FOCUSED GROWTH

Portfolio Comments
March 31, 2022

The first quarter of 2022 was rough, as the markets faced headwinds from the ongoing pandemic, surging inflation, supply chain disruptions, labor shortages, and most notably, the war in Ukraine. The Focused Growth portfolio fell -16.25% in Q1, lagging the -12.63% drop in the Russell 2000 Growth benchmark. High growth, higher multiple, long duration assets were not the place to be in Q1 of 2022. In fact, there were very few "places to be" (more on this below). Just two of the 58 subsectors in the Russell 2000 Growth Index rose in Q1; Oil, Gas and Coal (+38%) and Precious Metals and Mining (+2%). The worst performing sectors were Consumer Discretionary (-17.4%), Health Care (-15.2%), and Technology (-15.1%). In terms of impact relative to the benchmark, the portfolio was modestly hurt by its overall sector weights (helped by underweight in Health Care, hurt by overweight Consumer Discretionary and Technology), but the portfolio's underperformance relative to the benchmark was mostly due to stock selection. Particularly impactful was stock selection in Consumer Discretionary (-1.59%) and Industrials (-3.52%). Drilling down, in each of these two sectors, there was a single large holding heavily weighting on performance: Etsy (ETSY) in Consumer Discretionary and Kornit (KRNT) in Industrials.

The Three Largest Relative Detractors in Q1 Were:

- **Kornit** (KRNT) - Kornit is playing a leading role in digitizing and disrupting the traditional textile printing industry. Kornit reported strong Q4 sales, but profit margins disappointed investors both in terms of the company's Q4 results and guidance for 2022. This, combined with the above-mentioned shift away from higher growth, higher multiple stocks, left KRNT down -45.8% in Q1. We had a large position which impacted performance by -282 basis points. We have maintained a large position, adding to KRNT shares as the price has come in. We believe the fashion and textile industries are early in a shift from analog to digital, and we expect Kornit has the ability to sustain strong top and bottom-line growth for many years to come. The risk/reward is attractive.
- **Etsy** (ETSY) - Etsy operates a global online marketplace connecting sellers and consumers of unique and creative goods. ETSY shares fell 42.5%, and our large position resulted in a -210 basis point impact in the quarter. The company reported strong results for Q4 2021 and relatively reassuring guidance for Q1 of 2022. However, fears of slowing growth, difficult comparisons, and pushback from some Etsy sellers against the company's announced price increase all weighted heavily on the shares. We are maintaining a large position in ETSY, believing the company is well positioned to generate strong earnings and free cash flow growth for the next several years, and that the stock's risk/reward is attractive.
- **Enovix** (ENVX) - Enovix has designed a silicon-anode lithium-ion battery which has the potential to meaningfully (30%-50%) increase battery charge efficiency. ENVX shares fell 47.8% in Q1, which impacted the portfolio's performance by -97 basis points. ENVX has design wins in a variety of use cases including wearables (e.g., watches, fitness trackers), laptops, and mobile communications (phones and other handsets), and they are just beginning to ship their first production batteries. There have been some modest delays in shipments and production plans over the past few months, but we attribute most of the stock decline to the market's current risk aversion. We believe that Enovix has a good chance of gaining traction in several very large consumer applications over the next 12-24 months, and that the stock's risk/reward and expected return is excellent. Thus, we have added modestly to our holdings and maintain a mid-sized position in ENVX shares.

On the positive side, good stock selection in healthcare helped performance as the portfolio's two holdings, HealthEquity (HQY) and Evolent Health (EVH) each rose in the quarter, while the Healthcare segment of the benchmark fell 15%. In addition, Zeta Global (ZETA) which the benchmark (mis)classifies as a Financial was up strongly in Q1, while the overall Financials sector was down 13%.

The Three Largest Relative Contributors in Q1 Were:

- **HealthEquity** (HQY) - HealthEquity is the largest outsourced provider of health savings accounts (HSA). The company is well positioned to benefit from the secular shift to consumer-directed benefit plants (CDBP). HQY shares rose 52.2% (helping performance by +74 basis points) in Q1 on investor optimism regarding reopening (this helps HealthEquity as some offerings such as FSA/Commuter benefits are tied to employees returning to the office) and rising interest rates (HealthEquity benefits from higher interest rates since the company earns a float on custodial funds). We believe HQY shares are attractive and modestly added to the position in the quarter, maintaining a mid-sized position.
- **Evolent Health** (EVH) - Evolent Health helps healthcare providers and payers improve care and lower costs by implementing a value-based approach to healthcare. EVH rose 16.5%, contributing +65 basis points to performance in Q1. Over the past two years under new management, Evolent has done a good job executing on its fundamentally strong position in value-based care. We believe this is likely to continue and maintain a mid-sized position in EVH shares.
- **Zeta Global Holdings** (ZETA) - Zeta operates a marketing-technology platform that allows advertisers to combine their own internal data with third-party data to attract, retain, and cross-sell to customers. ZETA shares rose 51.2% in Q1, contributing +151 basis points to performance. The company reported strong Q4 results, guided positively for 2022, and provided investors with strong 2025 goals and a clear pathway for achieving them. ZETA remains a significant holding in the portfolio.

