Granahan Focused Growth Strategy
Portfolio Manager Commentary
September 30, 2021

Vacillation Between Value and Growth Continues

Along with market indices across the globe, US Small Cap Growth stocks struggled in the 3rd quarter, and the Russell 2000 Growth Index was down, -5.7%. This year's swings between growth and value continued, as investors once again re-opened their eyes to re-opening stocks, mirroring the behavior exhibited in April and early May. For the third quarter, the Russell 2000 Value Index was down -3.0%, 270 basis points ahead of the Russell 2000 Growth Index. Year-to-date through 9/30/21, the Russell 2000 Value is up +21.7%, outperforming the Russell 2000 Growth Index's +2.8% by a whopping 1890 basis points.

The Granahan Focused Growth strategy was up in Q3 with a return of +1.8% net-of-fees. Year-to-date has returned +13.3% net-of-fees compared to the +2.8% gain in the Russell 2000 Growth benchmark. I'm pleased with these returns, both absolute and relative. Though had I possessed that ever-elusive crystal ball, I'd have mortgaged the house and shifted into value stocks (but then again, I'd be counting on that crystal ball for sage advice as to when to rotate back again).

In Q3, Focused Growth's outperformance versus the Russell 2000 Growth Index was due to both good stock selection and sector allocation. Selection was particularly robust in technology, and also strong in healthcare and industrials, while selection in consumer discretionary and financials were negatives to performance in the quarter. Our sector allocations boosted the positive selection, mainly due to the portfolio's overweight position in technology (strong selection and overweighted in a sector that outperformed the overall Index) and underweight in healthcare (strong selection and underweight in a weak performing sector). In terms of individual names, the standouts are as follows:

Largest Relative Contributors (3 stocks in the Technology Sector):

- **SPS Commerce (SPSC)** - SPS is a cloud-based supply chain management software for retailers and their suppliers. SPSC shares rose in Q3 on strong reported Q2 results. The company raised its near-term growth outlook based on the broad strength in omnichannel retailing. We continue to hold SPSC shares.

- **Paycom (PAYC)** - Paycom provides payroll and human capital management software to medium-sized business. PAYC shares were up as the company reported solid Q2 results and that the early results of their new product, BETI, are very encouraging. BETI is a self-serve module that puts more of a company's payroll functions and details into the hands of the individual employee. We continue to hold our position in PAYC shares.

- **Workiva, Inc. (WK)** - Workiva sells a cloud-based software platform that allows companies to aggregate, collaborate and track complex regulatory and filing processes. WK shares rose in Q3 on good Q2 results along with investors' optimism for accelerated and sustained growth from Workiva's recently upgraded Wdesk platform and other newer product offerings (e.g., ESG reporting, global statutory reporting). We have trimmed the shares based on risk/reward but continue to hold a position in WK shares.

Largest Relative Detractors:

- **Cricut (CRCT, Technology)**- Cricut makes and sells a DIY craft-making platform. The platform consists of a hardware cutting machine, integrated accessories and materials, and cloud-based design software. The company went public in March 2021. Cricut reported a good Q2, but signaled it was seeing signs of a slowdown in user engagement in Q3. This is not surprising given the "reopening," and CRCT's shares fell on investors' concerns/uncertainty. We have modestly added to our position.
- **2U, Inc. (TWOU, Consumer Discretionary)** - 2U operates an ed-tech platform that enables its partner colleges and universities to deliver and support a broad range of online/hybrid educational offerings ranging from short courses to undergraduate and graduate degrees. TWOU shares fell as the company reported good Q2 results, though also signaled caution based on uncertain fall enrollments in the wake of re-opening as well as increased new student acquisition costs. We trimmed our holdings but retain a position.
- **Zeta (ZETA, Financials)** - Zeta operates a marketing-technology platform that lets advertisers combine their own internal data with third-party data to attract, retain, and cross sell customers. ZETA shares fell in its first full quarter as a public company despite posting solid Q2 results. We added to our holding, as we believe the company is well-positioned and as the stock's risk/reward grew more compelling.

