Small Cap Core Growth
Portfolio Commentary
2nd Quarter 2020

The second quarter of 2020 is one for the record books, as the Russell 2000 Growth logged its third highest return in its history. The Index's +30.6% return ranks behind only the 4th quarters of 1982 and 1999. To combat the economic effects of the coronavirus pandemic, governments and central banks around the world have pumped $7 trillion into the global economy. Improving economic trends from the extremely low levels reached in late March have also helped to buoy the markets.

In the 2nd quarter, the Granahan Small Cap Core Growth strategy returned +43.8%, net of fees, significantly above the also impressive return of its Russell 2000 Growth benchmark. Year-to-date, the strategy also soundly ahead of the benchmark, with a net-of-fee return of +11.7% versus -3.1% for the Index.

In the quarter, Pioneer and Core Growth holdings drove the outperformance. Three of the five top relative contributors hailed from the Pioneer LifeCycle category: **Digital Turbine** (APPS, info tech), **Immunomedics** (IMMU, healthcare), and **Twilio** (TWLO, info tech). Digital Turbine offers a software platform to mobile carriers that allows for apps to be pre-installed on a phone when it is activated either as a new phone or a used phone. The company reported strong Q1 results and outlook despite weak handset demand, as their mobile carrier partners have benefited from increased spending by app providers who want access to new phone initiations. Immunomedics was up in the quarter as its lead drug for the treatment of third line triple-negative breast cancer, Trodelvy, was approved by the FDA. We continue to hold the stock given promising early clinical data for Trodelvy to be used for other breast cancer indications. Twilio's suite of products, including SMS, voice, email, cloud and video, is uniquely built for the current environment, as work-from-home trends have forced many companies to test and launch new services, accelerate digital transformation, and increase remote customer communications. Twilio benefits from these secular tailwinds and accelerated adoption of services; we reduced our position due to valuation. Two Core Growth names round out the top five: **Etsy** (ETSY, consumer discretionary) and **Kornit Digital** (KRNT, industrials). Etsy is a two-sided online marketplace for unique and creative goods. After an initial headwind in the early days of the pandemic shutdown, Etsy's shares rallied sharply when Etsy sellers pivoted to creating PPE masks. We believe that the company is adroitly using this "mask dividend" to retain new and returning customers, and while we trimmed the stock based on valuation, we maintain a position. Kornit Digital provides the equipment and ink for on-demand printed garments and fabric. An important side benefit of Kornit's machines is that, unlike traditional

printing, the processing does not produce polluted water as a by-product. Kornit's stock was up in the quarter on increased demand as their newer machines have reduced the price per print. Management has raised out-year revenue estimates and margin goals; we continue to hold the stock.

On the negative side, the five largest detractors in the quarter included two Pioneers: **Veracyte** (VCYT, healthcare) and **eHealth** (EHTH, financials). Veracyte, a leading diagnostic testing company focused on thyroid cancer and pulmonary diseases, has been hurt by lower testing volumes due to the pandemic-induced slowdown in doctor visits. The company has an excellent management team, strong balance sheet and several new tests launching in 2021, all of which position the company for multiple years of robust growth. We have used weakness in the stock to increase our position. **eHealth** (EHTH, financials) is an online marketplace connecting consumers with health insurers for Medicare Advantage and Medicare Supplement insurance. The stock's sharp rise over the past year has attracted the interest of short sellers; this has made the stock controversial, weighing on the stock price in the quarter. Much of since controversy is related to assumptions around eHealth's estimates of churn and its implications for Lifetime Customer Value (LTV). We are comfortable with the company's assumptions, and confident in the growth outlook, and are holding our position in the stock.