As Usual, It Is an Uncertain World…But More Uncertain Than Usual

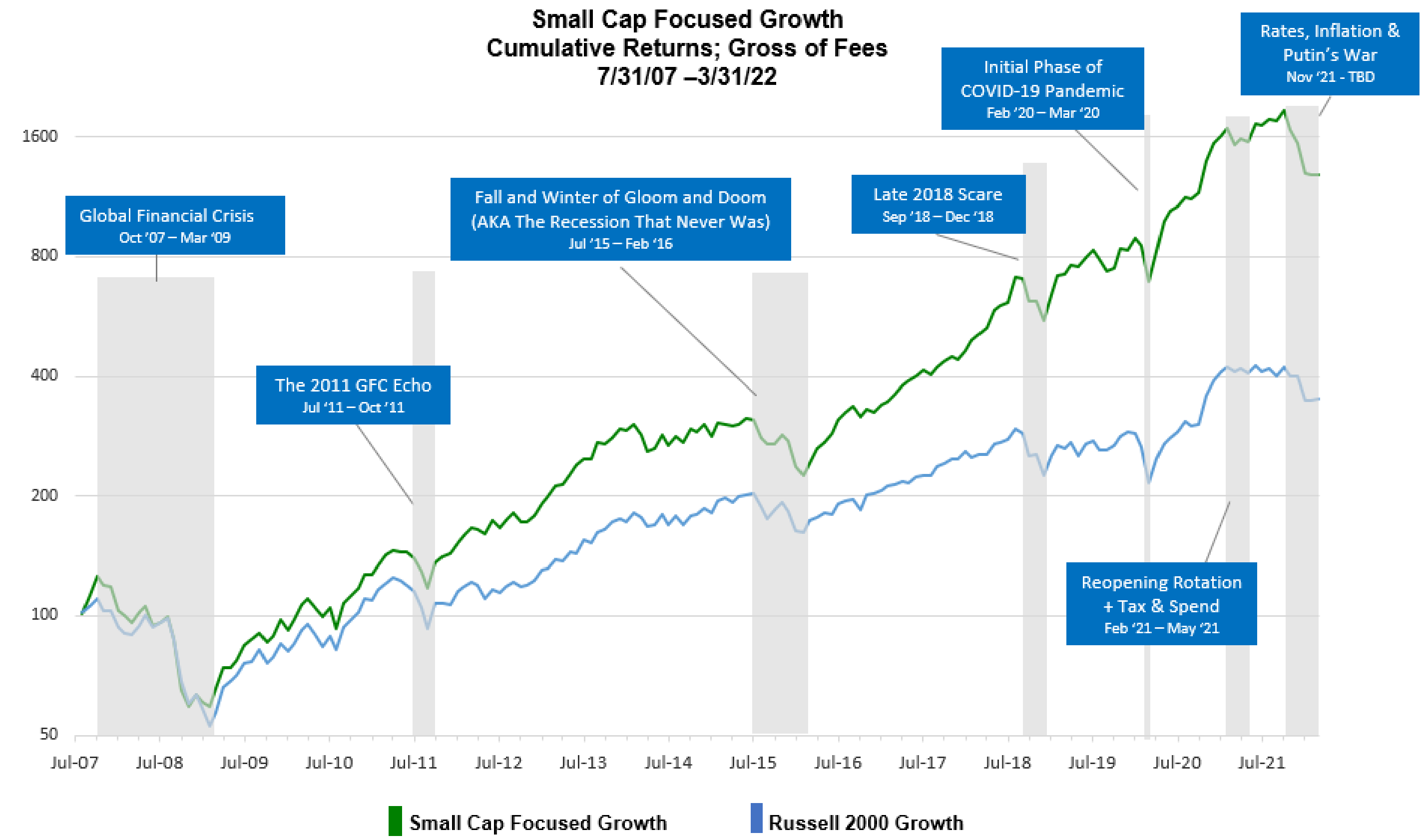
Russia's invasion of Ukraine and the death and destruction being brought on the people of Ukraine is horrible. I hope and fully expect that Putin and many of the others responsible will someday be brought to justice. In addition to the human suffering, the invasion eviscerated a sense of inherent stability the Western world has enjoyed and benefitted from during the 77 years since the end of World War II. And there is a risk that the war in Ukraine goes on for a long time, expands beyond the Ukrainian borders, and/or into a conflict involving chemical or nuclear weapons. These events have layered new uncertainties on top of an already uncertain world. Beyond the direct and indirect concerns surrounding Ukraine, the long list of additional concerns include: rising interest rates, inflation, tighter monetary policy, labor and supply chain shortages, and the risk of a recession. There are also many unknowns relating to Covid. We've never "come out of" a pandemic before. There is risk another variant could emerge.

