Granahan Small Cap Core Growth
Portfolio Commentary
3rd Quarter 2021

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 in this negative environment, the GIM Small Cap Core Growth strategy soundly outperformed its Russell 2000 Growth benchmark with a net-of-fee return of -2.7% versus -5.7% for the Index. Year-to-date, the strategy is significantly ahead of the benchmark, +12.2% net-of-fees versus +2.8%.

In the quarter, the portfolio's top 10 performers included seven companies from our Core Growth LifeCycle category, in line with what market pundits call a "quality" rally. The top five contributors, however, also included two Special Situation companies, **Evolent Health** and **Chart Industries**, and a Pioneer, **Veracyte**. The period's top performer was **Kornit Digital** (Core Growth, industrials), as the company's stock continued its upward trajectory from last quarter. The company's digital just-in-time textile manufacturing is resonating with customers, particularly given the current supply chain disruptions. Kornit's 5-year plan for digital printing includes new products that expand its TAM, new automated technology, and prospects for increased recurring revenues from a mix of consumable products. The company also published its inaugural ESG report to share its vision of transforming the world of fashion and textiles toward stewardship of a more sustainable planet. We are taking some profits due to position size. **Evolent Health** (healthcare) continued to focus on its growth opportunities through the sale of its managed care businesses and its sole attention on services; in particular, the New Century Health Division that is gaining traction. Evolent's stock sells at a major discount to peers, and that is gradually being corrected to the upside. On the last day of the quarter, there was a report that Walgreens is interested in acquiring the company; we are holding our position. **Veracyte** (healthcare) is a leader in genomic classifier tests used to detect, diagnose, and treat patients for eight of the top ten cancers. The strong stock performance this quarter was driven by a robust earnings report and increased investor confidence in the company's planned launch of several new tests later this year. We used the volatility early in the quarter to increase our weighting, as we believe that Veracyte's tests are becoming the standard of care, which in turn will drive long-term revenue growth of over 20%. **Chart Industries** (industrials) is a manufacturer of cryogenic equipment for LNG and other industrial gases, most notably hydrogen, which means Chart sells "picks and shovels" to the quickly growing LNG and hydrogen industries. We believe that Chart has the best prospects to benefit from the world's energy transition as it is not anchored to a single technology or energy source; their equipment and process is needed in most all of them. The company is becoming recognized as a strong play on hydrogen infrastructure, and the price reflects this; we are trimming. **Perficient** is a global digital consultancy firm serving Fortune

1000 clients. The combination of scale, enhanced reputation, and expanded global delivery capabilities has increased its competitive win rates on bigger projects, all contributing to sustainable double digit organic growth and an upward re-rating of the stock's multiple. We believe the accelerating revenue growth and margin expansion will generate strong double digit EPS growth for the foreseeable future. We are trimming given position size.

In Q3, holdings in the Pioneer LifeCycle category were the largest overall drag on the portfolio. Within the largest five detractors, three were from the Pioneer category: **Neuronetics**, **Chicken Soup for the Soul Entertainment**, and **Magnite**. **Lending Tree** (Core Growth), and **Airgain** (Special Situation) round out the bottom five for the quarter. **Neuronetics**, one of the smaller healthcare companies in the portfolio, sells equipment for a therapy that is effective in treating depression. The company delivered robust growth but missed high investor expectations. We used the weakness to add to our position given the positive long-term outlook for the innovative treatment. In addition, it is possible that fallout from the pandemic may lead to an increase in the number of patients seeking treatment for depression, which in turn would support higher growth for the company over the next several years. **Magnite** provides a technology solution to automate the purchase and sale of digital advertising inventory, a benefit for both buyers and sellers. The stock came under pressure as, even though digital advertising is a rapidly growing area, investors are less optimistic about sales growth in the 2nd half of the year. Magnite has made some critical acquisitions recently that may enhance their independent position; we are holding the stock. **Lending Tree**, an online marketplace for financial products, has had issues with the car insurance business and advertisers have been pulling back; we are trimming. **Chicken Soup for the Soul Entertainment** delivered a new television series a few days late due to a technical glitch, forcing the respective revenues into the third quarter. This delay caused the company to miss earnings for the second quarter, which also occurred right after the company issued equity in a secondary offering, putting pressure on the stock price. We are holding our position. **Airgain** is a leading supplier of advanced antenna technologies for high performance wireless systems across consumer, enterprise, automotive, and government end markets. Second quarter results were hurt by supply headwinds and a slowdown in new product uptake. Supply chain challenges are expected to continue for the coming quarters, and we trimmed our position due to execution risk. However, we are holding a smaller position as we believe the investment thesis is intact, and that the new product SAM expansion into Enterprise, Auto, and IOT, as well as its international sales expansion and margin improvements, will propel growth going forward.

For the nine months year-to-date, top contributors include **Kornit Digital**, **Evolent Health** and **Chart Industries**. Rounding out the top five are **Kulicke & Soffa** (manufactures critical parts needed for semiconductor manufacturing), and **Vericel** (regenerative medicine that utilizes a patient's own tissue to heal knee cartilage).

