CITYWIRE SELECTOR

CITYWIRESELECTOR.COM
APRIL 2020 • ISSUE 103

Profiles : **Star Manager**

STAR MANAGER STATS

COMPANY
Granahan Investment Management

SECTOR
Equity – US Small and Medium Companies

FUND
Granahan US Focused Growth

STYLE
Focusing on long-term, buy-and-hold opportunities among US small- and mid-cap stocks showing a competitive edge

Disciplined yet highly flexible, this fund manager's dynamic approach to markets has given him a consistent edge. Granahan IM's small-cap specialist talks desert islands, ditching sector categories and resisting temptation. **Sam Simmons** reports

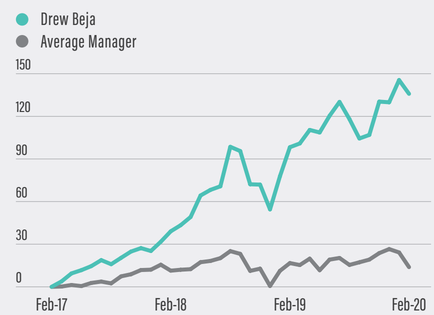
Maintaining a Citywire AAA rating for 21 months in a row is no easy task. Add the volatility in 2019 and the global pandemic this year into the mix and the achievement is doubly impressive. Drew Beja's 35 years' experience may have something to do with it. Granahan Investment Management's US small- and medium-cap specialist has run the group's US Focused Growth strategy for the past 13 years, but how has he kept up his success in more recent times, particularly since he started running the Ucits version, launched in 2014?

DESERT ISLAND DYNAMICS

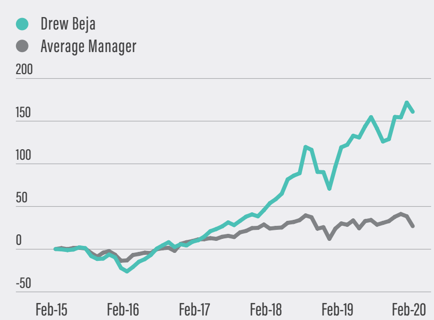
Beja outlines one key factor in his investment strategy: 'We are looking for "desert island-worthy" companies, meaning, if you stayed on a desert island for five to seven years, these companies would have become much more valuable by the time you returned. Another way to think of it is these businesses are on the right side of disruptive change. Most companies are on the wrong side and are swimming against the tide. We are interested exclusively in companies that are riding that wave.'

But surfing these trends is easier said than done. How does Beja identify likely contenders? 'We separate companies from stocks and analyse the two separately. In looking for a desert island company, we are exclusively looking at the business' prospects versus those of its stock. We then marry the company analysis with the securities analysis. This is where the stock's valuation comes into play, and for us specifically, our probability-weighted expected return analysis. This then becomes an important component in whether the stock merits a place in our portfolio, and if so, at what weight,' he says.

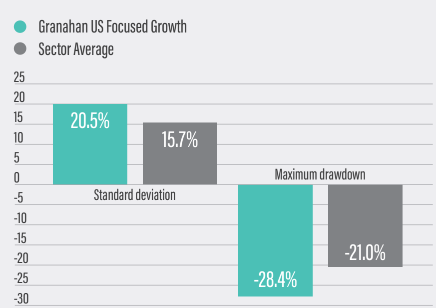
Beja is way ahead of his average peer over three years...



... and the gap is equally impressive over five years

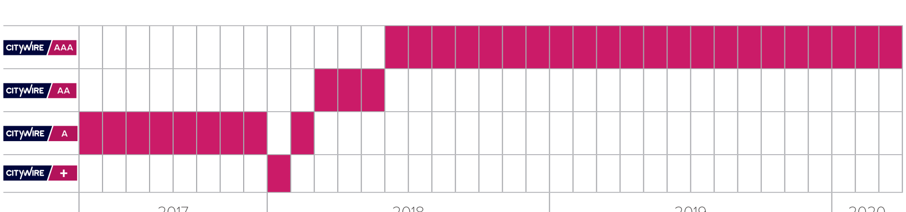


Beja has taken more risk over five years than the sector average



SOURCE: (all graphs) Citywire Discovery/Eikon

Beja has proved to be shrewd and resilient under the toughest conditions



SOURCE: Citywire Discovery

His approach has certainly paid off. Over three and five years his Granahan US Focused Growth fund has returned 139% and 164% respectively vs 14% and 27% from his average peer, as the graphs show.

