and utilities – strange bedfellows indeed.

When we do these analyses, we look for outliers. If there are any of note this cycle, it is the fact that growth has outperformed value in a way unlike any other in recent history save for the dot.com bubble. The median P/E ratio on larger cap value stocks has actually declined since 2016, while the median P/E ratio on growth stocks has expanded as one would expect in a falling interest rate environment.

At Granahan, our process and LifeCycles allow us to live with paradoxes like this. On the margin it means buying more Special Situation names and fewer Core Growth names, which highlights what I believe to be our competitive advantage.

At GIM, everyone has a sector expertise in an important area of the economy, plus everyone is an analyst and everyone is a generalist. We combine these skills with curiousity and the LifeCycle tool to produce a quiet but powerful advantage. Looking across LifeCycles, we seek well-managed companies with good growth prospects and staying power. Investing in our areas of expertise allows us to gain conviction and determine when to buy the stocks of these well-positioned companies opportunistically. Taken together, and as we adhere to our long-standing process, our clients benefit.

The Small Cap Discoveries investment process provides the opportunity to focus on what we do best at GIM as small cap specialists – security selection. LifeCycle diversification is key to the success of our process. In addition to expanding the opportunity set to uncover growth prospects throughout the small cap market, diversification by LifeCycles (Pioneer, Core Growth, Special Situation) helps to mitigate various factor risks – industry, size, quality, momentum, etc. Our process allows us the ability to focus solely on stock selection; that is, finding companies that are positioned to grow irrespective of the macro environment… irrespective of exactly where we are in the cycle, and irrespective of whether or not we feel growth stocks have gone too far for too long.

Performance

We measure the Small Cap Discoveries strategy against the benchmark that most closely approximates the size of companies we are investing in, the Russell Microcap Growth Index, with the Russell 2000 Growth as a secondary benchmark. The GIM Small Cap Discoveries strategy outperformed its primary benchmark, the Russell Microcap Growth, for the period. It also outperformed the Russell 2000 Growth Index.

			--------- Annualized ---------		
Performance	**YTD 6/30/2019**	**1-Year**	**3-Years**	**5-Years**	**10-Years**
GIM Small Cap Discoveries composite – net of fees	25.7%	0.4%	26.0%	13.8%	20.6%
Russell Microcap Growth Index	16.5%	-9.8%	9.8%	4.3%	11.9%
Difference	*+9.2%*	*+10.2%*	*+16.2%*	*+9.5%*	*+8.7%*
Russell 2000 Growth Index	+20.4%	-0.5%	14.7%	8.6%	14.4%
Difference	*+5.3%*	*+0.9%*	*+11.3%*	*+5.2%*	*+6.2%*

While outcomes are certainly relevant, the most important measure to us is whether or not we are following a repeatable process that can exploit the opportunities continually presented to us in small cap stocks. The philosophy and process of Small Cap Discoveries revolve around the opportunity for superior stock selection in the small and microcap universe, where there is the potential to differentiate oneself by capturing big winners and avoiding big losers.

LifeCycles and Cycles

Given that, as outlined above, we do not believe we have the ability to predict macro shifts and stock market cycles, we still believe that cycles are important and there is a need to have a sense of about where in the cycle we currently are. This is important to portfolio positioning, particularly on the margin with names going in and out of the portfolio, as well as position sizing.

The LifeCycle tool assists us to diversify the portfolio across innovative emerging growth companies, as well as high quality companies that may be temporarily affected by negative investor sentiment. Typical weights are 25% each in Core Growth and Pioneers and 50% in Special Situations. Special Situations are more prevalent in the smaller cap spectrum of the market, because lack of critical mass often precludes them from the consistency in financial results that many growth investors favor.

LifeCycle Weightings	**12/31/2018**	**06/30/19**
Pioneer (*earlier stage companies, creating new markets*)	28%	28%
Core Growth (*recurring revenues, visibility on earnings, solid record of strong earnings growth*)	18%	17%
Special Situations *(companies with prosaic record, internal or external factor that will accelerate earnings growth)*	51%	50%
Cash	2%	5%

The opportunities that we uncovered over the course of 2018 and through the first half of 2019 were heavily weighted to the Special Situation category, as we reduced Core Growth holdings where valuations had become stretched.

Performance Discussion

As we reiterate in every letter, one way we measure success in our process is by looking at the contribution to our performance from big winners, and the detraction to performance from big losers. The way we measure whether we are buying good businesses is by looking at the contribution from stocks that get bought out (a proxy for an attractive asset).

