SMALL CAP ADVANTAGE

Portfolio Comments
March 31, 2022

Distinguishing Features

GIM builds the Small Cap Advantage portfolio from the bottom-up; sector weightings are secondary to stock selection. As of March 31, 2022, the Small Cap Advantage portfolio maintained a significant overweight in Technology. The portfolio is also overweight versus its Russell 2000 Growth benchmark in Health Care, Real Estate, and Consumer Discretionary. We are equal weight in Utilities, and underweight the benchmark in all other sectors, with Industrials our largest underweighting. The portfolio has no exposure to Telecommunications and Consumer Staples.

Commentary

Market Environment

A tightening yield curve, spikes in oil prices, and inflation running at its highest level in 40 years have some worried we could be entering a period of stagflation. Other observers have pointed to the fact that higher oil prices and inverted yield curves have often preceded recessions. In fact, higher oil prices in 1987, 1996, 2011 or 2018 did not spark a recession, and in many cases a recession did not follow an inverted yield curve. Monetary policy is still eased, which could allow the economy to absorb some of the pain that comes from higher oil prices. Possibly one of the largest negatives today is the Ukrainian war. We've seen the short-term impact on oil supplies and pricing, but we can't predict the longer-term implications.

Despite the litany of negative factors underpinning the economy, growth has been strong in the US, although it is beginning to weaken. As of March 21st, nominal retail sales were up 18%, and bank loans were taking off as people hurried to take advantage of low interest rates before the hike. There is $2 trillion in consumer excess savings from staying home during the pandemic. Unemployment claims are at an all-time low. We'll have to wait and see which macro factors have the greatest impact on future results.

Performance Discussion

The Granahan Small Cap Advantage strategy returned -16.78% in the first quarter, behind the -12.63% return of its Russell 2000 Growth benchmark.

Negative selection in Industrials drove the underperformance for the quarter. Selection was also negative in Consumer Discretionary, Health Care, Consumer Discretionary, Technology, and Energy. Our underweighting in Energy also weighed on performance. Selection in Financials was the largest contributor to relative performance during the period.

With respect to LifeCycles, the Special Situation category nicely outperformed the benchmark, while Core Growth and Pioneers significantly underperformed during the quarter.

The largest detractors during the quarter were Core Growth companies **Kornit** (Industrials), **Etsy** (Consumer Discretionary) and **NeoGenomics** (Health Care). Pioneers **Flexion** (Health Care) and **Enovix** (Technology) round out the bottom five.

On the positive side, the largest contributors to the strategy were Pioneer holdings **Zeta Global** (Technology) and **Biocryst Pharmaceuticals** (Health Care), Core Growth names **HealthEquity (**Health Care) and **Enphase Energy** (Technology), and Special Situation **Evolent Health** (Health Care).

Outlook

Furey Research examined what worked the last time the U.S. went through a protracted stagflation (1974-1982) when inflation ran at nearly 9% per year while GDP grew at only 2% per year. The good news is that small-cap managers, both growth and value, were among the top performers. Furey has also done work that shows small cap companies usually outperforming large caps during rising bond yield environments. (Furey March 9, 2022) Technically, the Russell 2000 Growth Index has experienced a bear market, as the low of March 11, 2022 marked a 31.1% decline from November 8, 2021. All the gathering dark clouds surrounding macroeconomic change have caused investors to re-evaluate their stock ownership. Investors haven't had to contend with high inflation in decades, and a war in Europe has only added to uncertainty.

What we do know right now is that valuations for companies in our portfolio have come down significantly since the November 8th high in the Russell 2000 Growth Index. Evercore ISI Research has postulated that the stage is possibly set for small cap outperformance because of "attractive valuation with the next twelve-month P/Es now below average in a market still generally expensive." (Evercore 3/7/22) Earnings growth rates have come down slightly in many of our companies as they have decided to spend more on future growth while they too are experiencing higher prices in labor and materials. Companies with strong competitive positions are able to pass along higher prices, but of course, there is a lag.

We remain patient, strategic growth investors focused on our process with the goal of providing long-term outperformance for our clients.