Small Cap Core Growth
Portfolio Commentary
3rd Quarter 2019

The third quarter of 2019 was full of twist and turns in the stock market, caused in part by the conflicting dialogue surrounding the Fed and interest rates, uncertainty over the impact of tariffs and lack of any resolution in the trade war with China, and political tensions both in the US and abroad. The Russell 2000 Growth Index ended the 3rd quarter lower, posting a return of -4.2%. The Granahan Small Cap Core Growth strategy underperformed in this environment with a composite return of -5.6%, net of fees. The nine months year-to-date show strong returns, with the Russell 2000 Growth Index up 15.3%. The GIM Small Cap Core Growth composite remains solidly ahead of the benchmark with a YTD return of 21.5%, net of fees.

In the 3rd quarter, the portfolio's energy holdings weighed on performance and represented three of the five largest detractors, all from the Special Situations LifeCycle category – ProPetro Holding Corp. and Ring Energy (E&P companies operating in the Permian basin), and DMC Global (energy services company). These stocks have been plagued by volatile oil prices, concerns about 2H2019 production and the global economic picture. Energy investors continue to be frustrated as these stocks have underperformed energy prices, both as prices rose and as they fell. We have added to Ring and DMC Global, as we remain positive on company-specific growth initiatives and very compelling valuations. ProPetro delayed their 10-Q filing due to governance issues; we believe the issues will be resolved shortly, and we are maintaining our position. Exact Sciences (non-invasive screening for colon cancer), which is one of our top performing stocks YTD, was under pressure in the 3rd quarter. The stock of this Core Growth healthcare company came down as high growth stocks moved out of favor, and there are also some technical trading dynamics around their acquisition of Genomic Health. Exact Sciences has just begun to gain traction in the colon cancer screening market, so we are maintaining our position. In the consumer discretionary sector, Pioneer name 2U (online education platform for university graduate-level programs) continued to be under pressure due to shifts in the competitive landscape that are causing uncertainty about both the timing of earnings, as well as the potential. We hold a small position, and as we gain clarity over this well-managed company's earning potential in the coming months, we will decide whether to boost our position.

On the positive side, two healthcare stocks led for the quarter – Medicines Company (Pioneer) and Insulet Corporation (Core Growth). Medicines was up on positive phase III results for its cardiovascular drug; we are maintaining our position. Insulet reported strong results, as it is gaining market share through acceleration of end market demand for its novel diabetes devices; we are trimming based on valuation. In the info tech sector, the stock of Pioneer company Cloudera (data storage and analytics tools) rebounded after hitting a low in June when customers paused purchases after its merger with Hortonworks. The company has improved execution as it rolls out its new product platform designed specifically for the Cloud and Hybrid Cloud environments; we added to the position. Also in info tech, Enphase Energy (Core Growth) was up on a positive earnings surprise and positive

estimate revisions as the company is regaining share in the solar micro-inverter market. We believe the company will continue to gain market share as it transforms to a complete solution provider for the home solar market; we are adding to our position. Rounding out the top performers is Rubicon Project (technology solutions to automate the purchase and sale of digital advertising inventory), a Pioneer in the consumer discretionary sector. The company is accelerating growth and taking market share with its digital advertising platform; we are adding to our position.

Year-to-date through September, Medicines Company, Enphase Energy, and Exact Sciences were the top relative performers. Ring Energy, Evolent Health (value-based, technology-enabled healthcare service platforms, Pioneer), and Stamps.com (consumer discretionary, Core Growth) were the largest detractors for the nine months.

Attribution

In the quarter, both selection and allocation hurt relative performance. The portfolio's overweighting in energy, as well as stock selection, were the largest detractors in the quarter. Selection in the industrials sector also weighed on performance, and selection was slightly negative in financial services. The portfolio's underweight position in the real estate and consumer staples sectors hurt relative performance, as did the lack of exposure to the utilities sector. On the positive side, even as the sector was under pressure, selection in healthcare was strong. Stock selection was also positive in the communication services and consumer discretionary sectors. Our overweighting of the information technology sector more than offset slightly negative selection to provide positive attribution. The materials sector was neutral.

The Pioneer and Special Situation LifeCycle categories both underperformed the overall benchmark in the quarter. The energy holdings in the Special Situation category were the reason this LifeCycle underperformed in a down market. The Core Growth holdings outperformed the overall benchmark. Year-to-date, all three LifeCycles remain ahead of the benchmark return, with Core Growth and Special Situation stocks leading.

For the year-to-date, stock selection has driven the out- performance. The portfolio has shown positive stock selection in all sectors except consumer discretionary and energy. Info tech, healthcare and industrials have been the largest contributors through September.

