Small Cap Core Growth
Portfolio Commentary
1st Quarter 2021

Following the depths of the market downturn last March, the technology and healthcare bias of the Growth Indices drove exceptional outperformance versus their Value counterparts as the pandemic suddenly changed companies' day-to-day operations and procedures. In a reversal, for the first quarter 2021, the Russell 2000 Growth Index return of +4.9% significantly lagged the Russell 2000 Value return of +21.2%. Financials, energy and industrials stocks, a large component of Value Indices, surged based on the rise in interest rates and signs of inflation. In the first quarter 2021, the Granahan Small Cap Core Growth strategy handily outperformed its Russell 2000 Growth benchmark, +10.9% versus +4.9%.

The first quarter's top performers represented all three lifecycles and four sectors. The portfolio's strongest performing company in the first quarter was a repeat from 4Q2020, Pioneer holding **Magnite, Inc**. **(MGNI, consumer discretionary)**. MGNI's revenue comes from digital advertising, which is closely correlated to rising GDP growth. Economic forecasts for 2021 include high GDP growth, with digital ads growing 2x-3x faster than traditional advertising. Magnite reported strong fourth quarter results and made an acquisition that was well received by the market; we have been trimming the name to due to position size. The two Core Growth names among the top five were **Organogenesis Holdings (ORGO, healthcare)** and **Digital Turbine (APPS, info tech).** Organogenesis develops and commercializes a broad portfolio of skin-substitute products used in wound care. Market adoption of the company's newer products led to meaningful growth in 2020. While we trimmed our position given the outperformance, ORGO remains attractive given its double-digit growth outlook, robust profitability, and discounted valuation. The strength that Digital Turbine's stock exhibited in the last 3 quarters of 2020 continued into the first quarter. Digital Turbine offers a software platform to mobile carriers that allows for apps to be pre-installed on a phone when it is activated, whether it is a new phone or a used phone. The company reported robust Q4 results and a strong outlook, and it also made an attractive acquisition that significantly expands their potential market; we have trimmed our position and continue to hold the stock. Two Special Situation holdings round out the top five: **Vericel (VCEL, healthcare)** and **Chart Industries (GTLS, Industrials)**. Vericel's stock continued its rebound from 4Q2020 as its products targeting knee cartilage repair and severe burns recovered strongly from the COVID-19 disruption, and both are well positioned for strong growth this year. We have trimmed our position as the valuation has begun to reflect the near-term opportunities. Chart Enterprises manufactures engineered equipment for the industrial gas, energy, and biomedical industries. Chart has made investments and acquisitions over the past six months that use their existing technologies and equipment to address large high-growth opportunities in hydrogen infrastructure, carbon capture, LNG infrastructure and water treatment. The company also has significant patents in systems and methods for gas processing. We are holding our position.

Four of the five laggards the first quarter were information technology holdings and included two Core Growth names, **Cloudera (CLDR)** and **Euronet (EEFT)**, and two Pioneers, **Pros Holdings (PRO)** and **Nutantix (NTNX)**. Cloudera offers a platform for data management, machine learning, and advanced analytics serving mission critical enterprise workloads. Operating leverage in 2020 was particularly strong, however, the company will invest for growth in 2021 which will weigh on near-term profits. Expectations were reset and so was the multiple; we are adding to our position as the stock's valuation of 3.75X EV/sales is significantly below peers. Euronet provides ATMs and money transfer services primarily in Europe. While the company is a beneficiary of the digital financial transformation, it has been significantly hurt by COVID-19 travel restrictions. EEFT will be a clear recovery play once global travel resumes, though concerns around the timing of vaccinations, particularly in Europe, affects the stock price; we have added on weakness. Pros Holdings is another victim of COVID related travel restrictions, as 50% of the company's revenue stems from the airline industry. The company is a leader in price optimization software with AI and machine learning embedded in their products. We are expecting sequential improvement in results as the travel industry gains steam and the company continues to penetrate other markets; we are holding the stock. Nutantix has expanded its strategy beyond a pure hyperconverged infrastructure (HCI) to a broader hybrid cloud framework, positioning it as a key component to help organizations integrate on-premise and public cloud environments. We believe the company's new CEO will drive better economics and efficiencies in the operating model to capitalize on the secular tailwinds of hybrid cloud adoption. Nutanix is not expected to make money in the next few years, and multiples for these longer duration assets have contracted; we have added to our position. Rounding out the bottom five is a Special Situation holding, **Nautilus (NLS)**, a fitness equipment provider. The company had an analyst day where they gave information about margins that investors misunderstood, and the stock price dropped. We think 2021 will be a very good year for the company, and there is a tremendous valuation expansion opportunity; we are holding the stock.

