Small Cap Advantage

Portfolio Comments

September 30, 2021

Distinguishing Features

GIM builds the Small Cap Advantage portfolio from the bottom-up; sector weightings are secondary to stock selection. As of 9/30/2021, the Small Cap Advantage portfolio maintains its overweight position relative to the Russell 2000 Growth benchmark in both industrials (22% versus 15%) and info tech (27% versus 21%). Consumer discretionary (14% versus 16%) and healthcare (26% versus 28%) both remain underweighted to the Index. The portfolio is also underweight compared to the benchmark in the following smaller sectors: financials (3% versus 5%), energy (1% versus 2%), and basic materials (2% versus 3). The portfolio is roughly equal weight to the Index in real estate at 3%. We have no exposure to consumer staples, telecommunications, and utilities, where the benchmark weightings are 3%, 2%, and 1%, respectively.

Commentary

Market Environment

Mounting concerns over higher inflation, and the threat of a more contagious COVID variant spreading around the world, weighed on global markets this quarter with some areas seeing their first downturn since the start of the pandemic. Supply chain issues have caused uncertainty and, coupled with the disarray in Washington D.C., has prompted investors to harvest some profits. U.S. markets were down this quarter, and the Russell 2000 Growth Benchmark ended the quarter in the negative, -5.7%.

Performance Discussion

In this negative environment, the Granahan Small Cap Advantage composite returned -2.2%, net of fees, ahead of the -5.7% return of its Russell 2000 Growth benchmark. Year-to-date, the strategy soundly outperformed the Index with a net-of-fee return of +10.4% versus +2.8% for the benchmark. The out-performance in the quarter was due to strong stock selection led by technology, and assisted by selection healthcare, industrials, and real estate. The overweight positions in technology and industrials, as well as the underweighting in healthcare, boosted relative performance. Selection in materials and consumer discretionary weighed on performance in the quarter, though our underweight position in basic materials offset some of the negative selection here. Financials and energy also showed negative selection. Our lack of exposure to utilities hurt relative performance, while no exposure to consumer staples was a positive.

With respect to LifeCycles, the Core Growth category significantly outperformed the overall benchmark, and the Special Situation category also soundly outperformed. The Pioneer holdings were overall a large detractor in the quarter. Three of the five top contributors in the quarter were Core Growth technology holdings: **SPS Commerce**, **Paycom Software,** and **Workiva.** Two industrials round out the top five: **Kornit Digital** (Core Growth) and **Chart Industries** (Special Situation)

The largest detractors for the quarter represent all three lifecycles, including Pioneers **2U** (consumer discretionary) and **Aerie Pharmaceuticals** (healthcare). The quarter's largest detractor in the period was **Nautilus** (Special Situation, consumer discretionary). **Cricut, Inc** (Core Growth, technology) and **Materion** (Special Situation, basic materials) round out the bottom five.

Outlook

Year-to-date, for the Russell 2000 Growth index, profitable companies are up +14%, while loss-making companies are down at -10%. (Furey Research Partners, October 5, 2021; Q321 Letter). Divergences like this can also be viewed through LifeCycle diversification, the tool that also tends to bolster the portfolio in uncertain markets. Pioneers are on their way to earnings growth but much of the time are not profitable, and can be under pressure in "risk-off" markets, while Core Growth and Special Situation names generally show strong earnings growth. At this time, we see earnings projections rise for the portfolio while valuations have come down. Absolute valuations are near long-term medians for the Russell 2000 Index at 17X, and relative valuations versus large cap indices are at a two-decade low.

With many conflicting macro factors swirling around, it can be difficult for investors to clear through the clutter to make investment decisions. The GIM team continues to focus on secular trends that drive earnings growth. At Granahan Investment Management attention is on the fundamental drivers of our companies' businesses. It has always been the focus of our repeatable processes and has provided success for our clients over time.