FOCUSED GROWTH

Portfolio Comments
June 30, 2022

A Brutal Quarter

The GIM Focused Growth portfolio fell -28.0% in Q2, lagging the -19.3% drop in the Russell 2000 Growth benchmark. Brutal. The portfolio's shortfall relative to the benchmark was roughly equally attributable to poor stock selection (427 basis points) and allocation (432 basis points - i.e., higher weights in poorer performing sectors most notably Technology and Consumer Discretionary).

There is a wide range of factors conspiring as headwinds to Focused Growth's investment footprint. And while much of the quarter (and YTD) performance challenges can be attributed to these factors - which could be viewed as inherent in the high secular growth territory - there have also been self-inflicted wounds. In particular, I'm self-critical of the large positions we owned in Kornit (KRNT) and Etsy (ETSY). While I have high conviction both companies remain "desert-island worthy," it is now clear that each benefitted more significantly from pandemic tailwinds in 2020 and 2021 than I previously appreciated. Earnings estimates for both companies have been cut (significantly in the case of Kornit, less so in the case of Etsy), and valuation multiples have contracted meaningfully. Because these two were large positions, together they accounted for 344 basis points of negative impact in the quarter. More on these and the other large individual stock contributors below:

The Three Largest Relative Detractors in Q2 Were:

- **Kornit** (KRNT) - Kornit is playing a leading role in digitizing and disrupting the traditional textile and apparel printing sectors. The stock fell 62% in Q2 (impacting performance by -212 basis points). The company's business was very strong in 2020 and 2021, and it has become apparent that Kornit benefitted from pandemic tailwinds more than we realized. As a result, several of the company's customers have cut back or pushed off orders of both new machines and ink. We believe the company remains well-positioned to capture a large share of a growing market, and we maintain a mid-sized position in the stock.

- **Zeta Global Holdings Inc.** (ZETA) - 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. Despite strong operating results, ZETA shares fell 65% in Q2 (impacting performance by -181 basis points) as investors fear a slowdown in advertising may impact H2 and 2023 results, and an unusually large slew of insider stock became available for sale. We are maintaining a mid-sized position in the shares.

- **Etsy** (ETSY) - Etsy operates a global online marketplace connecting sellers and consumers of unique and creative goods. ETSY shares fell 41% in Q2, impacting performance by -132 basis points. The company reported decent Q1 results but guided for lower than consensus for Q2. While it was apparent that Etsy's strong 2020 and 2021 results benefitted materially from pandemic-related trends, and Etsy is doing a very impressive job retaining the large number of new customers earned during that period, the headwinds facing the company as the world re-opens are fierce. This has led to earnings estimate cuts for 2022 and 2023 (mid-teens reductions), but even more so, a large contraction in the company's valuation multiple. We are maintaining a large position in ETSY shares, 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.

The Three Largest Relative Contributors in Q2 Were:

- **Enphase** (ENPH) - Enphase is a leading provider of complete solar systems primarily for the residential power market. Even though ENPH shares fell -3% in Q2, it was a positive contributor of 68 basis points to relative performance due to the significant drop in the benchmark and our large weight in the stock. We believe Enphase's prospects are excellent and that the company is navigating tricky supply constraints in the current environment. We continue to hold a large position in ENPH shares.

- **CoStar Group** (CSGP) - CoStar Group has three broad operating segments: 1) Commercial Real Estate Information Services (CRE); 2) Multi-Family Residential Services (MFR - the most recognizable being the Apartments.com website); 3) A newer entry into Single Family Residential real estate (SFR) under the Homes.com umbrella site. Similar to ENPH, our holding in CSGP shares was a positive contributor of 64 basis points in Q2 despite the stock falling 9% in the quarter, as the benchmark was down materially more than this. We believe CoStar's two core businesses (CRE and MFR) have very solid prospects for sustainable growth in revenue and cash flows. Meanwhile, CoStar is investing heavily in its residential initiative, which is negatively impacting operating earnings by over $200 million in 2022 and will likely do so again in 2023. However, we believe this is a win/win. On the one hand we like CoStar's approach and odds of winning a large piece of the residential market, which could yield significant future earnings and cash flow. On the other hand, we believe that if after two or three years the company is not meeting its objectives in the residential business it would exit that business--and the $200+ million "drain" on cash flow would disappear. Net, we hold a large position in CSGP shares.

- **Datto, Inc.** (MSP) - Datto is a leading platform used by managed services providers to take care of IT needs for small-medium sized businesses. MSP shares rose 30% contributing 59 basis points in Q2 as the company agreed to be acquired by the private equity firm Kaseya. We eliminated our investment in the company as the deal's closing date approached.