Attribution

In the first quarter 2021, the Granahan Small Cap Core Growth strategy outperformed its Russell 2000 Growth benchmark. As is typical, the performance was driven by stock selection, this quarter led by healthcare and information technology, and assisted by industrials, real estate and communication services. The portfolio's underweighting in the healthcare sector boosted its relative performance, while the overweight position in info tech offset some of the strong selection here. Poor selection in consumer discretionary hurt the quarter's performance, as did our underweight position in this strong sector for the Index. Selection in the energy sector also weighed on performance, though our overweighting in this top performing sector for the Index offset the poor selection. The portfolio's underweighting in the materials and consumer staples sectors were negatives to relative performance, while the lack of exposure to utilities was a plus.

All three LifeCycle categories soundly outperformed the benchmark in the quarter, led by an especially strong showing from the Special Situation category, which had been a laggard over the last year.

Weightings

GIMI's bottom-up process leads us to continue maintain our significant overweight in information technology, and we are also overweight versus the benchmark in industrials, energy, and financials. We are underweight the index in all other sectors, with consumer discretionary our largest underweighting, followed by healthcare, real estate, consumer staples, and materials.

The Pioneer category is up slightly from last quarter, from 28% to 29%. Core Growth is down to 46% from 51% last quarter. We have eliminated some of our larger market cap companies in the Core Growth category, including **Exact Sciences (EXAS), Paylocity (PCTY),** and **Expedia (EXPE)**. Special Situations are 24%, up from 19%, largely due to the category's strong out-performance.

Themes

In early 2020, hackers secretly broke into SolarWind's Orion system and added malicious code. The Orion family of software products is used by 33,000 companies to manage IT resources. As a common practice in the software world, many providers regularly send out updates to their systems, whether it's fixing a bug or adding new features. SolarWinds is no exception. Beginning as early as March of last year, SolarWinds unwittingly sent out software updates to its customers that included hacked code. US agencies — including parts of the Pentagon, the Department of Homeland Security, the State Department, the Department of Energy, the National Nuclear Security Administration, and the Treasury — were attacked. So were private companies like Microsoft, Cisco, Intel, and Deloitte. The hack was so stealth that it went undetected for months. Fallout from this hack could accelerate broad changes in the cybersecurity industry. Companies are now assuming that there are already breaches, rather than merely reacting to attacks after they are found. We have owned cybersecurity companies in our portfolios for many years, as spending here has only increased with companies' greater reliance on cloud infrastructure and associated need for tighter defenses. The portfolio currently holds the stocks of seven cyber-security companies: **Qualys (QLYS), Radware (RDWR), Rapid7 (RPD), Proofpoint (PFPT), CyberArk (CYBR), Datto Holding (MSP)**, and **Zscaler (ZS)**.

Companies are temporarily shutting manufacturing plants due to lack of semiconductor chips. As the pandemic ramped in the first quarter of 2020, companies cut their chip purchases and orders dramatically. Unpredictably, the economy boomed from fiscal and monetary policies that flooded the market with cash, and spending on goods exceeded lowered forecasted demand. Chip manufacturers, coming out of a cyclical downturn in 2020, could not ramp up quickly enough to meet this new demand. TSMC, the largest chip manufacturer in the world, announced a $100 billion spending plan to increase capacity. Intel will build a new plant in Arizona. Companies in our portfolio that will benefit include **Brooks Automation (BRKS), Kulicke & Soffa (KLIC), Onto Innovation (ONTO),** and new holding **Veeco Instruments (VECO)**.