We normally expect our performance to be driven by a few top performing stocks, our losses in the bottom 15% to be contained, with the remaining stocks in the portfolio more neutral to performance.

During this 6-month period through June, our winners from the top 15% of the universe contributed disproprtianately, our losers from the bottom 15% lost more than the benchmark, and the middle of the pack slightly outperformed. The overall result was a gain of 5.32% over the Russell 2000 Growth Index and a 9.21% gain over the Russell MicroCap Growth benchmark.

During this period where the overall markets have done well, all three LifeCycle categories outperformed the benchmarks, with the Core Growth and Special Situation categories leading the performance for the portfolio.

We had no acquisitions in the portfoio during this 6-month period.

Small Cap Discoveries composite of client portfolios:
Top Relative Contributors for YTD 6/30/2019

Name	6-month Return	Relative Contribution	Comments
DMC Global Inc. (Special Situation)	80%	+1.56%	DMC Global is provides technology and services to the oil and gas fracking industry. The company offers industry-leading products that improve safety and efficiency for the frackers (drilling companies) and has reported meaningful market share gains, as demonstrated by 45%+ sales growth over the last four quarters.
Joint Corp. (Special Situation)	119%	+1.51%	The Joint Corp. develops, owns and franchises chiropractic clinics throughout the U.S. The company is the industry leader with 454 clinics (404 franchised, 50 owned), and it has gained market share due to its business strategy of providing consumers quality, convenient, affordable chiropractic care via a membership-based, walk-in, no insurance model.
NeoGenomics Inc. (Core Growth)	74%	+1.15%	NeoGenomics is a leading reference lab specializing in cancer genetic testing . It offers one of the most comprehensive menus of oncology-focused diagnostic testing, selling primarily to pathologists and oncologists. The company also has a growing clinical research business offering services to biopharmaceutical companies. Increasing FDA approvals for immunotherapy and targeted-therapy drugs, coupled with related therapies in clinical development, have resulted in increased demand.

Largest Relative Detractors for YTD 6/30/2019

Name	6-month Return	Relative Contribution	Comments
Atlas Financial (Core Growth)	-88%	-1.60%	Atlas Financial is a specialty insurer of taxis, Uber/Lyfts and non-emergency healthcare transportation. During 2019, the company reported the need to increase reserve estimates for unpaid losses on bodily injury claims in accident years 2016 and prior. These claims were showing higher severity than anticipated. We have sold our position.
Kindred Biosciences (Special Situation)	-24%	-1.19%	Kindred is a biopharmaceutical company focused on developing safe and effective medicines for companion animals. The company's strategy is to identify compounds that have already demonstrated safety and efficacy in humans and to develop those compounds in formats suitable for dogs, cats and horses. Kindred also has a deep pipeline of novel drugs and biologics in development across many therapeutic classes. Kindred's first approved drug is Mirataz for the management of weight loss in cats. The poor stock performance is due to a slow launch of this drug. We continue to hold our position because we believe that investors are under-valuing the broad pipeline the company is pursuing.
Sientra Inc. (Special Situation)	-50%	-0.74%	Sientra is a medical aesthetics company focused on two segments: 1) breast products, consisting primarily of breast implants and tissue expanders, and 2) miraDry for the treatment of underarm sweat and odor. Regulatory overhang with respect to breast implants (since resolved) coupled with competition from J&J and Allergan (90% of breast implant market combined) has resulted in revenue challenges that has required a significant dilutive capital raise. We are evaluating our position.

Where do we go from here?

With respect to where we are in the cycle, one never knows for sure. Granahan successfully navigated the 1999-2000 dot.com bubble using the same investment process – including LifeCycle diversification – that we use today. We are not saying this is a bubble, but we leave open the possibility that it is when we position our portfolios for the future. This means that we may leave some money on the table if momentum stocks continue to outperform, but importantly, we protect ourselves if they lose their popularity.

We will put one foot in front of the other and diligently follow our process, let the numbers and the facts guide us, and use our LifeCycle tool to ensure we are positioned for most scenarios. And, as we have discussed in past letters, we will continue to use our curiosity to learn more about the fertile areas of U.S. small caps (like biotechnology), and we will continue to invest in innovative and market leading companies. Our process has served our clients well, and it is the backbone that guides us to best position the portfolio for success in good times, as well as in tougher times.

Thank you for your confidence.

Gary C. Hatton, CFA
Chief Investment Officer
Portfolio Manager