On the negative side year-to-date, **908 Devices** (healthcare company with differentiated offerings and innovative technology to address biologic drug development) and **Nautilus** (home fitness equipment) are the largest detectors to performance. **Neuronetics**, **Lending Tree**, and **Euronet** (electronic payment solutions in the info tech sector) round out the laggards for the nine months.

Attribution

Robust selection in the industrials sector drove the outperformance for the quarter, boosted by our overweighting of the sector. Within the Russell 2000 Growth benchmark, healthcare was the largest detractor, and while the GIM portfolio's healthcare return was also negative, it was significantly ahead of the Index and resulted in strong relative contribution due to stock selection. Info tech and consumer staples also contributed nicely with positive selection; in addition, the overweight position in info tech was a plus. Good selection in communication services and real estate was offset by their relative weightings to the Index, which were overweight and underweight, respectively. Selection in consumer discretionary and financials detracted in the quarter, while energy and materials also weighed on relative performance. Our underweighting in materials partially offset the negative selection here.

The strong year-to-date outperformance to the benchmark is due to stock selection, led by our healthcare, info tech, and industrials holdings. The portfolio's consumer discretionary, financials, and energy sectors detracted.

GIM utilizes LifeCycle diversification (Pioneer, Core Growth, and Special Situation) to help mitigate risk. In the quarter, the Core Growth category significantly outperformed the overall benchmark, and the Special Situation category also soundly outperformed. The Pioneer holdings were a large detractor in the quarter.

Weights

GIM's bottom-up process leads us to continue to maintain our significant overweight in information technology, and we are also overweight versus the index in healthcare and communication services. Industrials and financials are about equal weight the Index. We are underweight the benchmark in all other sectors, with consumer discretionary our largest underweighting. The portfolio has no exposure to utilities.

Themes

ESG analysis has become an increasingly important part of the investment process for most money management firms. At GIM, we have always included some ESG elements in our fundamental research as we look at risks to the investment case, and over the last few years, we have more formally incorporated ESG data into our investment process. There is an underlying sustainability theme in the portfolio today; many of our companies are providing the tools for larger companies, individuals, and governments to meet their ESG goals. **Kornit Digital** eliminates water pollution in the textile industry, and the company also reduces waste by printing fabric as needed, which lowers inventory surpluses. **Power Integrations** has a suite of products that conserve and reduce power consumption. **ShotSpotter** and **Axon** have products that reduce fatalities caused by violent crime. **Evolent Health** reduces healthcare costs while promoting better health outcomes.

This year has proven to be a banner year for IPOs with 1,257 new companies coming public over the last 12 months. Russell FTSE added 68 IPOs to their indices on September 17th. Healthcare dominates the activity with 35 of 68 representing this sector. While it is difficult to track all the new companies with Wall Street pumping them out so quickly, we have noted that many of the biotech companies are very early stage, so these will not fit our disciplined process… yet. We will, however, be tracking them. Big Pharma companies are facing patent cliffs on many of their drugs over the next few years, and with their balance sheets flush with cash, they are buying up smaller companies with promising therapies. We have had seven healthcare buyouts in the portfolio year-to-date, with three since the beginning of August: **Acceleron**, **Intersect ENT**, and **Flexion Therapeutics**.

Another area of interest in healthcare is the greater understanding of cellular biology that is leading to increased healthcare innovation and investment. We have seen the promise of this innovation pushed forward in the response to the COVID pandemic. Many new biotech companies are based on scientific platforms, as opposed to single products. These platforms are built around a core scientific competency that can address a wide range of therapeutic areas. A company's valuation is not based on the potential of one product but is ascribed to the overall scientific platform's capabilities to deliver therapies for many diseases that have an underlying commonality. **Beam Therapeutics**, **BioCryst Pharmaceuticals**, **Blueprint Medicines Corp.**, **CRISPR Therapeutics**, **Editas Medicine**, **Intellia Therapeutics**, and **Veracyte** are companies in the portfolio that we believe have strong platforms.

Macro

Real GDP growth in the U.S. has slowed as various factors put pressure on the economy. The Delta COVID variant has brought back concern over shutdowns, while supply chain issues continue, due in no small part to the growing semiconductor chip shortages. Looming US tax rate hikes create uncertainty. Interest rates have moved up, strengthening the dollar and crimping revenues from overseas. Upward inflationary pressure on wages, rents, and commodity prices have triggered consideration for tapering by the Federal Reserve. There are also positive macro factors in the mix as the monetary stimulus continues to show benefit, and together with high consumer savings and inventory rebuilding, are providing some tailwinds for growth. In addition, vaccination rates are rising, and re-openings *are* happening. Overall, corporate earnings are robust. All in all, growth has slowed but the outlook for GDP growth is stronger than it has been in many years.

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 find the clarity 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.