Small Cap Select Opportunities

Portfolio Comments

June 30, 2020

Distinguishing Features

GIM builds the Small Cap Select portfolio from the bottom-up; sector weightings are secondary to stock selection. As of 6/30/2020, after the annual re-balancing of the Russell Indices, the portfolio continues its significant overweight position in the information technology sector, 40% versus 21% for the Russell 2000 Growth benchmark. The overweighting of the consumer discretionary sector has increased by 4%, now 21% versus 13%. Communication services also remains overweight versus the Index, 6% versus 2%. The overweight position in energy has been lowered to almost an equal-weight to the benchmark, 1% versus <1%. The portfolio continues its significant underweighting in the healthcare sector, 15% versus 33%. Industrials also remains underweight versus the Index, 10% to 13%, as does the real estate sector, 2% to 4%. Financials is equal-weighted to the Index at 4%. The portfolio continues to have no exposure to the consumer staples, materials, and utilities sectors, where the benchmark weighting are 3%, 2.5% and 2%, respectively.

Commentary

Market Environment

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.

Performance Discussion

In the 2nd quarter, the Granahan Small Select strategy returned +63.5%, net of fees, significantly outpacing the +30.6% return of its Russell 2000 Growth benchmark. Year-to-date, the strategy's return is +18.4%, net of fees, versus -3.1% for the benchmark.

The robust results in the quarter were a result of strong stock selection, led by information technology, healthcare, and consumer discretionary, and assisted by positive selection in industrials and communication services. The portfolio's overweight position versus the Index in the info tech and consumer discretionary sectors boosted relative performance, as did the underweighting in industrials. The underweight position in healthcare slightly offset the strong stock selection in this sector. Selection in real estate and financials weighed on performance, though the underweight position in the real estate sector offset the selection to result in slightly positive relative performance. The portfolio's overweight position in the energy sector more than offset our negative selection for this sector, resulting in positive relative performance. The portfolio's lack of exposure to the utilities, consumer staples, and materials sectors was also a positive.

With respect to LifeCycles, the Pioneer and Core Growth LifeCycle categories significantly outperformed the Index, while the Special Situation LifeCycle category just slightly outperformed the benchmark. Three of the quarter's top five contributors represented the Core Growth LifeCycle category: **Kornit Digital** (KRNT, industrials), **Enphase Energy** (ENPH, info tech), and **Etsy** (ETSY, consumer discretionary). Two Pioneer names were also included in the top five: **Digital Turbine** (APPS, info tech) and **Immunomedics** (IMMU, healthcare).

On the negative side, four of the five largest detractors in the quarter were from the Special Situation LifeCycle category: **Scorpio Tankers** (STNG, industrials), **BGC Partners** (BGCP, financials), **Newmark Group** (NMRK, real estate), and **Redwood Trust** (RWT, financials). Pioneer holding, **Magnite** (MGNI, consumer discretionary), rounds out the bottom five.

Positioning

Last quarter, we opened this section writing *"The year 2020 will be deemed historic in many respects due to COVID-19. First quarter business results and stock market movements were extremely volatile, and we expect more of the same throughout the year."* Indeed, this is what has been realized through the 2nd quarter. And fortunately, it has been (what we shall call) upside volatility. On reflection of the results year-to-date, it is clear that incredible dynamic forces of change have been at play. Business models have been violently affected, pathways to the digital economy have been tremendously accelerated, and the performance separation between the winners and the losers has dramatically expanded in a very short period of time. It is exactly this type of environment where active management can add significant value through fundamental research, analysis, and in the case of Granahan, strong collaboration.

In the quarter, we continued to follow our investment discipline by initiating or adding to positions in each LifeCycle with the best chances of fulfilling our stringent investment criteria, and selling the ones that we believe would not. In many cases, that meant looking for companies that would act as "tennis balls" bouncing strongly as we came out of lock down, and selling the "bowling balls" whose businesses would remain depressed. Given this view, it was important that our bottom-up stock picking approach was complemented with a wider view of the market environment. As we progressed through the quarter, we gained conviction that a market bottom had most likely been created off a very oversold condition. Our past experiences with such markets, combined with our thoughts on the existing one, indicated that that the market would not only continue to favor companies with consistently resilient fundamentals, but also select companies whose businesses were not as resilient, but had a recovery in process and their stocks were severely oversold. The environment provided ample opportunities for inflection-point investing, which is right down the fairway of the Select investment process. Additionally, given the past playbooks of similar markets (2003 and 2009), we anticipated that smaller companies would likely outperform larger companies, low-priced stocks would outperform high-priced stocks, and that stocks with risk factors such as leverage would outperform. To insure we were not underweighting the factors we believed would be favored in the market environment, many of our buys in the last three months included companies with strong investment themes that also had profiles that were consistent with this view (examples highlighted below). We were attracted to names that had recent high volatility, but were also at extremely powerful positive inflection points.

In March, we added two names from the consumer discretionary sector that have, to date, been a benefit to the portfolio – **Sonic Automotive** (SAH, Special Situation) and **Purple Innovation** (PRPL, Pioneer) – both of which have specific growth drivers. As we built our positions further in the second quarter, these newer investments have increased the sector weighting by about 4%.

The portfolio's diversification across LifeCycle categories (Pioneer, Core Growth, Special Situation) helps us to navigate the various market environments. Given the unusually poor performance of the Special Situation category in Q1, we anticipated a disproportionate gain from our Special Situations holdings in Q2, as many were oversold. This did not occur. For example, even as our buys of Special Situation **BGC Partners** (BGCP) in the first quarter were at lower prices than today, the stock has continued to underperform (we have subsequently reduced our position).

No matter the market environment, we believe that our Lifecycle diversification will keep us well positioned, and the portfolio will see overall benefit from our Special Situation holdings, particularly when valuations get stretched, or when the technology and healthcare sectors underperform the overall market. That said, our bottom up stock picking is likely to continue to favor more Pioneer and Core Growth names in the near-term.

Outlook

The uncertainty surrounding the economic impact of the pandemic along with the massive stimulus has created an interesting juxtaposition. So far, the stimulus is propelling the market higher; how the markets react to company earnings reports released in late July could prove interesting. 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. As bottom up investors, stock selection drives performance across sectors and LifeCycles in most all market environments.