SMALL CAP ADVANTAGE

Portfolio Comments
June 30, 2022

Distinguishing Features

GIM builds the Small Cap Advantage portfolio from the bottom-up; sector weightings are secondary to stock selection. As of June 30, 2022, the Small Cap Advantage portfolio was overweight in Technology and Health Care. The portfolio is also overweight versus its Russell 2000 Growth benchmark Real Estate. We are equal weight in Financials, Consumer Discretionary and Utilities, and underweight the benchmark in all other sectors. The portfolio has no exposure to Telecommunications or Consumer Staples.

Commentary

Market Environment

Everything we read today talks about record breaking negative macro-economic indicators, or at least things we haven't seen in 40 or 50 years. When the Chairman of the Federal Reserve stated that "there's no guarantee of a benign outcome" referring to tightening and the possibility of creating a deep recession, markets declined sharply. The Fed hiked interest rates by 50 basis points in May and 75 basis points in June, which was its largest single hike since 1994 - the only other year in 50 years where, like 2022, both stocks and bonds delivered historically low first half returns. Small business sentiment is the lowest in 48 years and consumer sentiment is close to its all-time low of 1991. While the news is not good with a war, high inflation, higher interest rates, a strong dollar and negative GDP growth, we should remember that the stock market is a leading indicator. The small cap growth market has been declining since May of 2021, forecasting the negative macro-economic news and the resultant pressure on earnings growth rates. If GDP growth is as negative this quarter as it was last quarter, we will technically already be in a recession - an odd recession though, as the unemployment rate is still quite low at 3.6%.

Performance Discussion

The Granahan Small Cap Advantage strategy returned -27.0% in the second quarter, behind the -19.3% return of its Russell 2000 Growth benchmark.

Negative selection in Industrials drove the underperformance for the quarter. Selection was negative in all sectors this quarter with the exception of Materials. Our underweight in Consumer Staples also weighed on performance.

With respect to LifeCycles, Core Growth, Special Situation, and Pioneer all underperformed this quarter.

The largest detractors during the quarter were Core Growth companies **Kornit** (Industrials), **Etsy** (Consumer Discretionary) and **Axon** (Industrials). Pioneers **Zeta Global** (Financial) and **Porch Group** (Financials) round out the bottom five.

On the positive side, the largest contributors to the strategy were Core Growth names **CoStar** (Real Estate), **Enphase Energy** (Energy), **Datto** (Technology), **OSI Systems** (Industrials), and Pioneer name **908 Devices** (Health Care).

Outlook

The current small-cap bear market has coincided with a period of solid company fundamentals and growing profits. Small-cap growth profits grew significantly over the last twelve-month period in which the small-cap growth index fell 33%. This divergence has led to a significant reduction in small-cap valuations. The market is forecasting a slowdown in revenue and earnings growth for the next several years, but even cutting growth rates significantly from the 66% we have seen over the last year to 20%, valuations look extremely interesting. The Russell 2000 Growth Index now has a lowered average PE on the next twelve months earnings estimates of 17.5x, down from its 32.5x valuation a year ago. We are adding to stocks in the portfolio that have no need for a lift in valuation, as the compounding of their earnings growth should bring positive results to their stock prices. The risk, of course, is that we could be wrong on our earnings estimates.

At the forefront of many investors' minds are questions concerning inflation, Fed policies, recession and when the market will recover. Based on our decades of investment experience, a market low is impossible to predict, and frankly, trying to answer these questions may be counterproductive. What we do know is that returns from bear market bottoms have been exceptionally strong historically, and it's not uncommon for the market's best days to soon follow the worst. Our focus is on talking with the management teams at our companies to ensure they have strong secular growth prospects.

As always, we appreciate and thank you for trusting Granahan with the management of your capital.