Small Cap Discoveries

Portfolio Comments

September 30, 2020

Distinguishing Features

The Russell Indices expanded the number of sectors represented from 9 to 12. The new sector distribution has split producer durables into a new industrial sector and a very small producer durables sector. Consequently, as of 9/30/2020, the Small Cap Discoveries portfolio's previous significant overweight position in the producer durables compared to that of the Russell Microcap Growth benchmark has shifted to a significant overweighting in the new industrials sector, 17% versus 9%, and a slight overweighting in producer durables, 3% to 1% (representing one holding, Kornit Digital). Consumer discretionary is about equal-weighted to the benchmark at 14%. Real estate, materials, and utilities are about 1% overweight their respective Index sector weightings, while energy and financials are about 1% underweighted their Index weightings. Healthcare has reduced its underweight position compared to the benchmark, now 45% versus 49%. Technology has moved to an underweight position, 12% versus 16%. The portfolio has no exposure to the small telecommunications and consumer staples sectors.

Commentary

Market Environment

Markets in the 3rd quarter of 2020 continued their upward climb off the March lows. As the economy slowly opens up from the pandemic restrictions, weekly unemployment claims fell below one million for the first time since the crisis struck. Promising news on potential vaccines for COVID-19, and better treatments for those that are infected, has helped buoy confidence as well. While corporate earnings fell sharply in Q2 from the year earlier, the pain for most companies was less severe than analysts had feared. The Russell 2000 Growth Index returned +7.2% while the Russell Microcap Growth returned +6.1% in the period. The heavy weighting in smaller biotech names has assisted the Russell Microcap Index in 2020, with its the year-to-date return of +8.1% leading the +3.9% return of the Russell 2000 Growth Index.

Performance Discussion

In this environment, the Small Cap Discoveries strategy outperformed both the Russell 2000 Growth and Russell Microcap Growth benchmarks with a return of +9.9%, net of fees. Year-to-date, the portfolio's net-of-fee return of +8.1% is ahead of the Russell 2000 Growth benchmark, and now in line with the return of the Russell Microcap Growth index.

For the 3rd quarter, its notable that relative outperformance versus the Russell Microcap Growth benchmark was due primarily to sector allocation, while stock selection drove the outperformance versus the Russell 2000 Growth Index:

<u>3Q versus the Russell Microcap Growth Index</u>: Sector allocation accounted for the outperformance versus the Russell Microcap Growth Index. The portfolio's underweighting to this benchmark in healthcare boosted our especially strong selection in this sector during the period. The portfolio's overweighting in consumer discretionary was a plus and more than offset the effect of negative selection here. The overweight position in both producer durables and industrials was a positive, while the underweight position in technology also helped

relative performance to the Russell Microcap Growth. Selection in real estate aided relative performance. Selection in the technology sector was the largest detractor, while selection in consumer discretionary and materials also weighed on performance. Our lack of exposure to the consumer staples was a negative.

3Q versus the Russell 2000 Growth Index: Stock selection was behind the outperformance versus the Russell 2000 Growth Index, led by strong selection in consumer discretionary and healthcare, and assisted by selection in real estate and producer durables. The overweight positions in consumer discretionary and producer durables boosted the relative performance versus this Index. The lack of exposure to telecommunications was also a plus versus this Index. Selection in technology was the largest detractor, while selection in materials, utilities, and energy also weighed on performance. The portfolio's underweighting in technology versus the Russell 2000 Growth partly offset negative selection here, while the underweighting in utilities hurt relative performance against this Index.

With respect to LifeCycles, the Core Growth and Pioneer LifeCycle categories soundly outperformed the Index, while the Special Situation category lagged. Two of the quarter's top contributors were from the consumer discretionary sector: **Digital Turbine** (Core Growth) and **MarineMax** (Special Situation). Two healthcare Pioneers were also in the top five, **BioLife Solutions** and **Xeris Pharmaceuticals**. **Innovative Industrial Properties** (Core Growth, real estate) and **CryoPort** (Pioneer, industrials) were also among the top contributors.

Three of the detractors in the quarter were technology names: **Limelight Networks** (Special Situation), **GAN Limited** (Core Growth), and **PROS Holdings** (Pioneer). **Materion Corporation** (Special Situation, materials), **Axon Enterprise** (Core Growth, industrials), and **Flexion Therapeutics** (Pioneer, healthcare) also detracted from the quarter's performance.

Outlook

There has been much talk about the performance divergence of small cap growth (SCG) stocks relative to small cap value (SCV) stocks, much like that of the Tech Bubble. While SCG relative valuation is elevated, it is nowhere near what it was at the peak of the Tech Bubble. SCG is posting better numbers than SCV with respect to sales growth, ROE, and cash flow margins, which is different than the Tech Bubble fundamental case. In today's environment, SCG cash flow margins are +2% higher than SCV (and rising), and the average SCG stock is generating $15m more cash flow over a 12-month period than the average SCV stock. SCG sales growth and ROE are also superior to SCV, which was not the case in 2000. As always, GIM continues to focus on the SCG companies that demonstrate these superior fundamental factors, while using our disciplined tools, including LifeCycle diversification, to invest in the stocks of these companies when risk/reward is attractive.

Disclosure:

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