Small Cap Discoveries

Portfolio Comments

March 31, 2021

Distinguishing Features

GIM builds the Small Cap Discoveries portfolio from the bottom-up; sector weightings are secondary to stock selection. Over the first quarter 2021, the Small Cap Discoveries portfolio saw an increase in its overweight position in industrials compared to the Russell Microcap Growth benchmark, now 19% versus 10%, reflecting good performance from Special Situation holdings in the sector. The portfolio's one holding in the utilities sector results in an overweight position here, 5% to 1%. Healthcare remains nearly equal-weight versus the Index (46% versus 45%), and the portfolio is also about equal-weight in materials (1%) and real estate (2%). The remaining sectors are underweighted the benchmark with technology continuing as the largest underweight, 13% versus 19% for the Index. Consumer discretionary also continues its underweighting (8% to 10%), as does financials (1% versus 4%). The portfolio has no exposure to the consumer staples, energy, and telecommunications sectors where the Index weightings in these small sectors are 3%, 3%, and 2%, 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 Growth Index return of +4.9% significantly lagged the Russell 2000 Value return of +21.2%. Even as microcap stocks performed very well across the spectrum, the Russell Microcap Growth Index return of +16.9% meaningfully lagged the Russell Microcap Value return of +29.4%. 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

The Granahan Small Cap Discoveries portfolio participated nicely in this environment, with its net-of-fee return of +18.5% handily outdoing the Russell Microcap Growth's +16.9% return, and significantly outperforming the +4.9% return of the Russell 2000 Growth.

For the 1st quarter, relative outperformance versus the Russell Microcap Growth benchmark was primarily due to stock selection, led by selection in the technology and utilities sectors, and assisted by industrials. Our overweight position in utilities partially offset the strong selection here, while our overweighting to the industrials sector boosted relative performance. Our underweight position to the benchmark in technology aided the sector's relative return. The healthcare sector was neutral to performance this quarter. Selection in financials and real estate were the largest detractors, and our underweight position in financials also hurt as it was the top performing sector for the Index. Selection in consumer discretionary and basic materials were also negatives. Our lack of exposure to consumer staples was a plus.

With respect to LifeCycles, the Special Situation and Core Growth LifeCycle categories soundly outperformed the Index, while the Pioneer category significantly lagged. Two of the quarter's top contributors were Core Growth healthcare holdings: **Organogenesis Holdings** and **Vericel**. Two Special Situations were also in the top five: **Sharps Compliance Corp** (utilities) and **Computer Task Group** (technology). Last quarter's top performer, **Magnite** (Pioneer, technology), was the sole Pioneer in the top contributors this quarter.

The five largest detractors in the quarter included four healthcare names: **Editas Medicine** and **Flexion Therapeutics** (Pioneers), **Cardiovascular Systems** and **NeoGenomics** (both Core Growth). The largest detractor in the quarter was **PROS Holding**, a Pioneer in the Technology sector.

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.