Small Cap Focused Growth
Portfolio Manager Commentary
4th Quarter 2019

2019 – A Big Year for Equities

The year 2019 was a banner year for most equity markets around the globe, as well as a sharp reversal from 2018 when most equity indexes fell. US small caps participated in the 2019 gains with the Russell 2000 Growth Index rising 28%. Within this context, the Granahan Small Cap Focused Growth portfolio enjoyed an unusually strong year in terms of both absolute and relative performance, climbing 49% on the strength of strong stock selection.

In terms of performance attribution for the Focused Growth portfolio, sector exposure had a slight positive impact overall. The portfolio's higher market cap versus the benchmark was a modest benefit, as was its style tilt toward high growth.

However, by far the most significant impact on performance was stock selection, which accounted for more than 20% of the 21% in outperformance versus the benchmark. Selection was positive in most sectors but particularly strong in Technology, Producer Durables, and Financial Services. The only material negative for stock selection was in Consumer Discretionary.

4Q 2019 - A Strong Quarter Despite a Headwind

The fourth quarter 2019 was also strong for small caps, with the Russell 2000 Growth Index rising 11.4%. The Granahan Small Cap Focused Growth strategy rose 12.7%, net of fees. Beneath the headlines, however, Q4 was a different kind of strong than the remainder of 2019. The Russell 2000 Growth Healthcare sector was especially robust, up 23% in Q4, with biotechs leading the way (+31%). Thus the portfolio, which generally does not own biotech or medical device stocks, faced a significant headwind from our healthcare underweight. However, despite this, the Granahan Focused Growth portfolio outperformed the benchmark. Again, stock selection drove performance led by Technology and Financial Services. On the negative side, Consumer Discretionary selection weighed on the quarter's performance.

Please use this link for further details on Q4 and 2019 attribution.

What's Our "Secret Sauce"?

In December, we traveled to the West Coast for a formal finals presentation to the investment committee of a potential new client. Very early in our presentation, I was asked by the Chairman of the committee, "how do you do what you do?" In short, he wanted to know "What is Your Secret Sauce?"

For readers who have persevered through our quarterly letters over the years, you know that my short answers are rarely such. So what's our secret sauce? I think the answer is: 1) Sound Philosophy; 2) A Disciplined and Repeatable Process; and 3) An Exceptional Team.

Sound Philosophy: Since inception in 2007, the "North Star" of the Granahan Small Cap Focused Growth strategy is a belief that strong investment returns could be achieved by

a. Focusing on companies that can sustain high growth; *and*,
b. Own the stocks of these companies when they are priced with an attractive risk/reward.

Disciplined and Repeatable Process: The four elements of our process are:

1. Company Analysis - We focus exclusively on companies we believe are Desert Island-worthy; that is, ones that can compound growth at a high rate for many years to come. We call them "Desert Island" companies because if we went away to a desert island for 5-7 years, the companies would be several times larger when we returned. The “Desert Island monitor” has about 100 such companies on it at any given time.
2. Stock Analysis - We seek to own the stocks these Desert Island (“DI”) companies when they are attractively priced, and to not own them when they are not. A subset of about 40 companies of the 100 on the DI monitor are owned in the portfolio. To determine which DI companies merit a position in the portfolio, we employ a strict valuation discipline centered on a probability-weighted expected return framework and risk/reward methodology that emphasizes the risk side of that equation – in short, our “Expected-Return” tool.
3. Portfolio Construction and Allocation - We integrate a wide range of factors that can be categorized in three central elements: Conviction, Risk/Reward, Diversification.
4. Risk Management - Risk management is tightly integrated into each of the first three steps of the process, but we also zoom out and incorporate several checks and balances to manage risk from a number of other dimensions.

An Exceptional Team: Our seven investment managers average 29 years of experience investing in small cap companies. Whenever I mention our team's experience, I am conscious of the fact that undoubtedly every firm boasts about the experience of its team – I have yet to see a firm brag about its *inexperienced* team. However, this team is the best I've worked with in my 30+ years of investing. I've also seen very few teams generate such strong investment performance, across a range of investment strategies, for such an extended period of time.

Secret Sauce: While all the ingredients noted above are important, I’m going to elaborate on the first part of the process, *company* analysis, as I believe it is critical to our competitive edge. Nothing else in the sauce matters if we don’t get the Desert Island decision right.

Desert Island (“DI”) companies do not come along every day. In fact, the 100-company DI monitor has very low turnover, about 10% per year. Thus, importantly, there is no pressure to find a new idea every day. This methodology enables us to get to know our DI companies well. In many instances, companies spend years on the DI monitor before their stock presents an opportunity that meets our risk/reward parameters.

