Granahan Small Cap Focused Growth Strategy
Portfolio Manager Commentary
2nd Quarter 2020

Whiplash?

If you don't have whiplash from the moves in the stock market year-to-date, you've either got a pretty strong neck or have been in a blissful news-free quarantine. If the latter, you'll be forgiven for uttering "Ho-Hum" as the Russell 2000 Growth's -3.1% return through June is hardly remarkable. But if the former, you've witnessed a remarkable and record-setting swing in the markets where, in a span of 110 days, the Russell 2000 Growth *declined* **43%** February 19th to March 18th) only to *rise* **66%** (March 18th to June 16th).

In the second quarter, the Focused Growth portfolio returned +49.9% net-of-fees compared to +30.6% for the Russell 2000 Growth benchmark. The portfolio benefited from strong stock selection across all sectors except financial services. Selection was particularly strong in technology and consumer discretionary. Factor-wise, there were some headwinds as "low-quality" characteristics were among the leading factors in Q2 (e.g., low-share price, small market cap, and high leverage). However, high-growth was also one of the best performing factors in Q2, and overall, investors gravitated to the Desert Island type of companies that we own. Interestingly, while the portfolio's large underweight to cyclical stocks was a headwind, it was more than offset by the factor tailwind of the portfolio's heavy weighting in companies that are, or likely will, benefit competitively from COVID-19. While hard to quantify, we have more to say on this below. Sector allocation was a positive overall, but most notably in consumer discretionary where the portfolio's overweight and strong selection made a significant positive impact. More detailed holding attribution analysis can be accessed here.

Why is "The Stock Market" going up given the level of uncertainty in the world?

This is the question investors and observers are naturally asking in view of the following:

1. COVID-19 has caused huge devastation across the globe. The US has experienced more than 138,000 deaths, almost 3.4 Million people in the country have contracted the disease, and in the time span of two months, the economy experienced a staggering swing from *record employment* to *record unemployment*. The ripple effects across our lives and across industries is unprecedented.
2. The huge protests and demonstrations triggered by the murder of George Floyd that include the mass expansion of the Black Lives Matter movement and calls for reform and even "defunding" (that is, re-purposing of funding) police departments.

3. The level of dysfunction in the White House has gone from high to higher. And, by-the-way, there is an election in November.

How do we square all this uncertainty with the fact that the stock market is rising?

Stepping back, it is helpful to remind ourselves that stocks are inherently a mechanism that discounts the value of *future* earnings and cash flow, not those of the *present*. So while the current period, and indeed the near-term future, are both uncertain and challenging, this is not inconsistent with investors' implicit collective confidence in a brighter longer-term picture. Hopefully this bullish view of the long-term is well-placed. Irrespective of this however, there is no doubt that certain sectors and companies will prosper and others will struggle. Today the public companies that are prospering are driving much of the broad market gains. But they represent a subset, of a subset, of a subset, of US GDP. Put another way, much of the "demand" for stocks is occurring in a relatively small number of stocks. This is a function of the fact that we are increasingly in a winners-take-most economy. In the large cap world (using data from Bloomberg and Factset) the top five companies in terms of market cap in the S&P 500 represent 24% of the index; this is up from just 10% in 2010. Notably, all five are now technology companies (Microsoft, Apple, Amazon, Facebook, and Alphabet), whereas in 2010 only two were technology companies (Microsoft and Apple).

A key component of "present value" is the discount rate one applies to those future earnings. With interest rates at historic lows, along with uncertainty surrounding many asset classes worldwide, it is perhaps understandable that investors would gravitate to US equities. Also supporting the "demand" side is that central banks around the world have injected levels of stimulus into the economy that would have been unthinkable just six months ago – including $2 Trillion and counting in the US.

On the supply side, public companies in aggregate represent an increasingly smaller subset of GDP. Due to M&A activity and companies staying private longer, the number of public companies in the U.S. has been cut roughly in half since 1996 from just over 8,000 to 4,400 by the end of 2018 (TheGlobalEconomy.com). In addition, per the SBA (Release No. 19-1 ADV, January 30, 2019), small businesses – which obviously are not public companies – account for just under 50% of GDP.

Bottom Line News Flash: *The disconnect between Wall Street and Main Street is in many ways greater than ever*.

