GRANAHAN INVESTMENT MANAGEMENT INC

SMID Select Opportunities

Portfolio Comments

September 30, 2020

Distinguishing Features

GIM builds the SMID Select portfolio from the bottom-up; sector weightings are secondary to stock selection. As of 9/30/2020, the SMID Select portfolio continues its overweight position to the consumer discretionary sector versus the Russell 2500 benchmark, now 22.6% versus 12.1%. The large overweighting in the information technology sector was reduced somewhat with the portfolio weighting now 35% compared to 27% for the benchmark. In the energy sector, the portfolio moved from equal-weight last quarter to an overweight, 4% to 1%. Communication services continues its overweighting versus the Index, 5% versus 2%. The 13% weighting in industrials is 1% above the Index weighting. The healthcare weighting continues to be significantly underweight the benchmark, 18% versus 28%. The real estate sector remains underweighted versus the Index, <1% to 3%. The portfolio continues to have no exposure to the materials, consumer staples, and utilities sectors, where the benchmark weightings are 3%, 3% and 1%, respectively.

Commentary

Market Environment

Markets in the 3rd quarter of 2020 continued their upward climb off the March lows. As the economy slowly opens up from the pandemic restrictions, weekly unemployment claims fell below one million for the first time since the crisis struck. Promising news on potential vaccines for COVID-19, and better treatments for those that are infected, has helped buoy confidence as well. While corporate earnings fell sharply in Q2 from the year earlier, the pain for most companies was less severe than analysts had feared.

Performance Discussion

In the 3rd quarter, the Granahan SMID Select strategy returned +22.4%, net of fees, strongly outperforming the +9.4% return of its Russell 2500 Growth benchmark. Year-to-date, the strategy's return is +46.8%, net of fees, well ahead of the +11.6% for the benchmark.

Outperformance in the quarter was a result of strong stock selection, particularly in the information technology sector. Healthcare and energy also showed good selection. The relative performance in healthcare was boosted by our underweighting here, while the positive energy selection was somewhat offset by our overweighting of the sector. Positive selection in the industrials and communication services sectors was offset by their respective allocations. Selection in consumer discretionary, real estate, and financials weighed on performance, though our overweight position in consumer discretionary more than offset the negative selection. The lack of exposure to the utilities and materials sectors was also a positive to relative performance.

With respect to LifeCycles, the Core Growth and Pioneer LifeCycle categories significantly outperformed the Index, while the Special Situation LifeCycle category lagged. Two info tech holdings from the Core Growth category were the top performers in the quarter: **Digital Turbine** and **Enphase Energy**. Two healthcare names were also in the top five: **Evolent Health** (Special Situation) and **Immunomedics** (Pioneer). **Purple Innovation** (Pioneer, consumer discretionary) rounded out the top five.

On the negative side, four of the five largest detractors in the quarter were from the info tech sector: **Cloudera** (Pioneer), **Western Digital Corp.** (Special Situation), **Euronet Worldwide** and **Ciena Corp.** (both Core Growth). **Ligand Pharmaceuticals** (Core Growth, healthcare) rounds out the bottom five.

Positioning

Much has been written about ESG, Sustainability, Impact Investing, and Socially Responsible investing, yet there remains confusion on exactly how these ideas are measured and how to incorporate these important factors into the investment process. For instance, most large companies now have a statement of social purpose, many are PRI signatories, and some have joined collaborative efforts to tackle environmental and/or societal issues. Today, with the rise of rating systems, it is easier to evaluate large companies with respect to ESG initiatives – most of which are self-reported to the rating databases. Given that, many of our smaller companies do not screen well with various ESG grading systems – their boards are too small compared to larger peers, or they do not have policies in place for social purpose, or they are simply too small to have the internal resources to report on the many required metrics. From an investment perspective, as a bottom-up shop, GIM views ESG factors in the fundamental, bottom up process with an eye to risks for the company, and in turn, the stock price.

In our research, we also find that many small companies provide another component to ESG – pathways to sustainability – such as innovators that help larger companies reduce their impact on the environment, companies that provide better health outcomes for patients at lower costs, or promote social justice and opportunities, or reduce opioid addiction, etc. The Select portfolios have a significant weighting in these types of companies, anywhere from 25%-35%. There are now over 70 countries worldwide that have pledged to become carbon neutral by 2050. If this is going to be even a remote possibility, there are bound to be many companies, and hence plentiful opportunities to invest in companies, that will assist with this goal. At Granahan we are actively seeking and investing in these companies. We believe these are companies that are externally making the world a better place, which is a distinct difference from those working to the goal of being a slightly smaller part of the sustainability problem internally (per ESG ratings).

As growth equity investors, our bottom-up research has found that individuals, companies, and the government are more and more attracted to products that offer sustainability. The stock market has also begun to discount the possibility of continued growth in sustainability-focused companies. For instance, note the rise in Tesla's stock price, or that Invesco's Solar ETF (TAN) – an ETF that I own personally – is up 103% through the first three quarters of the year. In the Select Strategy, one of our top holdings is Enphase Energy, a company that manufacturers micro inverters for residential solar installations. Enphase, through the first three quarters of the year, is up 216%.

When we examine the current Select portfolio, nearly a third of the portfolio could be considered as companies in the sustainability category. This includes solar companies (**Enphase Energy, Canadian Solar**), hydrogen fuel cell companies and infrastructure (**Chart Industries, Ballard Power Systems, Plug Power**), certain health care companies (**Exact Sciences, Quidel Corp., Evolent Health, Pacira Biosciences**), and even technology companies that reduce the amount of power consumed in data centers (**Vicor Corp.**). In the Select strategy, we are not just seeking sustainable companies, we are focused on the companies that offer the most upside potential through growth, using our disciplined processes to invest in these companies when risk/reward is attractive.

Outlook

There has been much talk about the performance divergence of small cap growth (SCG) stocks relative to small cap value (SCV) stocks, much like that of the Tech Bubble. While reiterating that we do not have a crystal ball, SCG relative valuation is elevated, though it is nowhere near what it was at the peak of the Tech Bubble. SCG is posting better numbers than SCV with respect to sales growth, ROE, and cash flow margins, which is different than the Tech Bubble fundamental case. In today's environment, SCG cash flow margins are +2% higher than SCV (and rising), and the average SCG stock is generating $15m more cash flow over a 12-month period than the average SCV stock. SCG sales growth and ROE are also superior to SCV, which was not the case in 2000. As always, GIM continues to focus on the SCG companies that demonstrate these superior fundamental factors.

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