



## SMID CAP SELECT

### Portfolio Comments

June 30, 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 and Consumer Discretionary being our largest underweights. The portfolio has no exposure to Utilities and Energy.

#### 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

It was another very tough quarter for performance in the strategy. Our Special Situation stocks were by far our best, with Pioneers next and soundly outperforming Core Growth. In hindsight, we were too early in moving some of our Special Situation weight back into Core Growth, but we are steadfast in our belief that this will be rewarded in the long-term. The Granahan SMID Cap Select strategy returned -29.4% in Q2, behind the -19.6% 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.

The largest detractors during the quarter were Core Growth names **Digital Turbine** (Information Technology), **Kornit** (Industrials), **Chegg** (Consumer Discretionary), and **Lending Tree** (Financials) and Pioneer **Magnite** (Communication Services).

On the positive side, the largest contributors for the second quarter were Core Growth names Array Technologies (Technology), **Enphase Energy** (Technology) and Vita Coco (Consumer Staples). Special Situation holdings **Evolent Health** (Health Care) and **Chart Industries** (Industrials) finish out the top five, for the second quarter in a row.

##### Positioning

Historically, we have seen faster growing companies command higher valuations than lower growth companies, but in today's market, that's not consistently been the case. It's hard to gauge whether we could already be in a recession today, or whether we are just in the early stages of peak inflation. While wages and rents continue to rise, it appears that physical goods prices began coming down across the board during most of Q2. We think this bodes well for lower



inflation rates eventually. While it is likely that some earnings expectations still need to move lower from here, it is possible that the market may be already discounting a recession.

As we have said before, we do not have a crystal ball in terms of when the recovery will occur. Instead, we are remaining vigilant in our quest for finding stocks with the best risk/reward dynamics over the medium to long-term. Ultimately, we believe that growth rates will normalize, and inflation rates will come back down. This tends to favor growth stocks, especially the ones that can continue to grow faster than GDP and help their clients lower costs and improve productivity. Many of the negative macroeconomic dynamics we are grappling with today are not sustainable and the portfolio is positioned to capitalize from improving earnings in companies that should have very strong long-term secular growth ahead.

**Porch** (Pioneer, Technology) has 25% of its business tied to housing transactions and its stock is down over 80% year to date. We believe Porch can grow its revenues at a 20% plus CAGR for the next five years and we have added to our position. **Vita Coco** (Core Growth, Consumer Staples) became victim to high shipping prices, yet still has been an outperformer year to date. We are seeing it trade at a massive discount to traditional valuations for other Consumer Staples companies growing revenues at a similar 15% rate. Combined, we have two great growth companies whose prospects over the longer term should be much better than they are today while still exhibiting great growth and taking market share. While we clearly did not have this right in the portfolio last quarter, we feel good about our companies' fundamentals. Porch and Vita Coco are good examples of why.

## **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 will the market 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.

### Disclosure:

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