Small Cap Select Opportunities

Portfolio Comments

September 30, 2021

Distinguishing Features

GIM builds the Small Cap Select portfolio from the bottom-up; sector weightings are secondary to stock selection. At quarter-end, the Small Cap Select portfolio remains overweight in info tech versus the Russell 2000 Growth benchmark, now 34% versus 22%. The portfolio also continues its overweight relative to the Index in communication services, 9% versus 2%, due to our high conviction holding in Magnite. Industrials is now slightly underweight the Index (13% versus 14%). The consumer discretionary underweight position increased, now 9% versus 15%. Healthcare's underweight is slightly lower this quarter, 26% versus 28%. The portfolio is also underweight compared to the benchmark in the following smaller sectors: financials (3% versus 5%), materials (1% versus 3%), consumer staples (1% versus 3%), and real estate (1% versus 3%). We continue to have no exposure in utilities.

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 Small Cap Select composite outperformed its Russell 2000 Growth benchmark with a return of -4.0%, net of fees, versus -5.7% for the Index. Year-to-date, the strategy is soundly ahead of the Index, +18.2% net-of-fees versus +2.8% for the Index. Outperformance in the quarter was due to very strong selection in healthcare, industrials, and consumer staples – sectors where the portfolio showed strong positive absolute returns while the Index had negative returns (healthcare and consumer staples) or was flat (industrials). Our underweight position in healthcare also boosted relative performance. Positive selection in real estate was offset by our underweighting of the sector. Our large overweight allocation to communication services hurt relative performance, as this sector had the worst absolute return for the Index. Selection in info tech and consumer discretionary weighed on performance, though our overweighting of info tech partially offset the negative here. Selection in financials also detracted.

With respect to LifeCycles, the Special Situation category significantly outperformed the overall benchmark. The Core Growth category also outperformed nicely, while Pioneer holdings lagged considerably. Two Special Situation holdings were in the quarter's top five contributors, **Evolent Health** (healthcare) and **Chart Industries** (Industrials), as were two Core Growth holdings, **Kornit Digital** (industrials) and **Array Technologies** (info tech). **Veracyte** (Pioneer, healthcare), a detractor last quarter, rounds out the top five.

Two Pioneer holdings were the largest detractors in the quarter, **Magnite** (communication services) and **Chicken Soup for the Soul Entertainment** (consumer discretionary and a top performer in Q2). Special Situations **Nautilus** (consumer discretionary) and **iCAD** (healthcare) were also in the detractors for the period. Core Growth holding **LendingTree** (financials) rounds out the bottom five.

Positioning

Over the last few years, it has been notable that the overall portfolio valuation has been consistently lower than that of our benchmark. In the 3rd quarter, this reversed and deserves further examination. We believe the primary take away is that lower valuation does not always translate into lower risk. Over the last two quarters, we trimmed two top-ten positions that had very low valuations and used the proceeds to purchase a new name with a relatively high valuation, one that is now in the top 10. We believe the resultant positioning has reduced the risk in the portfolio. Let me explain.

Our first significant sale involved harvesting profits in our **Kulicke & Soffa** holding ("K&S"), which was the portfolio's top contributor this year. To be clear, Kulicke & Soffa's business continues to be strong, and the stock's valuation remains extremely low at around 10X next year's earnings; however, K&S is in the highly cyclical semiconductor capital equipment industry where investors typically reduce their exposure purely on speculation of a slowdown. Our experience in this industry has shown that the longer the cycle endures, the more risk that there will be downside volatility in the near future. It is possible that we are in a "supercycle," though we felt it prudent to cut our position size to <5% to adjust for the perceived rising risk.

The second sale of a top ten position involved our holding in **Nautilus**, a stock that proved to be a poor investment. From the time we first purchased Nautilus, it has been one of the lowest valuation companies in the portfolio. The problem in this case, however, is that the earnings numbers are coming down. Margins have been severely compromised this year due to supply chain issues and transportation costs. In addition, a major competitor in the fitness equipment world (Peloton) has been discounting its lower priced equipment, despite inflationary cost pressures. This has proven to be a very bad sequence of events, and we believe there is still downside to earnings expectations going forward. Unfortunately, while our Nautilus stock sales have proved appropriate, they were not timely enough to prevent Nautilus from being a detractor in Q3, and the largest detractor year-to-date. Fortunately, the positive effect of K&S more than offset the negative from holding Nautilus. Looking at the two stocks together, the bottom line to the portfolio was a positive contribution that would have placed the two combined in the top 5 contributors year-to-date.

With respect to the relationship of portfolio risk and valuation, the sales of both K&S and Nautilus have reduced our exposure to very low valuation stocks by close to 7%. More importantly, in turn, we believe the risk to the portfolio is also reduced.

Going further, we repurposed the proceeds from these low valuation sales into a stock that was trading at a high valuation – **Array Technology**, manufacturer of solar trackers. Earlier this year, Array found itself in a tricky situation. Steel is a large input cost for solar trackers, and the company was sometimes waiting months after an order was quoted to buy the needed steel. This dynamic essentially destroyed the company's earnings prospects in 2021 as steel prices more than tripled in less than nine months. In its Q1 earnings release, the company withdrew its 2021 guidance. Street earnings estimates came down hard, to the point where the stock was trading above 75X next year's earnings forecasts. At this point, we believed the stock was so severely punished that it offered a low risk, high reward opportunity. Demand for solar trackers, in general, is price inelastic and relatively strong (+20% growth), because even with higher steel prices, the return on investment remains compelling enough to include them in a solar project. The company worked to adjust its quoting and purchasing habits to enable the low 2021 margins to quickly recover. The "expensive" stock in the second quarter was trading at less than 15X our estimated earnings potential of $1 per share, and we took advantage of the volatility to make the name a top 10 position. Again, with the stock down big, and only an internal adjustment to be made, we thought Array represented a good low risk, high reward opportunity. Fortunately, our decision appears to have been a good one. On the company's

2Q earnings call, the management team indicated that the company is now quoting projects with a firm price for just 7 days and then securing the steel immediately after contracting. The company also suggested that margins will return to previous levels even with the cost inflation. This is indeed good news, as total margin dollars will now actually benefit from the inflation. While the stock is still recovering from its losses in the first half of the year, the "expensive" Array is a top contributor in Q3, and in the top 10 contributors year-to-date.

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 our portfolios 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.

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