GRANAHAN INVESTMENT MANAGEMENT INC

Small Cap Discoveries

Portfolio Comments

December 31, 2019

Distinguishing Features

GIM builds the portfolio from the bottom-up; sector weightings are secondary to stock selection. As of 12/31/2019, the Small Cap Discoveries portfolio continues its significant overweight position in the producer durables compared to that of the Russell Microcap Growth benchmark, 20% versus 12%. The overweighting in the materials sectors continues; the current weighting is 6% versus 2% for the benchmark. Energy slightly increased its overweighting (now 5% versus 2). Technology is now equal weighted to the benchmark, 13%. Consumer discretionary and financial services continue their underweight positions: 4% versus 8% for consumer discretionary, and 3% versus 11% for financials. Healthcare has moved to a slight underweighting, now 46% versus 48%. The portfolio is about equal-weight to the Index utilities, while the portfolio continues to have no exposure to the small consumer staples sectors.

Commentary

Market Environment

In the fourth quarter, the continued strength and sentiment of the US consumer, falling inflation, and a slight upward revision of US real GDP growth number for the 3rd quarter, outweighed any worries over trade wars and political issues. The Russell MicroCap Growth returned a robust +17.69%, while the Russell 2000 Growth returned +11.39%. For the year 2019, the Russell MicroCap Growth Index was up 23.33%, and the Russell 2000 Growth returned +28.48%.

Performance Discussion

For the 4th quarter, the Small Cap Discoveries portfolio significantly underperformed the Russell MicroCap Growth benchmark and Russell 2000 Growth benchmarks, returning +9.03, net-of-fees. However, the portfolio finished 2019 between the two benchmark returns, at +25.93%.

As is typical, whether the portfolio outperforms or underperforms, stock selection accounted for the performance. Healthcare selection attributed for much of the underperformance this quarter, as the benchmark's healthcare return was almost double the Index's overall return. Interestingly, the 4th quarter was one of the most BioPharma driven quarters in over 30 years, driven by the most expensive, smaller BioPharma companies – particularly those with low or no sales, and those with no products in Phase II or Phase III trials (Furey Research Partners, 4Q19 quarter-end letter). The Discoveries strategy has a strong footprint in the BioPharma and Med-Tech industries; however, our process leads us to those companies that have staying power – that is, companies with a strong pipeline of drugs, and/or those with a royalty stream to help fund early stage drug discovery, and/or those with a large-pharma partner. It is rare that we invest in binary-outcome theses. So, while the 4th quarter performance is clearly disappointing, we did not drift from the Discoveries process.

In other areas, selection in producer durables, energy, consumer discretionary, and financial services also weighed on performance. The portfolio's overweight positions in producer durables, energy, and materials were negatives, though offset by the effect of our underweightings in consumer staples, financial services, and consumer discretionary. On the positive side, the portfolio showed good selection in utilities, materials and technology.

The portfolio's Pioneer and Special Situation LifeCycle categories significantly underperformed the overall benchmark, while the Core Growth holdings soundly outperformed the overall Index return. Four of the five largest detractors in the quarter were Special Situations: Modine Manufacturing and NV5 Global (both producer durables), Profire Energy (energy), and Harvard Bioscience (healthcare). One of last quarter's top performers, Oxford Immunotec Global (healthcare, Pioneer), rounded out the bottom five this quarter.

On the positive side, three of the top five performers in the quarter were Core Growth: NeoGenomics and Pennant Group (both healthcare), and AquaVenture Holdings (utilities). Lawson Products (materials, Special Situation) and argenx SE (healthcare, Pioneer) were also in the top five.

Outlook

The most obvious risks to the markets in 2020 are the US election and that there will be significant profit-taking after the outsized stock market gains of 2019.

There is also the "wall of worry" that includes US/Iran tensions and fear of broader escalation, the decline in the Institute of Supply Management readings, and concern that tariffs will cause a recession. The "phase one" trade deal between America and China can be considered a marginal positive because more tariff hikes were avoided and some existing tariffs were moderated.

Interestingly, even with the strong equity returns in 2019, cash flows out of equity funds were a net negative. According to Furey Research Partners, "when trailing-year fund flows have been this low in the past 10 years, forward stock market performance has been quite good." (Furey Research Partners, 4Q19 quarter-end letter).

Earnings growth in our portfolios continues to be very strong – particularly in healthcare, producer durables and technology. Even as growth has moderated from the extremely high levels we saw in our portfolios mid-2019, it still remains higher than historical levels. That said, there are indications that earnings growth for the Russell 2000 Growth Index troughed in the third quarter, perhaps precipitating the rally at year's end. While the resulting valuations for small cap stocks moved up, their valuations relative to large cap stocks are much more attractive, particularly when excluding loss-making companies.

The last two quarters highlighted how investor sentiment can shift dramatically in a short time period. We frequently comment that we have no crystal ball (nor do we believe that there is a reliable one out there). Instead, we are focused on executing our process as tightly as possible – separating companies from stocks as we seek strong well-positioned companies and use our tools to invest in the stocks of these companies when risk/reward is attractive. As bottom up investors, stock selection drives performance across sectors and LifeCycles.