Proteomics, the study of proteins, is an emerging area of healthcare that could meaningfully advance treatment of numerous diseases. Proteins are the workhorses in the body that determine a large proportion of human processes and functions. When a person gets sick, it is due to the malfunctioning of proteins and how they are working together. Documenting these protein networks opens new possibilities for precise diagnostics and treatments that can tackle a disease most effectively. Existing methods are only the tip of the iceberg, and the promise of new technology will enable research on a complete picture. Proteomic research is poised to improve the efficacy of medicine so people can live healthier lives. **Quanterix (QTRX), 908 Devices (MASS)** and **Seer, Inc. (SEER)** are portfolio holdings that deliver this new technology, so one day we will realize the full promise of proteomics.

The biotechnology industry has benefitted over the past several years from more favorable government agency towards innovation. With the recent political change in Washington DC, the FDA appears to be slowing the drug approval process through increased scrutiny on current filings. The Federal Trade Commission announced a working group that will examine how recent pharmaceutical deals have impacted competition. The implication is a tougher M&A regulatory environment that could limit a key driver for the sector. Finally, the use of reconciliation (just 51 votes not 60) by a Democratic-controlled Senate increases uncertainty around political debates impacting the biotech sector. While our investment decisions come from the bottom-up, these are the high-level factors behind our underweighting of the sector.

<u>Macro</u>

Covid-19 has led to a full pivot embracing Modern Monetary Theory, which includes hyper-spending in a new era of fiscal dominance with the Central Bank essentially becoming subservient. Stimulus attributed to the pandemic so far totals $5.74 trillion (including the recently passed 2021 American Rescue Plan). The infrastructure bill currently proposed at over $2T would increase total Covid-19 stimulus spending to almost $8T. The goal is to grow the economy to full capacity through government spending. We are experiencing an unprecedented joining together of extreme monetary and extreme fiscal policies that hasn't been seen since the 1960s. The markets demonstrated in the 60s that these extreme policies are very bullish for stocks, especially small cap stocks.

Because of the massive spending and a receding pandemic due to successful mass vaccinations, the US economy appears due for a record-breaking year of job growth. In March, 916,000 jobs were added and the unemployment rate dropped to 6%. With the stimulus bill passing and massive infrastructure spending in the offing, economists have been cutting their year-end unemployment forecasts to 4.5% or lower. It took a decade to get back to that level after the financial crisis. The Institute for Supply Management said that its manufacturing index had jumped to 64.7% in March; the highest since 1983.

The pandemic resulted in many changes to how individuals do things, and forced adjustments by businesses given threats and opportunities – both of which have major implications for the economic cycle. Tech-savvy companies have been investing to capitalize on trends accelerated by the virus, and productivity growth is likely to continue its post-lockdown resurgence. This could help tame a rebound in inflation. Yet there’s a risk that the K- shaped US economic recovery, in which low-income workers struggle as the rich get richer, could linger as the low skilled jobs become automated.

<u>Outlook</u>

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 that number has been continuously adjusted upward to its current 6%. Productivity growth is also forecasted to rise to 1.8%, which is up from the 1.4% annual growth that we have experienced 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 productivity-enhancing technologies that also lowered costs did extremely well. We believe similarly situated companies will do well in the current environment as interest rates rise and signs of inflation are on the horizon. For companies in the Russell 2000 Growth Index, free cash flow margins have improved dramatically since the 1990s and now stand at a nearly 40-year high (Furey Research Partners, March 25, 2021; Growth has its Virtues). Since the end of the year, earnings growth expectations for the Russell 2000 Growth Index have increased while valuations have come down, with Price/Earnings ratios falling 35% and Price/Sales ratios declining 19% in our portfolios. Stock selection drives performance for the GIM strategies, particularly stocks of innovative, financially sound companies that provide the necessary tools and products for businesses to stay relevant in the changed, post-pandemic world.