# Small Cap Advantage

**Portfolio Comments**

**March 31, 2021**

## Distinguishing Features

As of 3/31/2021, the Small Cap Advantage portfolio remains overweight in technology compared to the Russell 2000 Growth benchmark, 26% versus 18%. The portfolio also continues its overweight to the Index in industrials (19% versus 15%). The largest underweighting to the Index continues to be the healthcare sector, 26% versus 33%. Several sectors are nearly equal-weighted to the benchmark: consumer discretionary (16%), financials (4%), real estate (3%), energy (2%), and basic materials (2%). The portfolio currently has no exposure to the small telecom, utilities, and consumer staples sectors, where the Index weightings are 2%, 3%, and 3%, respectively.

## Commentary

**Market Environment**

Following the depths of the market downturn last March, the technology and healthcare bias of the Growth Indices drove exceptional outperformance versus their Value brethren as the pandemic suddenly changed companies' day-to-day operations and procedures. In a reversal, in Q1, the Russell 2000 Value Index posted its 2nd best quarter ever relative to the Russell 2000 Growth Index, returning +21.2% versus the Russell 2000 Growth's return of +4.9%. Financials, energy and industrials stocks, a large component of Value Indices, surged based on the rise in interest rates and signs of inflation.

**Performance Discussion**

In the 1st quarter, the Granahan Small Cap Advantage composite returned +5.5%, net of fees, slightly ahead of the +4.9% return of its Russell 2000 Growth benchmark. Overall, sector allocation was a positive to performance while stock selection weighed slightly on the quarter's performance. The portfolio had strong stock selection in the healthcare sector that led performance, aided by the portfolio's underweighting of the sector. Selection in technology and indusrials contributed nicely, with the overweight position in industials boosting relative performance, while the overweighting in technology offset some of the good selection here. Selection in consumer discretionary and energy hurt the quarter's performance. The underweighting of consumer discretionary also weighed on relative performance, while our overweight position in energy offset much of the negative selection here. Our lack of exposure to utilities was a plus, while no exposure to the telecommunications and consumer staples sectors hurt relative performance in the quarter.

With respect to LifeCycles, the Special Situation LifeCycle category soundly outperformed the Index, as Special Situation holdings represented five of the 10 top contributors in the quarter. The Core Growth and Pioneer categories lagged the overall Index return in Q1. Three technology names were in the top five: **Magnite** and **Sprout Social** (both Pioneers), and **Brooks Automation** (Special Situation). Two Core Growth holdings round out the top five: **Vericel Corp** (healthcare) and **Axon Enterprises** (industrials).

On the negative side, the quarter's largest detractor was **LivePerson** (technology, Special Situation). Three Core Growth holdings were in the bottom five: **Paycom Software** (technolgy), **CoStar Group** (real estate), and **Enphase Energy** (energy). Pioneer holding, **eHealth** (financials), rounds out the bottom five.

**Outlook**

As vaccinations proceed, GDP growth forecasts continue to rise. At the beginning of the year, US economists were forecasting a 4.5% GDP growth rate for 2021, and upward adjustments now have it at 6%. Productivity growth is forecasted at 1.8%, up from the 1.4% annual growth that we have had since 2006. The shift to digitization is expected to fuel much of this increase, as companies continue their investments in automation that were initiated by spending in the pandemic to enable remote work and contact-free environments.

In the mid-1970's, as the economy moved out of recession, interest rates and inflation rose precipitously. In that period, companies that helped other enterprises with cost-saving, productivity-enhancing technologies did extremely well. We believe similarly situated companies will do well in the current environment as interest rates rise and signs of inflation emerge. In addition, smaller cap companies tend to be more nimble and able to pass along cost increases than their large cap brethren, and well-positioned Special Situation companies are poised to perform well in this type of environment. Stock selection drives performance for the GIM strategies, particularly, stocks of innovative, financially sound, and agile companies that provide the necessary tools and products for businesses to stay relevant in the changed, post-pandemic world.