



Granahan Small Cap Discoveries

Portfolio Comments

September 30, 2021

Distinguishing Features

GIM builds the Small Cap Discoveries portfolio from the bottom-up; sector weightings are secondary to stock selection. Since last quarter, the Small Cap Discoveries portfolio has slightly trimmed its overweight position in industrials versus the Russell Microcap Growth benchmark, now 18% versus 13%. The portfolio has furthered its overweight position in healthcare from last quarter, now 48% versus 43%, as we have added names to retain our weighting while the benchmark weighting reflects the sector's poor performance in the quarter. The portfolio is slightly overweight in the following sectors: technology (12% versus 11%), materials (4% versus 3%), utilities (3% versus 1%), and real estate (3% versus 2%). Consumer discretionary continues to be the portfolio's largest underweight, 8% versus 17% for the Index. The portfolio is equal weight to the benchmark in financials at 3%. The portfolio continues to have no exposure to energy, telecommunications, and consumer staples, where the benchmark weightings are 4%, 2%, and 2%, 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 Microcap Growth Index ended the quarter down sharply at -9.1%.

Performance Discussion

In this negative environment, the [Small Cap Discoveries](#) composite returned -10.9% net-of-fees, underperforming its Russell Microcap Growth benchmark's return of -9.1%, and also behind the -5.7% return of the Russell 2000 Growth secondary benchmark. Year-to-date, the strategy is up +8.9% net-of-fees, compared with +9.6% for the Russell Microcap Growth Index and +2.8% for the Russell 2000 Growth. Versus the Russell Microcap benchmark, the underperformance in the quarter was due to poor selection in the healthcare sector. Selection in technology was also a negative. While selection in industrials weighed on performance, our significant overweighting of the sector resulted in positive attribution. On a positive note, the portfolio showed very strong selection in real estate during the period. Our underweight position in consumer discretionary was a plus, as was our lack of exposure to consumer staples. Conversely, the portfolio's overweighting in utilities and underweight position in financials were negatives in the quarter.

With respect to LifeCycles, the Core Growth holdings were substantial outperformers versus the overall benchmark. The Pioneer category significantly underperformed, while the Special Situations category also lagged. The five largest detractors include three healthcare holdings: **Neuronetics** and **Aerie Pharmaceuticals** (both Pioneers), as well as **Cardiovascular Systems** (Core Growth). Two Special Situation names, **Nautilus** (consumer discretionary) and **Sharps Compliance** (utilities), round out the bottom five.



The top two contributors in the quarter were from the Core Growth LifeCycle category, **Kornit Digital** (industrials) and **Innovative Industrial Properties** (real estate). Although the healthcare sector and the Pioneer LifeCycle category both detracted from the portfolio's overall performance, the breadth of our exposure to innovative healthcare companies resulted in three of these Pioneers making the list of the quarter's top contributors: **Veracyte, Spero Therapeutics, Enanta Pharmaceuticals**.

Positioning

We expect increased volatility given the uncertainties created by the COVID Delta variant and its impact on the healthcare and consumer sectors, while the current supply chain and logistics problems will likely have ripple effects through many sectors of the economy. The short-term influence of these issues also provides opportunity due to price dislocation, and we will continue to initiate or add to positions as a company's long-term fundamentals dictate and the stock's risk/reward warrants.

The Discoveries strategy seeks to invest in innovative small and micro-cap companies, and we continue to find compelling investment opportunities in healthcare, technology, and industrials.

Outlook

Year-to-date in the Russell 2000 Growth Index of small cap companies, profitable companies are up +14% versus -10% for loss-making companies (Furey Research October 5, 2021; 3Q21 Letter). Divergences like this can also be viewed through LifeCycle diversification, the tool which also tends to bolster the portfolio in uncertain markets. Our Pioneers are on their way to earnings growth but much of the time are not yet profitable, while our Core Growth and Special Situation names generally show strong earnings growth. We are now seeing earnings projections rise for the portfolio while valuations have come down. Absolute valuations are near long-term medians for the Russell 2000 Index of 17X, and relative valuations versus large cap indices are at a two-decade low. Many names that are under pressure in the Discoveries portfolio continue to have strong fundamentals, and as noted above, we are adding to these positions.

With 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.

Disclosure:

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