Beja is aware, however, that his strong returns don't make him infallible.

'We run a focused, high-conviction portfolio. The majority of our outperformance in 2019 resulted from strong stock selection. I would like to say that our selection works every day of every year, but of course that is not the case.'

OUTDATED SECTOR CATEGORIES

Beja does not support the use of sector categorisation. He believes the lines are blurred and companies often fit into more than one sector.

'We don't see sector categorisation as the critical determinant of risk. That's a narrow and, in many ways, outdated way to look at risk, and can give an investor a false sense of security. After all, is Amazon a tech company, a consumer products company or a food retailer? What we focus on is how different companies' fundamental factors might be correlated, or inversely correlated, with one another.'

Correlated risk is a measurement Beja has used for his entire investing career.

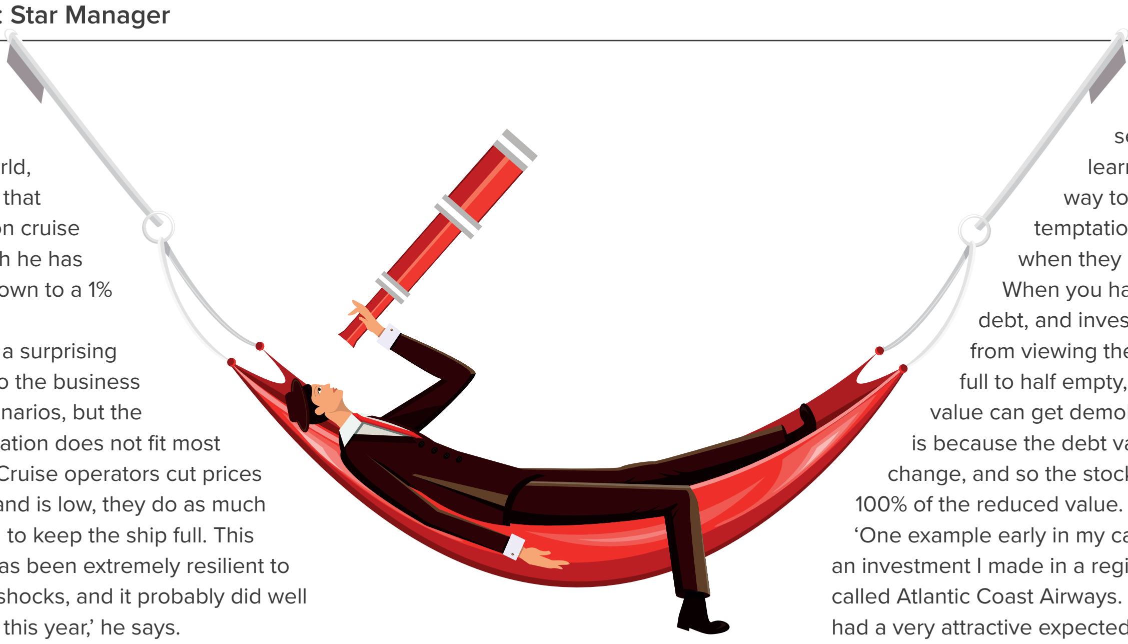
'Twenty years ago you might have invested in a diverse set of 'bricks and mortar' businesses, say a bank, a hospital, and a retailer. You might have felt that the only correlated risk was that these companies delivered services in bricks and mortar buildings. And unless bricks and mortar cause cancer, you've got no correlated risk. Today we've got online businesses in each of these vertical markets, such as Q2 in online banking, Teledoc in medicine, and Etsy in retailing.

'These companies have large, open-ended opportunities with the same lack of correlated risks their precursors had in bricks and mortar buildings. In fact, tragically, we are learning now that these bricks and mortar businesses are each correlated in terms of their vulnerability to a pandemic such as Covid-19.'

CORONAVIRUS IMPACT

Most investors have had to shake up their allocations following the impact of Covid-19 and Beja is no exception.