Three Special Situation holdings round out the bottom five in the quarter: **Scorpio Tankers** (STNG, industrials), **BGC Partners** (BGCP, financials), and **Limelight Networks** (LLNW, info tech). Scorpio Tankers' shipping vessels transport refined petroleum products worldwide. Its stock was down on declining charter rates; we are maintaining our position. BGC Partners provides voice, electronic and hybrid brokerage services primarily to the bond market. The stock fell in Q1 after the company announced a dividend cut and continued to lag in the 2nd quarter as trading activity slowed; we have reduced our position. Limelight provides content distribution services to large media companies that offer online video streaming. Limelight's stock retreated from its strong Q1 showing due to the increase in internet video streaming at the onset of the pandemic. We remain optimistic for a strong year for the company given continued adoption of online video and the resumption of live sports later this year.

Year-to-date, four of the five top performers are from the info tech sector and represent all three LifeCycle categories: **Enphase Energy** (Core Growth), **Limelight Networks** (Special Situation), **Digital Turbine** and **Twilio** (both Pioneers). Consumer discretionary holding, **Etsy** (Core Growth) rounds out the top five. On the negative side, four of the five largest detractors are Special Situation holdings: **Newmark Group** (real estate), **BGC Partners** (financials), **Ring Energy** and **ProPetro Holding Corp** (both energy). Core Growth holding, **Euronet** (info tech), is also in the bottom five year-to-date. We have increased our position in Euronet, reduced Ring Energy, and have sold ProPetro.

Attribution

In the second quarter, as is typical, the performance was driven by stock selection. The portfolio showed broad-based positive stock selection, as the total return of our stocks in most all sectors (real estate is the exception) soundly beat the respective returns in the Index. The strong performance was led by info tech and healthcare. The portfolio's underweight position in the industrials sector assisted relative performance, as did the lack of exposure to utilities and consumer staples. Allocation in real estate (underweight) and energy (slightly overweight) also provided positive attribution.

For the six months YTD, stock selection in the info tech sector contributed half of the outperformance in the period, as disruptive technology adoption during the COVID-19 pandemic has resulted in accelerated growth rates for many of our companies. Relative performance in consumer discretionary, industrials, and materials was boosted by our underweight positions in these poor performing sectors for the Index. Selection in real estate weighed on performance, though this was partially offset by our underweight position here. Our overweighting of the energy sector hurt relative performance.

GIMI utilizes LifeCycle diversification (Pioneer, Core Growth and Special Situation) to help mitigate risk. All three LifeCycles soundly outperformed the benchmark in 2Q, led by the Pioneer category. Year-to-date, the Pioneer and Core Growth categories led performance, while the Special Situation category lagged the return of the benchmark. Weightings have changed slightly – Pioneers are 34%, Core Growth 46% and Special Situations 19%.

GIMI's bottom-up process leads us to continue our significant overweight in information technology, and we are slightly overweight versus the benchmark in financials and communication services. With the Index's rebalancing at the end of June, industrials has moved to a nearly equal-weighted position. Healthcare is now our largest underweighting. We also remain underweighted versus the Index in consumer staples, real estate, and consumer discretionary.

Themes

We are all aware of the continuing efforts to contain the COVID-19 virus that brought the world's economies to a standstill with a fierceness and velocity for which few were prepared. Simultaneously, the pandemic has deepened reliance of consumers and businesses on technology, as people increasingly turn to shopping online, communicating virtually, and streaming content. As Microsoft CEO, Satya Nadella, noted in a recent earnings statement, "We've seen two years' worth of digital transformation in two months." Stocks in our

portfolio that have benefited are not just technology companies, but also those that embrace technology within their business models. Examples include online retailer **Etsy** (consumer discretionary), virtual medicine provider **Teladoc** (healthcare), and insurance-related companies **EverQuote** (communication services) and **Kinsale Capital Group** (financials). Technology names benefitting from the current work-from-home environment and associated accelerated shift to cloud architecture include: **Digital Turbine**, **Twilio**, **Okta**, **Zscaler** and **Limelight Networks**.