An Unusually Wide Range of Factors Influencing Small/Mid Cap Stocks

Zooming Out: Big Change/Uncertainty/Disruption Abounds

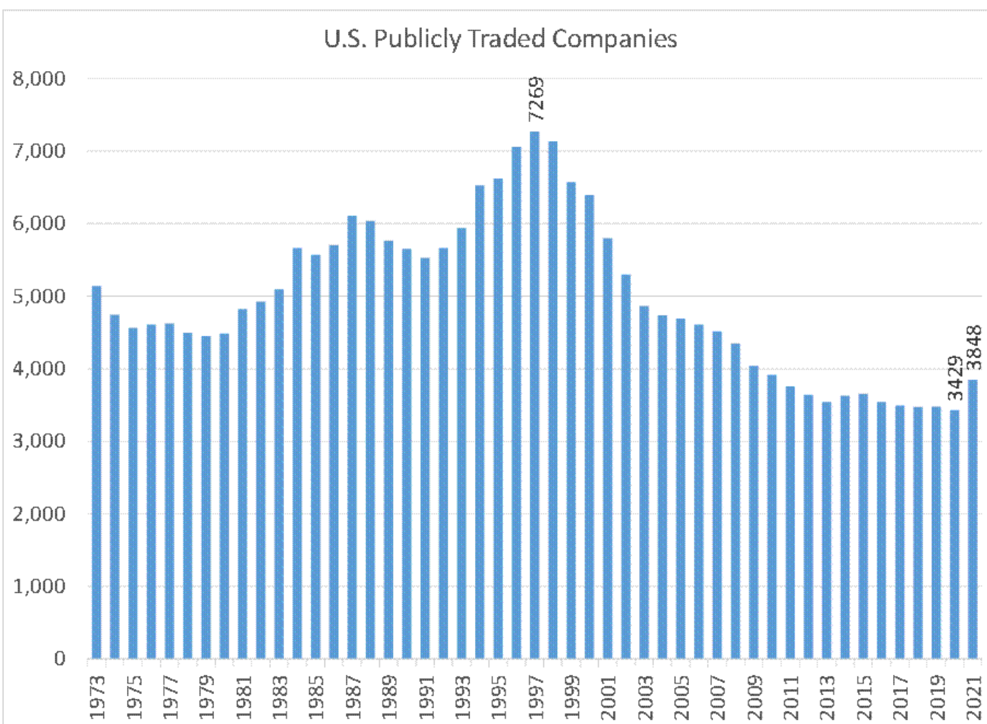
There are always a wide range of macro factors that influence stock movements, but it feels like there are currently more than typical. I'll forgo sharing my thoughts on every single one of them, but I will zoom in on a few:

Psst, Everything is in Short Supply So Buy Your Holiday Gifts…Yesterday…

A wide range of factors is conspiring to create shortages of just about everything. Demand is accelerating in the US due to pent up desires and savings, investment gains, and government spending that has ballooned over the past 18 months. At the same time, supply is not keeping up. On the labor side, while Covid has hopefully peaked in many developed nations, that isn't the case in many countries where production occurs. The current supply of labor is also constrained by other factors including childcare challenges, government pandemic unemployment assistance, workers rethinking work and work/life balance, the ability to work from anywhere, and workers feeling the tug of YOLO. An August 2021 survey by PWC found that a stunning 65% of workers are considering changing jobs, and that 88% of executives are experiencing higher than average worker turnover. The supply/demand imbalances have combined to create shortages of a wide spectrum of materials including steel, oil, and semiconductors, along with a long list of final products ranging from freezers, to automobiles, to Halloween costumes. Together this threatens economic growth over the coming quarters.

…Well, a Shortage of Everything Except IPO's

There is one group that missed the supply shortage memo: Investment Bankers. There is absolutely no shortage of companies going public via traditional IPO's, direct listings, SPACs (and eventual de-SPACs), all of which expands the investable universe of small/mid cap stocks. This is a reversal of a 23-year trend in which the number of public companies consistently shrank. I welcome this change. While most of these newly public companies won't fit our "Desert Island-worthiness" test, some will. And given the large volume of new companies, there will undoubtedly be pricing inefficiencies as both the sell-side and buy-side struggle to keep up with new issues. Yay!