For example, he had a 3.6% position in



OneSpaWorld, a company that runs spas on cruise liners, which he has now sold down to a 1% position.

'There is a surprising resilience to the business in most scenarios, but the current situation does not fit most scenarios. Cruise operators cut prices when demand is low, they do as much as they can to keep the ship full. This company has been extremely resilient to all sorts of shocks, and it probably did well until March this year,' he says.

'However, Carnival has stopped its cruises for two months, so there will be no spas. From a business point of view, OneSpaWorld is a very good company. However, the business will not hold up in this scenario, and the stock has been hammered. We will continue to analyse the various scenarios to determine if we hold, buy or sell.'

Beja's investment strategy means he is constantly trimming or adding exposure depending on how well the stock is performing.

PANDEMIC BEATERS

So what stocks have returned well for Beja recently?

'There are some stocks that have benefited from the current pandemic, such as Teledoc. Telemedicine, unsurprisingly, has had a short-term boost, as visits are up sharply since the pandemic began. Irrespective of how long the current situation lasts, the adoption curve of telemedicine has probably steepened and will remain so for some time to come. That said, Teledoc shares are up 49% this year and we've cut the position down hard to a 50-basis point position, from 1.75 at the peak this year.'

Beja believes a thematic change will see an increase in the use of medical advice online, a shift he believes will not revert following the conclusion of the pandemic.

AGAINST THE BENCHMARK

The Russell 2000 benchmark increased its exposure to financial services in 2020, yet Beja reduced his.

He explains this is another illustration of the inadequacy of sector categories.

'In financials, we have one investment, eHealth. It is not an insurance company, but a marketplace that connects people who want supplemental Medicare insurance. eHealth is the leading marketplace connecting these two entities.'

Beja's strategy meant he was trimming his exposure as the stock grew. However, he stopped reducing as the expected returns started to decline.

'Our discipline particularly suits us in times of enhanced volatility, as does separating companies from stocks. You could have an instance where there is a wonderful company, and yet its stock is overpriced. We spend a lot of time analysing companies we are currently investing in, because they might then miss a quarter, or interest rates may go down, or some other factor will occur which might cause Wall Street to overreact and present a buying opportunity.

'An example is Paycom. In 2019 it was a very good stock rising nearly 100%. Over the course of the year we trimmed our investment as our expected return diminished. Recently, in the last couple of weeks, we have been adding to it again as the stock has come down hard and the expected return has improved. The company's business is not immune to macro factors, but it is resistant.'

STOCK SEDUCTION

Beja's success is not only underpinned by shrewd investment skills, he has also had some tough lessons to learn.

'Stocks that appear cheap can be seductive. I've learned the hard way to resist that temptation, particularly when they have debt. When you have a firm with debt, and investors switch from viewing the glass half full to half empty, the equity value can get demolished. This is because the debt value doesn't change, and so the stock suffers 100% of the reduced value.

'One example early in my career was an investment I made in a regional airline called Atlantic Coast Airways. The stock had a very attractive expected return, but the company had a lot of debt. If I recall correctly, it was during the Asian contagion of 1997 when its business dropped significantly and the equity value was destroyed. That's not the only example, but this one has stuck with me for more than 20 years,' he says.

Most fund managers will tell you that making mistakes is a part of the game, but holding them to your heart for two decades is a sure-fire way to ensure they drive improvement.

A SENSE OF PERSPECTIVE

Another lesson Beja's 35-year career has taught him is there is never any room for complacency. 'This business has a way of keeping us all humble, you never have it all figured out. I am a big believer in having a disciplined philosophy and process. But the process, while disciplined, is not static. We tweak as we learn and as the world turns. We've never experienced something like Covid-19 before, but we are now seeing this particularly "long tail" event and its tremendous impact. There are lessons to be learned every day, some bigger than others,' he says.

Beja oversees $1.2bn (€1.12bn) in assets under management, via the various iterations of his $300m Focused Growth fund and believes a good way to stay humble is to remember the clients.

'We are intent on executing our strategy to the best of our ability day in, day out. We never forget we are stewards of peoples' savings, retirement plans and pensions. We invest their capital alongside our own and it carries a very serious responsibility which we take to heart.'