These Are the Times That Try Growth Investors' Souls

Interest rates are up dramatically. Since September 2021, 30 Year fixed mortgage rates have almost doubled from 2.9% to 5.7% (source [Mortgage News Daily]), while yields on the two-year constant maturity US Treasuries are up from 0.20% to 3.07% (Bloomberg). Higher interest rates leave investors discounting earnings at a higher rate. If all else were equal, such a big move in rates would be a fierce head wind for secular growth stocks, which investors value based on future earnings. But of course, all else is not equal. Inflation is also up, the Federal Reserve is tightening, and war rages in Ukraine. And, although the U.S. economy has thus far demonstrated resilience to these challenges, the odds of a recession have risen. In fact, many investors are all but certain a recession is coming, if not here already. At a recent conference in Boston, JP Morgan CEO Jamie Dimon stated that his best prediction was that there are about equal one-third odds that the U.S. will: a) avoid a recession; b) experience a narrow recession; c) have a deeper recession. The net result is that the investor sentiment pendulum has swung heavily from greed to fear over the past nine months, and investors have fled asset classes, sectors, and stocks perceived to be riskier and/or longer duration.

Here We Are, Uncertainties Abound. What Are We Doing?

While I've said many times, "I don't have a crystal ball," our baseline assumption is that the odds of a recession or slowdown have gone up, which we incorporate into our bottom-up scenario and valuation analysis. As a reminder, our process seeks to identify desert island worthy companies--those we believe are likely to grow to be much larger over the next five to seven years. We then seek to own stock in such companies when the risk/reward and probability-weighted expected returns are attractive.

Today we have on the one hand higher rates and a cloudier macro view, but on the other hand, a significant contraction in valuations. Where does this net out? All things considered I believe that the forward probability-weighted expected returns for the Focused Growth portfolio appear quite attractive. That is not to say stocks can't go lower. Of course, they can. There is no way to know when sentiment will shift from negative to neutral or positive. Finally, as always, I encourage investors to review and adhere to their asset allocation plans.

Update on Diversity, Equity, and Inclusion

Two years ago, in my Q2 2020 letter, I discussed Wall Street's too white, too male problem. I wrote about it being a "top of the funnel" challenge which led to too few analysts, portfolio managers, and asset management executives being female and/or people of color. In August of 2020, we were co-founders of the Wall Street Diversity Accelerator (WSDA) internship program. The goal was to bring more diverse people into the funnel by introducing rising college sophomores and juniors to the asset management industry. That first summer, we had 7 interns and 5 firms participated. It went well, and we got positive feedback from both the interns and the firms. So, we expanded in the summer of 2021, with 15 interns working at 10 firms. Again, the feedback was positive, and we just completed the 2022 WSDA program with 26 interns and 20 asset management or registered investment advisor (RIA) firms participating. Beyond the successful WSDA internships, we are seeing concrete positive results. Many of the interns from 2020 and 2021 are getting terrific jobs/internships at firms ranging from JP Morgan to Morgan Stanley to Vista Equity Partners. While we still have a long, long way to go, I'm pleased to report that we and many others in our industry are beginning to make a slight dent in improving diversity in the investment business. I'll keep you posted.

Three Books Worthy of Reading and a Terrific TV Series

- Freezing Order, Bill Browder. In a follow-up to his NY Times Best Seller Red Notice, former hedge-fund manager Bill Browder exposes Russian President Vladamir Putin's theft of hundreds of billions of dollars and the extreme and deadly actions Putin has taken to hide his tracks. Along the way, Browder details many related parts of the journey including passage of the Magnitsky Act in the U.S. and 27 other countries, which has been used to sanction and freeze assets of human rights offenders around the world.
- The Power Law, Sebastian Mallaby. A good, not great, book detailing the history of venture capital in the Silicon Valley. I'm glad I read it as it gave me more granularity on some of the major and minor VC players over the years. The best part is Mallaby's summary and series of specific recommendations for oversight at the conclusion of the book.
- Those We Throw Away are Diamonds, Mondian Dogon, Jenna Krajeski. The autobiography of Dogon's harrowing, compelling, and inspiring journey as a refugee from the Democratic Republic of Congo to deadly refugee camps in Rwanda, and ultimately to attain a Master's at NYU.
- Gaslit, TV Series on Starz or Hulu. Exceptional performances by Julia Roberts (Martha Mitchell) and Sean Penn (John Mitchell) and others, in a captivating and head-shaking storyline which gives us an angle on the Watergate scandal you probably didn't know.

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.

Turbulent times and markets aside, I hope you are having an enjoyable summer.

Sincerely,

Drew

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