There are also healthcare names in the portfolio that have directly benefited from Covid-19. **CytoSorbents**, for instance, sells a blood-filter technology that removes toxins that cause cytokine storms in patients. New holding **Vapotherm** sells a mask-free respiratory system. There are other companies in the portfolio that are beneficiaries both now and going forward, as the shift to move procedures out of costly hospital environments to outpatient care settings takes hold, including **Pacira Biosciences**, **Teladoc** and **Exact Sciences**.

As mentioned above, the portfolio's healthcare exposure is currently underweight versus the Index. It is notable that COVID-19 related names have driven 50% of the YTD performance for biotech ETFs even as they represent just 20% of the biotech indices (BTIG Healthcare Sales Summary, July 10, 2020). Though we are carefully monitoring COVID-19 therapeutics, and investing in well-positioned names, we believe current valuations for this sub-sector may be stretched, as the returns on investment for many of the underlying early-stage products are questionable.

Corporations are making significant progress in addressing issues around sustainability. Most large companies now have a statement of social purpose, many are PRI signatories, and some have joined collaborative efforts to tackle environmental and/or societal issues. Davos 2020 further added to the momentum on stakeholder capitalism, as well as disclosure of progress on environmental, social, and governance (ESG) metrics. These actions are encouraging. Strong corporate governance and transparency have always been attributes we seek in our fundamental research as necessary to earn a place in GIM portfolios. Today, with the rise of rating systems, it is easier to evaluate companies with respect to ESG initiatives. While many of our smaller companies do not screen well with various ESG grading systems – their boards are too small compared to larger peers, or they do not have policies in place for social purpose, etc. – they may provide another component to ESG. Our portfolio holdings include innovators that help larger companies reduce their impact on the environment through new processes that result in lower carbon use and water pollution, including **Enphase Energy** (solar microinverters), **Vicor** (power conversion) and **Kornit Digital** (zero-wastewater textile printing).

Macro

The massive amounts of stimulus that have been pumped in to economies around the world, and the intent for various countries to add more over the next year, helps to explain why stock markets have surged over the last 3 months. The U.S. unemployment rate is high at 11.1%, but is down from 13.3%. There are other financial measures that have been reported as better-than-expected, especially coming off the deep plunge in these metrics after the rapid shutdowns of so many economies in March. Still, emergency unemployment insurance in the U.S. expires in July, and many state and local budgets are in dire straits. Recent COVID resurgences have increased anxiety that there could be new shutdowns that will slow recoveries. It also will be interesting to see what happens to the stock markets as second quarter earnings are reported.

Outlook

As we deal with fresh concerns about a new wave of infections, and the uncertain outlook for the timing of a vaccine, it has never been more difficult to forecast earnings for our companies. Certainly, most of our companies have pulled guidance, some because of a surge in demand and others because of the rapid decline in demand. We are involved with many companies that are in the demand surge, and with few where demand declines are long-term negatives. Around 35% of our companies have stocks that have hit new all-time highs because of surging demand. On the other side, some of our healthcare companies have seen short-term revenue shortfalls as elective procedures have been delayed, while at the same time they are anticipating significant backlogs for demand as the pandemic eventually wanes.

Wall Street strategists have attempted the difficult task of forecasting earnings, and have cut estimates drastically; hence, P/E ratios and valuations of the Indices look high. The P/E was historically high at the start of the last three economic recoveries – in the early 1990s, 2002, and in late 2009. Earnings are often depressed after a recession, elevating multiples. But as the economy begins recovering, earning rise, resulting in a higher market with lower valuations. Steve DeSanctis (Jefferies strategist) points out in his 2020 second-half outlook letter that when small companies have been this cheap relative to large companies, small has outperformed over the next year. At GIM we remain focused on executing our process as tightly as possible – separating companies from stock to seek strong well-positioned companies. Subsequently, we use our tools to build significant holdings in select companies when the respective stock has an attractive risk/reward. Stock selection drives our strategies' performance across sectors and LifeCycles in most all market environments.

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