And the Same Factors are Present Down Market (Cap)

Each of the factors discussed above taking place in large cap stocks is also occurring down the market cap spectrum, including the trend toward "winners-take-most." There are puts and takes, but these factors are largely a tailwind for the types of companies in which we invest. COVID-19 has accelerated adoption of a number of secular trends that were in place before the pandemic such as, telemedicine, work from home, digital disruption, cloud computing, ed-tech, and fin-tech. And an increasing share of current GDP is being captured by companies benefiting from these trends given the upheaval of so many industries due to COVID 19. Consider the digital disruption in the insurance industry, where traditional bricks and mortar agencies and in-person relationships with agents, are shifting to online platforms. This benefits companies such as **eHealth** (EHTH) and **SelectQuote** (SLQT) in the Medicare Advantage market, **EverQuote** (EVER) in auto insurance, and **Lemonade** (LMND) in renter's and home-owners' insurance.

Even many of the "Desert-Island worthy" companies that have experienced a near-term contraction in business trends due to COVID-19 are faring well on a relative basis (i.e., compared to their competitors and alternative assets in which investors can invest). For example, two portfolio companies engaged in payroll and human capital management software – **Paylocity** (PCTY) and **Paycom** (PAYC) – initially reported that business slowed sharply in late March and that revenue would likely decline roughly in line with employment. However, the secular growth trends of cloud-based HR software and mobile-computing, along with COVID-19's impetus toward a more distributed workforce, strike us to conclude that the pandemic will benefit the revenue and earnings for both companies over the intermediate (2-5 year) period. So, pain now, pleasure down the road.

As one combines the higher projected growth of these companies with lower interest rates and the other factors discussed above, one can start to see some method to the market's supposed madness. As always, we are not trying to anticipate whether the market will rise or fall. However, the Focused Growth Strategy will continue investing in companies that we believe are on the right side of disruptive change, whose respective stocks, in our view, have attractive risk/reward and probability-weighted expected returns. We believe this approach to investing has a good chance of providing success for our clients in most market environments.

We All Can Do Better – And as it Relates to Diversity, We on Wall Street have even Further to Go than Most

There is an old expression that some people are born on 3rd base and think they hit a triple. On a relative basis, this applies to most white men born in the US (myself included). That doesn't mean that many haven't worked hard, overcome adversity, and punched above their weight in terms of achievements. But rather that there are systemic and structural factors at work that act as big tailwinds for some, and fierce headwinds for others. Here are just a few stats to illustrate:

- 2.6% of Wall Street executives are black. I don't have statistics on what percentage of analysts and portfolio managers are black, but 2.6% feels about right. That is, it is a very, very disproportionately low number, and…wrong.
- A 2015 New York Times article found that among the S&P 1500 there were more male CEOs named John than female CEOs of *any* name.
- According to this recent WSJ article, Adtelem CEO Lisa Wardell is the ***only*** black female CEO of a publicly traded U.S. company. For those scoring at home, this works out to 0.03%.

Clearly, Houston (and New York, and Silicon Valley, and Boston…), we've got a problem. And it is particularly acute on Wall Street where, because the playing field has been so tilted in favor of white (males), the pool of experienced professionals and executives is pitifully low. We've got to do better. And that includes us at Granahan Investment Management. We are a relatively small company. And in many ways, we've got an idyllic environment (terrific investors, independent, a very warm and positive culture with a deep dedication to performance and high service levels for our clients) – with many Desert-Island worthy attributes. On some metrics of diversity and inclusion, we score well (for example our CEO and 50% of our team is female). On the other hand, all 18 members of our team are white. We at Granahan believe that we and our colleagues in the investment management industry have a great deal of work to do. Hard work. Expanding the number of analysts, portfolio managers, and executives in the industry won't happen overnight. We need to start at the top of the funnel with scholarships, internships, mentorships and entry-level/training/apprenticeship positions. We at Granahan—recognizing (very belatedly) that a more broadly diverse work force is critical to enabling our own company to thrive on the Desert Island—have started on this hard work. I pledge to update you at least once per year, but don't hesitate to press us on this subject.

Before closing, in keeping with my practice of sharing content and apropos of this topic, here are a couple of books and a film that I highly recommend:

- Fire Shut Up in My Bones – Charles Blow's griping memoir about growing up in a small town in Louisiana in the late 20th century, his trials and journey to be becoming an award-winning New York Times columnist.
- Tough Love – Autobiography by former National Security Advisor and UN Ambassador and potential Vice Presidential Candidate nominee Susan Rice, providing a reminder of what experience, competence and dedication can look like at the highest levels of government.
- 13th - Academy Award nominated documentary by Ava Duvernay explores the effects that mass incarceration has had on perpetuating the vicious cycle of structural racism.

Summary

As always, on behalf of the entire team at Granahan Investment Management, thank you for for your continued interest in our firm and strategies. We will endeavor to continue to execute our investment processes with rigor to best perform for our clients and their beneficiaries, while remaining engaged as thoughtful and forward-thinking corporate citizens. Please stay safe and don't hesitate to reach out if you have any questions, comments or Desert-Island worthy ideas.

Sincerely,

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