Small Cap Focused Growth
Portfolio Manager Commentary
2nd Quarter 2019

The Stock Market Takes a Breather

First some context:

- Q4 2018: Widespread fear and pessimism – stocks down hard.
- Q1 2019: The sky isn't falling after all – stocks rebound strongly.
- Q2 2019: A few zigs and zags, though relatively benign – stocks up modestly.

Well OK, so there were a few issues: Concerns about tariffs on China and Mexico, on Hong Kong's autonomy, Iranian's nuclear moves, and speculation about if/when the Fed will cut rates. But compared to the outsized moves in recent quarters, the stock market in Q2 was pretty docile.

			-------------Annualized----------------		
	2Q2019	**1-Year**	**3-Year**	**5-Year**	**10-Year**
Small Cap Focused Growth *Composite, Net of Fees*	9.7%	31.3%	39.4%	22.1%	25.4%
Russell 2000 Growth	2.8%	-0.5%	14.7%	8.6%	14.4%

Past performance is not indicative of future results.
Detailed performance presentation available upon request.

For the quarter, the Focused Growth portfolio rose 9.70%, net-of-fees, while the benchmark Russell 2000 Growth Index was up 2.75%. Amidst the low growth world in which we live, investors are clearly paying a premium for growth, and this is benefitting the portfolio. That said, and as is typical, stock selection was the primary driver of the portfolio's outperformance versus the Russell 2000 Growth benchmark in 2nd quarter. The portfolio's top 3 relative contributors were Coupa Software (COUP, +160 basis points); CoStar Group (CSGP, +118 basis points) and Beyond Meat (BYND, +108 basis points). The largest detractors were 2U (TWOU, -198 basis points), Virtusa Corp. (VRTU, -73 basis points), and Etsy (ETSY, -69 basis points). Detailed attribution is available here.

Overall, stock selection was positive in all sectors except Consumer Discretionary. Technology, Producer Durables, Consumer Staples and Financial Services drove performance in the quarter. The contribution in Consumer Staples (not an area that we frequently have exposure) is unusual and due to our sole holding there – above mentioned Beyond Meat (BYND) – where our 0.4% average position rose 300%. This compares with Index's 2.5% Consumer Staples weighting up an average 1.5% in the quarter. More on Beyond Meat, a new addition to the Desert Island list, below.

The portfolio's overweight position in Producer Durables boosted relative performance, while the overweighting in Technology was a slight negative. The underweight in Healthcare assisted relative performance. The portfolio's lack of exposure to Energy was a positive, while no exposure to the Materials sector was a negative. Again, more details can be accessed here.

The Environment is Currently Constructive for U.S. Small/Medium Growth Stocks

Before sharing a few macro observations, I must insert my usual caveat that I don't believe my macro crystal ball is a reliable tool for forecasting. To that I'd add Peter Lynch's cautionary comment that "Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves." Caveats sufficiently supplied, with respect to the U.S. Economy:

- GDP growth is reasonable,
- Interest rates are low,
- Corporate cash flows and balance sheets are healthy,
- Tax rates are low, and
- Consumer confidence is good.

That is not to say this economy is "working" for all Americans – that is decidedly not the case (more below). Nor is it to say there aren't risks (more on these below also). However, it is my view that the economic backdrop is currently a tailwind for U.S. secular growth companies.

OK…But What Could Put a Monkey Wrench or Pitchfork in it?

1. **The 2020 U.S. Presidential Election:** As summer winds down, attention will turn toward the 2020 U.S. Presidential election. Setting aside the current occupant's long list of negative attributes, and the intermediate risks of a ballooning Federal Deficit created by the 2018 tax cut, from a purely "Short Term Wall Street Lens," this administration has been bullish for the market. Thus, the prospect of ***any*** Democratic candidate taking over the White House would be viewed by many as an incremental negative for stocks, or at least an incremental risk.

   Heightening this risk is that in my view the odds of an extreme candidate winning the Democratic primary are increasing. Should this occur, the probability she/he would win the Presidency strikes me as low. Why? In my opinion, the election is likely to again come down to a handful of swing voters in a handful of swing states (Pennsylvania, Wisconsin, Michigan and Florida). I personally find it improbable that a far left candidate will capture the hearts, minds and votes of a majority of swing voters in those states. I believe this is unfortunate for the country and the world, as I think the current President is causing significant and lasting damage and in addition comes replete with significant long-tail risks. But he nonetheless represents stability and status quo to Wall Street, which tends to overvalue such things, while undervaluing individual and even aggregated long-tail risks. In contrast, whereas a centrist Democrat is likely to be viewed by Wall Street as a slight incremental negative, even a long-shot prospect of a left wing nominee would be apt to send shivers down Wall Street's spine and drive down stock valuations. Net, near term there is a good chance market moves will be inversely correlated with the chances of a non-centric Democratic candidate being nominated.

2. **IPO's:** In the Q1 letter I discussed a few big trends in the market to keep an eye on. One was that companies are staying private longer, and if/when they do go public, they are doing so at much higher valuations (which is pushing up the size of companies in which we invest). However, there is another element to the IPO window worth watching – the quality of the companies trying to fit through it. To date, in my opinion, the companies going public have generally been of very high quality, though valuations of the respective stocks are frequently quickly getting pushed to extreme levels.