Amidst all of this, it is not surprising that investors are demanding more return for taking risk. However, it feels worth taking a step back and reminding oneself of two things:

1. From a macro perspective, investors are generally very concerned about the above. Thus, stocks are down. The questions are: What will occur *relative to expectations* on these factors? Has the market effectively priced in these risks? Too much? Too little?
2. The Answers? No one knows. It is very difficult, if not impossible, to consistently add value from macro predictions because: a) such predictions are hard to get right; b) one is not just predicting on an absolute basis, but even more so, relative to unclear consensus expectations on all of the variables; and c) chain multiplying each of these predictions could result in a bad outcome even if one gets many or most of the macro predictions right. For example, sitting on the sidelines during the early part of the 2020 pandemic was in hindsight a great move. But then one had to have the foresight to begin buying in mid-March of 2020 when things looked and felt very scary. Similarly, selling out of the market in August 2008 just before the Global Financial Crisis no doubt would have felt great. But then buying at the bottom in March of 2009 would have been very hard.

As the graph below illustrates, there have been seven drawdowns of at least 20% since the inception of the Focused Growth strategy. Every one of these drawdowns is triggered by fears. And the odds of selling at the top and buying at the bottom each time are long.

Granahan Focused Growth: Largest Drawdowns Since Inception



Past performance is no guarantee of future results. This information is supplemental to the complete performance results and disclosures.
The SCFG Composite returns used are 7/31/07 – 3/31/22.

I can't predict whether the Ukraine war will last years, or if Putin will last into next week. Thankfully, sound investment policies don't rely on trying to consistently rotate in and out of the market, or in and out of asset classes. Instead, they depend on constructing and executing sound asset allocation policies. The Focused Growth investment philosophy does not rely on consistently making macro calls, but rather attempts to 1) identify superb companies which we believe can sustain solid secular growth for years to come, and 2) invest in those companies when the probability-weighted expected return and risk/reward are attractive. That is not to say that such companies and stocks are immune to macro factors, as the past five months have clearly demonstrated. However, I believe that over time there is a good chance that the inherent secular growth of these quality companies will lead to good investment returns.

This Too Shall Pass. Investing Like It's 2024…Because Before We Know It, It Will Be

While there are many macro factors that we can't consistently predict or control, one thing that is predictable, is that time will pass. The Focused Growth portfolio's most defining characteristic is that we are investing in companies we believe are well-positioned to sustain secular growth over the next 3, 5, 7 years. Thus, we are not dependent on guessing whether the market is going to favor growth or value in any given time frame. And while the companies in which we invest are not immune to macro forces, most of the factors that determine whether they achieve such secular growth are manageable. We are a little over one year from a time when investors will be focusing on 2024 earnings, and when I look at the probability-weighted expected returns of the companies in the Focused Growth portfolio on 2024 earnings, I believe they are quite attractive.

While the world has become more uncertain, it has also pretty quickly become less flat (to borrow a term from Thomas Friedman's landmark 2005 book *The World is Flat*). Leaning into this, we have investments in companies that stand to benefit from the shift from "just in time" inventory to "just in case" inventory. Companies such as Stratasys (SSYS - additive printing) and Kornit (KRNT- digital printing) which enable manufacturing flexibility as it relates to time, place, and customization. LoveSac's (LOVE) “Sac”tional couches are manufactured in a variety of locations and their modular and evergreen design, along with the fact that the fashion is in the cover (can be made on demand - I expect someday soon digitally printed perhaps on a Kornit printer), gives LoveSac an advantage over the couch competition.

At the same time, while higher interest rates are a threat to the economy and could hinder growth in many companies in which we are invested, there are others which have elements of their business models that are anti-fragile to higher rates. These include Health Equity (HQY - earns a float on custodial funds, see above), and Paycom and Paylocity (PAYC and PCTY - earn a float on overnight payroll funds).

Some Content Worth Reading, Listening To, or Watching

A Few Podcasts:

Vox's **Ezra Klein** has three excellent recent podcast interviews:

- Larry Summers - On the economic and geo-political outlook.
- Tim Snyder - On Putin's myths.
- Daniel Yergin - The preeminent oil expert on why Russia's oil influence may have peaked.

Against The Rules Season Three - Michael Lewis follows up his recent book The Premonition, with the third season of his terrific podcast series, this one focused on society's unsung and underappreciated “experts"

Two Entertaining TV Series Featuring the Rises and Falls of Two Imperfect Leaders:

- Super Pumped: The Battle for Uber – Features some great performances including Joseph Gordon-Levitt as Uber CEO Travis Kalanick, Kyle Chandler as famed venture capitalist Bill Gurley, and Uma Thurman as Arianna Huffington.
- WeCrashed - The Story of WeWork – Also some terrific performances including Jared Leto as WeWork CEO Adam Neumann and Anne Hathaway as Rebekah Newmann.

A Book:

- **The Stoic Challenge** by William B. Irvine. Serves as a good reminder to focus on things I can control during this time where so much is beyond it.

As always, on behalf of the entire team at Granahan Investment Management, thank you for entrusting us with the management of your capital. Please note that it is managed alongside our own. Enjoy your spring.

Sincerely,
Drew

Andrew L. Beja, CFA
dbeja@granahan.com