Source: Furey Research Partners

Good-bye Donald, Hello Xi

Amidst his efforts to curb capitalism, it appears that China's President Xi Jinping inherited Donald Trump's mantle of the King of Rapid-Fire Head-Spinning "What Did He Say" headlines. As with the supply chain challenges noted above, Xi's actions create uncertainty about economic growth as well as geo-political stability. Among the moves we've seen in recent months out of China: 1) Prohibition of all crypto transactions/mining and the creation of the country's own digital currency; 2) A ban on tutoring by for-profit education companies; 3) Various restrictions on its largest tech companies, such as Alibaba and Didi; and 4) A 3 hour-per-week limit on video gaming by children under 18, and they can only play Friday-Sunday. At the same time, China's recent threatening military flights and comments vis-a-vis Taiwan have brought increased concerns about Taiwan's sovereignty, as well as its role as the dominant supplier of critical leading-edge semiconductors (amidst a world already experiencing short supplies of key semiconductors).

So is it Time to Hide My Money in the Underwear Drawer?

All the uncertainties outlined might provoke investors to ask the question "Is it a time when I should be in cash instead of investing in the market?" Similarly, at the beginning of this letter, I noted that year-to-date the Russell 2000 Value has outperformed the Russell 2000 Growth index by 1910 basis points. This begs the question I'm often asked by investors: "What do you think about growth vs. value?" My thoughts on the "in or out of the market" question and the "growth vs. value" question, mirror my thoughts on "large stocks vs. small stocks" or rotating "in/out of certain sectors." I put them in what legendary investor Charlie Munger calls the "Too Hard" pile – that, is I don't believe I can consistently add value trying to make such decisions, so I try not to make them. Thankfully (and perhaps in response to the above), Focused Growth's philosophy and process are not contingent on such timing questions. Rather, the strategy is designed with the prospect and intention to generate good returns for investors over most intermediate and long-term environments. Simply put, we try to focus our energies on "Desert Island-worthy" companies – those that would be much, much larger upon our return if we were stranded on a desert island for 5-7 years. And we seek to own the stocks of these Desert Island companies when their probability-weighted expected-return and risk/reward are favorable. While I wouldn't call this "Too Easy," I believe it is more consistently achievable than those "Too Hard" rotation questions referenced above, particularly when I consider the likelihood of success after chain-multiplying the odds of getting multiple decisions right over a long period of time.

I offer one other bit of food for thought on the issue of market timing. Given the range of threatening factors discussed above, many observers are surprised that stocks haven't retreated – at least not yet. On one hand, it is rational to believe that greater uncertainties about the future raise the discount rate that investors require be placed on future cash flows, and thus hurt stock prices. However, the broad investment crowd has collectively benefitted from its wisdom of "buying the dips" over the past 40 years. Now, of course, what has been "wise" over the past 40 years will not necessarily prove to be so over the next 40 years (or 4 years, or 4 hours). Nonetheless, the experience over this period does serve to remind us of the market's resiliency.

A few things of late that I have found worthy of a read or listen:

- Atlantic Monthly - The Everything Shortage. A good, relatively short article providing a bit more context to the above discussion about supply/demand.

- Invest Like the Best - Interview with Lone Pine Founder Steve Mandel who is definitely one of the best investors of our time (next time we talk, remind me to tell you my Steve Mandel story).
- Finding Freedom is an autobiography by Erin French, a chef and entrepreneur whose story is worth telling. French started and runs *The Lost Kitchen* restaurant in Freedom, Maine. By the way, you should make yourself a calendar reminder right now to send a postcard next spring to try and land one of the crazy hard-to-get reservations at The Lost Kitchen.
- Two Episodes of Malcolm Gladwell's *Revisionist History*:
    - The Dog Will See You Now - It turns out our four-legged friends should be leading the way in testing for Covid and lots of other things.
    - Laundry Done Right - Will forever change the way you do laundry.
- *Seven Days in June* - Tia Williams' entertaining novel about a single mom, who writes erotic goth while bringing up a teenage daughter and dealing with severe migraines and a whole lot more.

Summary

As always, on behalf of the entire team at Granahan Investment Management, I thank you for entrusting us with the management of your capital. Please note that it is managed alongside our own. I wish you and yours a happy, healthy, and prosperous holiday season.

Sincerely,

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