SMID CAP SELECT

Portfolio Comments
March 31, 2022

Distinguishing Features

GIM builds the SMID Cap Select portfolio from the bottom-up; sector weightings are secondary to stock selection. At quarter-end, the SMID Cap Select portfolio maintained a significant overweight versus the Russell 2500 Growth Index in Information Technology and Communication Services. We are equal weight to the benchmark in Consumer Staples, and Industrials. We are underweight the benchmark in all other sectors, with Materials being our largest underweighting. The portfolio has no exposure to Utilities and Energy.

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

The first quarter of 2022 was another remarkable period where high-growth companies were penalized by the market. The Granahan SMID Cap Select strategy returned -14.12% in Q1, behind the -12.31% return of its Russell 2500 Growth benchmark. Higher interest rates and inflation resulted in a collapse in multiples, causing major changes in the prices of many of our secular, high growth companies. **Kornit** in Industrials was the poster child here, causing this sector to fare poorly in stock selection. The soaring of oil prices caused by the war in Ukraine put our underweight in Energy and Materials under pressure, and we saw long suffering energy stocks surge. Selection in Communication Services and Information Technology was negative, though our overweighting of these two sectors acted as an offset. Financials were neutral to performance. Selection in Consumer Discretionary, Healthcare and Consumer Staples were the strength in the portfolio this quarter.

The largest detractors during the quarter were Core Growth names **Kornit** (Industrials) and **Digital Turbine** (Information Technology). Three Pioneers round out the bottom five: **Magnite** (Communication Services), **Porch Group** (Information Technology), **and Veracyte** (Health Care).

On the positive side, the largest contributor for the second quarter in a row was Core Growth name **Enphase Energy** (Technology). Two other Core Growth holdings were also in the top five: **Chegg** (Consumer Discretionary) and **Ameresco** (Industrials). Special Situation holdings **Evolent Health** (Health Care) and **Chart Industries** (Industrials) finish out the top five.

Positioning

We are working our Core

While valuations and investors' appetite for long duration assets decreased, inflation and interest rates rose. Looking at our companies through the lens of Life Cycles, we saw our Special Situation holdings, which were up for the quarter, dramatically outperform our Core Growth stocks, which in turn dramatically outperformed our Pioneer stocks, which ended down a significant amount. Unfortunately, we don't have a crystal ball to know when this will reverse. The effects of Russia's invasion into Ukraine accelerated inflation and fear.

As we always point out, our portfolios are structured consistently with a view as to where the best risk/reward dynamics are from the bottom up. Today, we are seeing the best opportunities to add alpha in our Core Growth stocks. We have essentially been selling our lowest valuation Special Situation stocks and our money losing Pioneer companies to purchase more shares in the Core Growth companies that have both strong growth and strong earnings. Why are we doing this?

Special Situations to Core Growth

As many of our Core Growth stocks have gone down significantly in the last year, we have seen a lot of our favorite long-term growth companies go from high multiple valuations to much more reasonable valuations. Many of our holdings that had strong relative valuation arguments, now also have strong absolute valuation arguments. In tandem, our lower valuation Special Situation stocks have had fairly consistent valuations; stock price increases have coincided with earnings increases. The net effect of these two dynamics is that the valuation gap between our faster, long-term, Core Growth companies and our slower, long-term, Special Situations growth companies has contracted significantly. Because of this, we see a much stronger risk/reward profile of the higher growth, Core Growth names. For example, we have been selling our local TV Broadcaster, Gray Television, to purchase more of one of our favorite stocks, Digital Turbine, which is a digital advertising company and is now trading at a mid-teens EV/EBITDA ratio, despite being one of our fastest growing companies with a strong outlook for growth.

Pioneer to Core Growth

We feel that by owning more of our Core Growth stocks, we are positioned to own those tennis balls that bounce strongly when the market does bottom. Furthermore, we feel that the risks for underperformance are diminished as these companies have real valuation support from an earnings perspective, as long as we don't enter into a major profit recession. While Pioneer stocks could offer even more meaningful upside to an improvement in risk appetite, we feel that the risks involved in these companies have increased significantly. This is because many of our Pioneer companies are burning significant amounts of cash. The fact that their stock price is down, could significantly increase the cost of capital of the company and potentially force the company to dilute existing shareholders to improve their balance sheet as the cash reserves decline. As such, while the reward potential of our Pioneers has grown, the risks of owning them has also grown and the company cannot fall back on earnings as a floor on valuation.

Outlook

While some of our repositioning has been rewarded recently (i.e., increasing our weight in **Enphase Energy**), we are still waiting for the environment to change for the better in order to really see the benefits of our focus on our Core. 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 2021. 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.

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