   In Q2, case in point is Slack Technologies (WORK). I believe this enterprise communications platform company is superbly positioned for sustainable long term growth. Unfortunately, despite retreating more than 15% from its (direct listing) IPO price, it still has a market cap in excess of $20 Billion—which is 34X FY1/2020E *revenue*. Another IPO in Q2 was Beyond Meat (BYND -- Manufactures and sells the plant-based Beyond Burger). In many ways, Beyond Meat is also a quintessential "Desert Island" company. The company is strongly positioned within a huge and growing opportunity, and it is well managed, well financed, and has a strong culture. Unlike Slack, we were able to build a position in BYND shares shortly after its IPO. However, we sold the stock less than two months later as the price went…well…*beyond* where the stock's risk/reward was attractive. Nonetheless, Slack and Beyond Meat are just two examples of many recent IPO's that have been of very high quality. Both remain on our Desert Island Monitor as Wall Street may provide future opportunities to invest. Bottom line is that, with respect to the IPO window, it is worth keeping an eye on the quality of companies going public. Historically the longer the window "stays open" the more quality tends to degrade—which is often a pre-cursor to a market correction.

3. **Risk Aversion and/or Growth Slows:** There are, of course, plenty of other reasons the market could correct. These range from factors currently on mainstream radars, such as the tariff wars with China or a slowdown in consumer and/or corporate spending, to any number of shocks that may cause investors to tilt toward risk aversion.

4. **Wealth, Income and Opportunity Disparity:** Financial leaders ranging from JP Morgan Chase head Jamie Dimon, to Bridgewater Founder Ray Dalio, to Blackrock CEO Larry Fink, to Warren Buffett have recently weighed in regarding the widening disparities in wealth, income and opportunities in the U.S. Suffice it to say that the economy is not working for a large percentage of Americans despite this period of general economic prosperity. Globally these trends have played a significant role in Brexit and enabling dangerous populistic

figures to take power in a number of countries. The political landscape in the U.S. is so divided that legislators on either side of the aisle who are anywhere near the middle are nixed or marginalized in favor of extremists. Beyond this, principles once considered bedrocks of Democracy – freedom of the press, judicial independence, central bank independence – no longer feel so.

As if threatening Democracy weren't enough, the economic zeitgeist is also fueling a debate in the U.S. that is somewhat hard to fathom for those of us over, say, age 50: the virtues of capitalism vs. socialism. According to a 2018 Gallup poll, the percentage of Americans aged 18-29 with a positive view of capitalism has fallen from 68% to 45% since 2010. The percentage with a positive view of socialism? 51%. In my opinion, Churchill's famous quote about democracy is just as apropos with respect to capitalism. It is the worst form of economic structure except for all the others. As Warren Buffet said recently, "This country has done an incredible job in terms of the deployment of resources and human ingenuity, and that is a product of the (capitalistic) system." However, to be sustained long-term, capitalism requires referees to deal with anti-competitive threats, safety nets for those in need, and at times such as the current, structural help to ensure that most citizens feel the benefits of economic growth.

> *"The problem is that capitalists typically don't know how to divide the pie well and socialists typically don't know how to grow it well. While one might hope that when such economic polarity and poor conditions exist, leaders would pull together to reform the system to both divide the economic pie and make it grow better (which is certainly doable and the best path), they typically become progressively more extreme and fight more than cooperate."*
>
> *Ray Dalio*
> *Founder and Co-Chairman Bridgewater Associates*

Historically when wealth disparity becomes so severe, there have been pitchforks and revolutions. While we aren't yet seeing this, the above trends represent potential threats to social stability and are existential risks for the capital markets generally and longer duration small cap growth stocks specifically. I worry about leading Democratic candidates embracing political positions such as "Medicare for All" and "Total Forgiveness of All Student Loan Debt", because they feel like a recipe for four more years of the current administration. Three ideas that I believe can be steps in the right direction:

1. Explore paths to the political middle ground, such as:
    - Ranked-choice-voting, which naturally results in more centric legislatures (click here to learn how it works in the State of Maine), or
    - A mixed presidential ticket – How about Amy Klobuchar (D) and John Kasich (R), or Mitt Romney (R) and Deval Patrick (D)?

2. Break-up Big Tech (ex: Google, Amazon, Facebook). This could unleash competition, innovation and growth, and help spread the wealth.
3. Greatly increase investment in both education (early, basic and re-education) and preventative healthcare.

Recommendations: Books, Articles, Podcasts

Switching topics from saving the world to saving one's psyche, below are a few books and podcasts I'd recommend:

Books:

- "The Moment of Lift" by Melinda Gates. OK, if not saving the world, Melinda and her husband are doing a pretty good job at saving millions of lives and improving prospects and health all over the globe. In spite of the author's strong emphasis and reliance on data, this book is an easy and enjoyable read on how.
- "Flywheel" - "Good to Great" Author Jim Collins drills down on the power flywheel concept.
- "City of Girls" - "Eat Pray Love" author Elizabeth Gilbert's fun and very well written novel set mainly in 1940's New York City.

Podcasts:

- Michael Lewis - Series "Against The Rules" about the demise of referees in the real world in wide-ranging areas, such as anti-trust, art, and grammar.
- Malcolm Gladwell - Recently released Season 4 of his terrific podcast "Revisionist History"
- Michael Bennet – ReCode's Kara Swisher interview with this centrist Democratic Presidental Candidate and Colorado Senator.

To drill down a bit more on the topics of wealth disparity, capitalism, etc., I point you to:

- Ray Dalio - Here's a link to his April 2019 piece "Why and How Capitalism Needs to be Reformed"
- Warren Buffett - Interviewed here with his partner Charlie Munger and Bill Gates
- Scott Galloway - A good podcast interview making the case for breaking up big tech, and more.

On behalf of the entire team at Granahan Investment Management, thank you for your continued interest in Small Cap Focused Growth. Please don't hesitate to reach out with any questions, comments, Desert Island-worthy ideas or ways to save the world.

Sincerely,

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