GRANAHAN INVESTMENT MANAGEMENT INC

Small Cap Focused Growth
Portfolio Manager Commentary
3rd Quarter 2019

The Stock Market Pivots to "Risk Off" with Rotation from Growth to Value

The 3rd quarter was relatively uneventful… until mid-September. In September, market sentiment shifted suddenly and violently. Investors moved, en masse, out of higher growth stocks and into value stocks. Why? We will explore some possibilities below.

			----------Annualized----------		
	3Q2019	**1-Year**	**3-Year**	**5-Year**	**10-Year**
Small Cap Focused Growth *Composite, Net of Fees*	-7.6%	+4.4%	+28.9%	+21.3%	+22.5%
Russell 2000 Growth	-4.2%	-9.6%	+9.8%	+9.1%	+12.3%

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

Investment returns in Q3 were negative both in absolute and relative terms for the Focused Growth portfolio. The portfolio returned -7.6%, giving back some of the gains year-to-date, as the Russell 2000 Growth benchmark was down less at -4.2%. From a sector attribution perspective, the largest detractors were Consumer Discretionary and Financial Services – both primarily due to poor stock selection. This was offset partially by Healthcare, where contribution to performance was due to the portfolio's small weight in this sector. More detailed attribution analysis is available here.

Why the Sudden Rotation? – FUD

The reason for the abrupt shift in the market is hard to pinpoint exactly, but in my mind, much can be aggregated into the acronym "FUD" (Fear, Uncertainty & Doubt).

Image Courtesy: Looney Tunes Wiki

Stock market investors hate uncertainty. Hence, when uncertainty goes up, they demand a higher rate of return on future earnings. On the margin, this hurts high growth stocks, for which a large part of their value is attributable to earnings in out-years (i.e., longer duration stocks). So, what are investors uncertain about? Again, hard to say, but I believe that some issues driving investor unease are the following:

- **The US Election** - I think the political environment is a meaningful contributing factor to the recent stock market movements. To borrow Peter Finch's famous performance from the 1976 film "Network," many Americans are "Mad as Hell and not going to take this anymore." – mad about the wealth disparity, mad that Washington is dysfunctional, mad that Donald Trump is POTUS, mad that capitalism isn't working for them. The extent of this discontent may be underestimated. In my view, it is increasingly likely that Senator Elizabeth Warren will be the Democratic nominee for the US Presidency, with perhaps a 50/50-ish chance of winning in 2020 (Ladbrokes has her odds at 40%). For many investors, the prospect of a President Warren creates a great deal of FUD due to her strong rhetoric in support of wealth redistribution – her plans for regulation, for increasing labor's share of the economic pie, and her support of Medicare-for-All.

- **The Economy** - As happens periodically, consensus view has shifted to the perception that a recession is coming soon. Consensus view tends to be an inaccurate indicator of a coming recession many times before ultimately getting it right. Could this be the one they get right? Possibly yes. Possibly no.

- **IPO's and Venture Cooling Off?** - During the summer, and as we mentioned in the Q2 commentary, there were signs of some frothiness in the IPO market. The valuations of Uber, Lyft, Peleton – all potentially interesting investments at the right price – are case studies of frothiness-in-action. Similarly, WeWork's highly visible demise from a $47-billion valuation to questionable viability felt like a watershed moment, and another signal that certain elements of the capital markets were not reflecting the reality of company fundamentals (in this case, core business viability, late stage venture valuations, corporate governance, and basic business practices, among others).

- **Other**: There are many other factors contributing to FUD – BREXIT, the Kurds/Syria/Turkey, unrest in Hong Kong, and the US trade war with China – along with heightened uncertainties about the economy, inflation, interest rates, and Trump.

All of the above are present, and there is certainly plenty to worry about if one chooses to do so. On the other hand, if one believes that Wall Street tends to "Climb the Wall of Worry," these plentiful worries can be a good thing for active investors, to the extent they are already priced into the market.

How Long Will This Last?

It's impossible to say how long the current market sentiment will last (aka, "Uncertain"). Given Wall Street's aversion to FUD, it is quite possible that we are in for a period of sustained volatility as the November 2020 US Presidential Election approaches.

So What to Do?

- **Stick to One's Asset Allocation Plan**
  As we've discussed repeatedly in the past, we don't believe that market timing through attempting to predict macro factors is a repeatable and winning long term strategy. The above factors (worries) are a good reminder for investors to make sure they are within the parameters of their asset allocation strategy.
- **Find Stocks Which Will … *Nevertheless Persist***
  For our part, using our investment process, we will work hard to navigate successfully through this period. On the margin we are increasing exposure to stocks that we believe are:
  1. Secular Growth at a Reasonable Price (S-GARP)
  2. Recession Resistant
  3. President Warren Agnostic

Is Anything For Certain? It is Often Dark Before the Dawn

I am confident that the US will find a constructive path forward, and when it does, investors will decide it is again safe to swim in the ponds of higher growth stocks. I believe our well-positioned Desert Island-worthy companies will continue to grow through most macro environments. The math of high-growth compounding works in our favor, and in time, investor sentiment toward the stocks of Desert Island companies will catch up with their growth trajectories.

Recommendations:

Two Books:

Malcolm Gladwell's – "Talking to Strangers" – Gladwell helps us understand why people act as they do, and how and why our initial presumptions are often wrong.

Delia Owens' – "Where the Crawdads Sing" – Owens' debut novel set in and around a small town and nearby marshlands on the North Carolina coast with an improbable and compelling central character.

Two Podcasts:

Patrick O'Shauhnessy's – "Invest With The Best" Interview with Bill Gurley. I believe that Bill Gurley is one the best thinkers in modern investing, and he dives into a wide range of topics in this interview.

"Land of the Giants" - Season 1, Amazon - An excellent look at Amazon from a host of different angles. The podcast may leave you rethinking assumptions about this giant's net virtue in our society.

On behalf of the entire team at Granahan Investment Management, thank you for your continued interest in our small cap equity strategies. Please don't hesitate to reach out with any questions, comments, desert island-worthy ideas, or anything else about which you are uncertain.

Sincerely,

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