SMALL CAP CORE GROWTH

Portfolio Comments
June 30, 2022

The second quarter of 2022 was riddled with negative macroeconomic news, including very high inflation readings and projections of a recession, which sparked a broad selloff across all markets. The Russell 2000 Growth Index was down 19.3% for the quarter ending June 30, 2022, and the GIM Small Cap Core Growth strategy fared worse at down 24.2%. For the first 6-month period of the year, the Russell 2000 growth index posted its worst first half on record at down 29.5% and the GIM portfolio was down 34.8%.

Our largest detractor this quarter was **Kornit** (Core Growth, Industrial), a provider of innovative digital printing solutions for the global print textile industry. Kornit aims to revolutionize the industry by facilitating the transition from analog textile printing processes to digital methods of production. Long term secular trends (particularly around eliminating water pollution), new product introductions, and a scaled digital presence is expected to fuel their $1B revenue target and operating margin leverage. While we have seen multiple contraction, margin headwinds and some e-commerce slowdowns weighing on the stock short-term, we are adding to the position size on weakness. **Digital Turbine** (Core Growth, Technology) has been hurt by slowed advertising in Europe. Their Ignite software connects brands with their target audiences and is a beneficiary of recent privacy initiatives announced by Apple and Google. We are holding, as valuation is very compelling and the FCF yield is 9.8%. **Edgio** (Special Situation, Technology), formerly Limelight, is undergoing a transformative combination with EdgeCast. The deal doubles the size of the company, increases scale, and improves diversification and overall profitability. The stock was under pressure ahead of the deal closure due to the loss of an EdgeCast customer. While this loss created short-term revenue headwinds, its EBITDA estimates remain intact with greater cost synergies and overall positive economics. We added to the position on weakness given the strong outlook for the combined company. **Thredup** (Pioneer, Consumer Discretionary) reduced 2022 revenue guidance based on consumer spending weakness. We believe the company has created a significant competitive moat by making early investments into proprietary processing and distribution networks. Their new Dallas facility increases total capacity to nearly 17 million items, a 150% boost from its current capabilities. Management expects its current cash balance of nearly $185 million to be plenty as they forecast a declining cash burn. We are adding to the position. **Castle Biosciences** (Pioneer, Healthcare) is a leading diagnostic company focused on transforming disease management through its advanced tests which focus on several types of skin cancer and Barrett's esophagus. We believe the company has executed exceptionally well during the pandemic despite disruptions in dermatology practices. The stock came under severe pressure after acquiring a testing company in the mental health market, and a large shareholder telegraphed selling their position on that news. We used the weakness to add to our position given its very attractive valuation and compelling multi-year growth outlook. The acquisition, in our opinion, adds a new growth opportunity where CSTL can provide advanced tests to help transform treatment for mental health patients.

Strength in the portfolio came from two core growth alternative energy companies (that are categorized as technology companies in GICs): **Array Technologies** and **Enphase**. The U.S. federal government has decided to temporarily lift tariffs on solar panels, removing a significant headwind for the solar industry. We added to Array on weakness and have been trimming our large position in Enphase on the strength. **James River** (Core Growth, Financial) is focused on the excess and surplus (E&S) subset of the property and casualty (P&C) insurance market. The industry continues to be very strong as larger competitors exit and overall business fundamentals remain robust. James River has disposed of non-core businesses and is now focused on the highly attractive E&S market. The stock trades at a compelling valuation relative to peers, and we expect quarterly financial reports to serve as catalysts for the stock. We are holding the stock. **908 Devices** (Pioneer, Healthcare) is a disruptive life sciences company focused

on mass spectrometry that is used for chemical analysis. There is excitement from investors as the company addresses two significant opportunities. The company's handheld device is showing strong adoption to help combat the opioid crisis. There are also early signs of traction with the company's desktop device with large biotech and pharmaceutical companies for drug development and manufacturing. Given our increased confidence in the long-term growth potential for the company, we have added to our position. **Chart Industries** (Special Situation, Industrials) manufactures highly engineered equipment used in the production and storage of hydrocarbons an industrial gas. With the surge in demand for liquefied natural gas (LNG) and hydrogen, Chart is in position to benefit from the energy transitions going on around the world. We have trimmed some on strength.