Weightings

Since the end of last year, Pioneers have increased from 21% to 26% of the portfolio. Core Growth and Special Situation weightings have both decreased; Core Growth from 48% to 45%, and Special Situations from 32% to 27%. We continue to make portfolio adjustments across LifeCycles based on valuation, conviction, and risk/reward.

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 healthcare, energy, and communication services. Our sizable underweight in consumer discretionary continues, and we are now also underweighted in the industrials sector due to a few sales. We remain underweighted versus the Index in consumer staples, materials, real estate, financials, and utilities.

Themes

Cloud Computing infrastructure and Software-as-a-Service delivery models require companies to monitor performance of applications, as well as infrastructure and networks, to make sure quality-of-service requirements are met. Platforms for SaaS-based monitoring and real-time unified data analytics bring together data from a variety of IT components – ex: servers, databases, SaaS delivered applications, and third-party services – to present a unified view in one centralized dashboard. Two companies that deliver performance monitoring tools are New Relic and DataDog. These companies are currently benefitting from several secular tailwinds, including the shift to Cloud, next-generation architectures, multi-cloud adoption, the rise of DevOps environments, and ongoing digital transformation.

Historically, cancer treatment has focused on improving surgery, chemotherapy and radiotherapy; however, these efforts have yielded limited results while typically causing additional pain and long-term damage. In a recent *Wall Street Journal* article, Dr. Azra Raza, an oncologist at Columbia University, described the current treatment paradigm as a trio of slash, poison and burn. Today, there is an industrywide effort to move away from the focus on improving treatments of late-stage cancer, and toward increased screening of patients to identify cancer cells very early in order to improve outcomes and save lives. Exact Sciences, Veracyte, and Castle Biosciences are all companies with meaningful cancer screening and early detection tests. Exact Sciences has developed a highly effective stool-based colorectal test, called Cologuard, an insurance-approved alternative to colonoscopy that is gaining traction among physicians. Veracyte, a leading genomic diagnostics company, has three commercial tests that help diagnose various cancers. The company is expanding its technology to identify disease at earlier stages while also using genetic information to improve the treatment of patients. Castle Biosciences targets skin cancer with genetic tests that are transforming the way doctors identify, stage, and treat melanoma patients. Incorporating genetic information into the diagnosis improves the risk assessment of patients with disease, while also tailoring treatment decisions. These innovative companies are transforming the way we identify and treat cancer. We believe these companies can meaningfully improve the diagnosis and treatment of cancer patients by helping identify the disease at the beginning of its development, not at the end-stage when treatment options are limited.

While there are many efforts underway to improve cancer diagnosis and treatment, similar paths to identify and treat neurological diseases, such as Alzheimer's and Multiple Sclerosis, are underway, though they are still in their infancy. Biomarkers, unusual protein or genetic material, can be identified very early in diseases like Alzheimer's, and current research could yield early-stage detection and therapies. Quanterix is a pioneer in this field; the company has a platform being utilized by the top biopharma companies to study the next generation of neuro-therapies in order to identify and treat neurological diseases at the beginning of their development.

Macro

The stock market has been grappling with the implications of ramped up trade tensions, political conflict, and the recent weak survey numbers from the Institute for Supply Management's ("ISM") manufacturing index, which can be an early indicator of an economic contraction. However, the jobs numbers, including a 50-year low in the unemployment rate, are inconsistent with various economic reports that suggest the US economy is headed into a recession. One theory is that the economy is indeed still growing, albeit at a slower pace.

Outlook

Year-to-date 2019, earnings growth rates for our portfolio companies continue to be strong – stronger than we expected considering the tough comparisons to those of last year that included a boost from the 2018 tax-cut. Valuations have moderated recently. According to small cap strategist Furey Research Partners, U.S. small caps have significantly underperformed large caps, and the relative valuation is now at a 20-year low. Having said that, within the small cap sector, growth has significantly outperformed value for several years – until just recently. Much has been written about the recent market moves as a possible rotation from growth to value. However, historically, such a rotation needs much stronger GDP growth, higher interest rates, and rising inflation … or a recession. We believe the current economic environment continues to be positive for well-positioned growth companies, and that the macro-economic backdrop, while relevant, is not as important as our adherence to our proven processes. The upcoming Q3 earnings calls will be interesting as companies provide further insight into what they are experiencing and expecting in their markets and with respect to demand for their products. Our bottom-up research leads us to companies that have strong secular growth drivers with flexibility and innovation to grow through most macro environments, and our process (including LifeCycle diversification) guides us to own the stocks of well-positioned companies when risk/reward is attractive.