GIM’s team is good at identifying DI companies – each member knows the characteristics that are integral to a DI candidate, so it is easy to dismiss most companies. And once we find one, we continue to vet the company to make sure it stays DI-worthy. Every company on the DI monitor has its own Expected-Return model (“ER”) that is a live document, updated continuously both with data and with each new piece of information uncovered by our team. One advantage of the long-term nature of analyzing and validating the companies on the DI monitor is that when there is a downdraft in one of the companies' stock price, we can capitalize on it quickly. That is, we stay current and don't have to scramble when opportunities are presented.

In sum, if I had to pick one essential element out of the many important ingredients in our well-crafted secret sauce, it is our experience and focus on uncovering and continually analyzing Desert Island companies.

2020 Outlook - Who Knows What Evil Lurks in the Hearts of Men?

Lest you think otherwise, I'm referring to global macro-economic uncertainties, not the next move out of the White House, although both are consistently unpredictable. It does seem apropos to borrow from the 1930's Radio The Shadow though, given all that is indeed lurking. There are high stakes surrounding geo-political events in Iran, Iraq, China, North Korea, Hong Kong, and Turkey, among others. There is Brexit (and more unsettling to some, Meghzit). There are the growing tensions caused by income and wealth inequality. Many also wonder if the U.S. economy will have a soft-landing, a hard-landing, or no fall and hence no landing. There is the ballooning Federal deficit and the growing Federal debt. Finally, there is the uncertainty surrounding the 2020 Presidential Election, not only regarding the results but the integrity of the election itself. Indeed, if one wants to worry about worries, there are plenty.

But wait, there are also many positives. We have low inflation, low unemployment, low household debt as a percentage of personal income, record household net worth, and low energy prices. There is also much cash sitting in the coffers of both corporations and private equity funds, facilitating potential acquirers of companies, including well-positioned Desert Island-worthy companies.

So Amidst All These Macro Cross-Currents What Does One Do? *New Decade, Same Conclusion*
I always keep in mind (both my mind and those of regular readers of the quarterly letters) that it is untenable, if not impossible, to consistently add value through market timing. Or put another way, the odds of doing so are very poor. So if the odds of achieving something are highly unfavorable, be it betting on the Cleveland Browns to win the Super Bowl, besting World Series of Poker Champion Annie Duke in a game of Texas Hold'em, or trying to time the market, it's probably a good idea to not try to do it. Thus, the beginning of a new decade is as good a time as any to make sure one has a sound asset allocation strategy, that asset allocations are within their appropriate bounds, and that the specific investments meet one's criteria. Once one is comfortable with this, stay calm, relax and…listen to some podcasts.

Turning From 1930's Radio to 2020's Podcasts
Are podcasts great or what!?!? Each day, I drive to and from work from Boston to Waltham. According to Google, it is 14.7 miles – almost all of which can be highway. But here on earth, on a good day, the commute is at least 45 minutes. Good thing we have podcasts and audiobooks. Here are a few I enjoyed that you might want to check out:

Podcasts -

- Math & Magic - iHeart Chairman and CEO Bob Pittman is a terrific interviewer, hosting great marketers. Try these recent episodes: Nickelodeon Founder Gerry Laybourne and Charlamagne tha God (host of the Syndicated radio show The Breakfast Club).

- Pivot - Weekly podcast featuring Kara Swisher (*Recode* and *New York Times* columnist) and Scott Galloway (NYU Professor and author). The podcast is an easy and entertaining way to keep up on what's going on in tech. You can also click here to catch Swisher's interview with Rick Smith (see below).

Audiobooks (also available in that ancient medium called print) -

- The End of Killing - By Rick Smith
  This is a compelling and important book written by Axon Founder and CEO Rick Smith (note, Axon is a Desert Island company, and we currently hold a good-sized position in the Granahan Focused Growth Portfolio). The book paints a clear picture and pretty clear pathway to achieve Smith's vision of making the bullet obsolete by 2030. It includes a sober, balanced discussion of the virtues of, and the potential for, use of non-lethal weapons – not only in policing, but also in the military, on campuses, in schools, and elsewhere.

- Play Bigger - Al Ramadan, Dave Peterson, Christopher Lochhead, Kevin Maney
  I missed this book when it came out a couple of years ago, but luckily a friend recommended it. The authors define, frame and walk through examples of the criticality of category-creating companies: think Salesforce (CRM), Uber (ride-share), Coupa (enterprise spend management) and HubSpot (inbound marketing). This book is well worth the read for investors and budding entrepreneurs.

On behalf of the entire team at Granahan Investment Management, thank you for entrusting us with the management of your capital. Best wishes for a prosperous, enjoyable, fulfilling and peaceful 2020. Please don't hesitate to reach out with any questions, comments, or desert island-worthy ideas.

Sincerely,

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