Detractors for the six months include Kornit, Digital Turbine, thredup, **Porch Group** (pioneer, consumer discretionary) and **Quanterix** (pioneer, healthcare). Positives for the year-to-date include **Evolent** (special situation, healthcare), Enphase, Chart Industries, **Texas Capital Bank** (core growth, financial) and **Euronet** (core growth, financial).

Attribution

Our overweight in Information Technology and Healthcare were the biggest allocation effect penalties in Q2. Stock selection, where we are overweight growth, was the largest penalty. In reality, there was nowhere to hide this quarter. Selection was a negative across all sectors, with the exception of Materials, where we eked out a gain relative to the index. The six-month attribution is similar, with Financials acting as the only positive relative to the Russell 2000 growth Index.

In terms of LifeCycles, Core Growth companies have turned in the worst performance for both the quarter and year-to-date because of the downdraft in Kornit and Digital Turbine. Pioneers are improving as the biotech industry starts to recover somewhat, and Special Situations have performed the strongest, with particular strength coming from our semiconductor holdings.

Weights

The annual refresh of the Russell 2000 Growth Index in June decreased the benchmark's Healthcare weight from 29% to 22%. Prior to the rebalance, our weighting was in line with the index, however we are now 10% overweight, with 32% of the strategy allocated to the Healthcare sector. We are overweight Technology as well. We see significant valuation compression in companies with secular growth tailwinds that bode well for future earnings. Our alternative energy companies are labelled as Technology names, so optically, we are underweight the index in Energy by 6%. Consumer Discretionary is down 3% from last quarter, and our weighting has declined by 1% making for a 5.5% underweight versus the Index. We are also underweight Industrials, Materials, Real Estate and Consumer Staples.

LifeCycle weightings are similar to last quarter, with Pioneers at 31%, Core Growth up +1% to 49%, and Special Situations down -1% to 18%.

Themes

Jonthan Lejuez, managing director from D.A. Davidson's technology group asserted, "at the highest level, organizations of all shapes and sizes are having to expand and modernize their IT footprint –simultaneously, at speed, and all without disrupting overall experience. The pace of investment and innovation to meet such demands makes IT transformation a continuous process inside an organization rather than a 'project'. And the resulting complexity is simply tremendous. It requires the most advanced management and automation capabilities while constantly optimizing security posture to ensure there is sufficient protection from the newest and/or most sophisticated threats to those IT estates, wherever they reside." We have many companies in the portfolio that benefit from these tailwinds. In security, we own **Qualys**, **Rapid7**, **Cyberark** and **Radware**. In IT services we own **Grid Dynamics**, **Globant** and **Perficient**.

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*). 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) 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 design is evergreen. Additionally, the furniture's fashion is in the cover, which can be made on demand. We anticipate someday soon this will be digitally printed (perhaps on a Kornit printer), giving LoveSac an advantage over the couch competition.

It's worth noting that the biotech index (XBI) appreciated nearly 700% from February 2011 through its peak in February 2021. Biotech was on a tear as we entered COVID-19, and we saw record numbers of biotech startups going public during 2020 and 2021 - this included early-stage companies that did not have a drug ready to test in clinical trials. That used to be taboo. Until about a year ago, raising money through the stock market was easy for biotech companies. Now, the XBI index is down nearly 60%. Small-cap biotech and life science companies have been hit even harder than their larger brethren. Given our mandate for investing in growth and innovation, recent performance has suffered. As of the end of Q2, more than half of the names in the biotech sector are trading below $100M enterprise value, and nearly one-third are selling at less cash than is on their balance sheet. We continue to adhere to our processes with a bias towards biotech companies with good science platforms. We look for companies developing drugs, tests and treatments designed to treat unmet medical needs. We are sensitive to near-term balance sheet issues given the macro backdrop, but we believe there are stocks poised for dramatic upside on positive news. While we can't call a bottom, we do believe strongly that the risks to small cap growth companies are being recognized more than the opportunities, which is a major reversal from the past few years.

Macro 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%.

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.

Jane White
CEO, Co-Founder