Granahan Small Cap Focused Growth Strategy
Portfolio Manager Commentary
3rd Quarter 2020

Stock Market Posts Gains in Q3 Despite Much Ado About Much

Amidst challenges and uncertainties galore, the Russell 2000 Growth Index posted a solid 7.2% gain for the third quarter. The Small Cap Focused Growth portfolio rose 7.6%, net-of-fees, slightly outperforming its benchmark. In terms of attribution, stock selection during the quarter was modestly negative with weakness in Consumer Discretionary, Financials, and Industrials. Offsetting this was strong selection in Technology, Energy, and Real Estate. Allocation was an overall positive contributor to relative performance. Please use this link for detailed attribution comments.

Notable for both Q3 and the year is the stark performance variance between "growth stocks" and "value stocks." For example, year-to-date for small caps, the Russell 2000 Value is down at -21.5% while the Russell 2000 Growth is up, +3.9%. In Q3, the R2G rose +7.2% and the R2V +2.6%. According to Jefferies Small Cap Strategist Steve DeSanctis, the trailing twelve-month performance spread of 30% between the Russell 2000 Growth and the Russell 2000 Value is the widest it has been since March of 2000. I share some thoughts on the "Growth vs. Value" debate below.

On the Election, COVID, the Economy, and Growth vs. Value

Investors have a full plate of issues with which to grapple, and in the spirit of the times – i.e., a debate where only one voice can be heard – I'll weigh in with my perspective on a few of the concerns.

The U.S. Presidential Election – A Contrarian View

The polls largely show that Biden is leading in most swing states. Nate Silver's 538 has Biden's odds of victory at 86%. But, as witnessed in 2016, such polls don't necessarily equate with results. Moreover, in this presidential cycle, C-19 is shifting many citizens to mail-in voting, while the President is claiming that the process can't be trusted, and that he won't necessarily abide by the results. Well…buckle your seat belts.

Many, if not most, Wall Street observers believe that a Trump re-election will be bullish for the stock market, while a Biden administration would be bearish. I have a different view. While taxes are likely to be higher and regulation tighter under Biden than Trump, the scope of relevant considerations is much broader than simply taxes and regulation. My own list of concerns about a second Trump term is too long for this letter. Though a few items included on the list are irresponsible fiscal deficits that pre-date C-19, corresponding record Federal debt, gyrating trade and foreign policies, the likelihood that the trends of income and wealth disparity will continue to worsen, polarization of the populace, the media, and Congress, alienation of our allies and cozying up to our foes, *and* disregard for climate change, science broadly, ethics, decency, and our democracy. But beyond these specifics lies a deep lack of confidence in Trump's judgement and ability to effectively govern. Taken in full, and adding the many potential "Black-Swan" events that inevitably face a President (that in aggregate are not Black Swans), leads me to conclude that a second Trump administration is the riskier proposition.

In sharp contrast, in addition to having an actual plan for dealing with C-19 along with many sound and detailed policy positions, Biden is likely to restore competency, predictability, ethics, and civility to the Federal Government. This includes the appointment of people and the reinstatement of support structures that have been proven by the test of time to assist our country with whatever challenges that may present themselves. Critics claim higher taxes will stymy investment, though history suggests that this is not the case. The Clinton and Obama administrations both managed to balance steady economic and employment growth with strong free-trade and fiscal discipline, enabling the stock market to thrive during both Presidencies.


Mark Cuban
@mcuban

I have started I don't know how many businesses in my life. Not one time have I ever considered the income tax rate before starting a business. I'm an entrepreneur. I start companies.

10:55 AM · Oct 5, 2020 · Twitter Web App

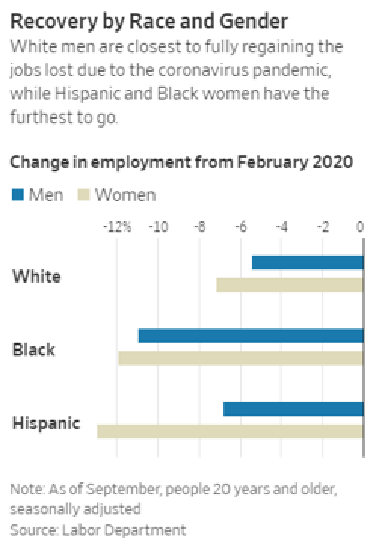
3K Retweets 240 Quote Tweets 31.8K Likes

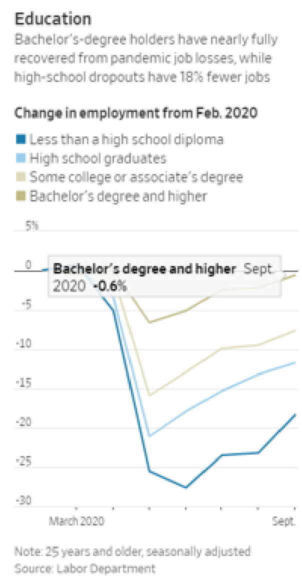
Getting Past COVID: Bearish Short-Term, Bullish Intermediate & Long-Term

I recently listened to an interview with former FDA Commissioner Scott Gottlieb. I'm not a medical expert, but it seems to me things are likely to get worse vis-a-vis C-19 before they get better. Optimistically, a vaccine will be approved in 2-4 months. Even under this optimistic case, it is unlikely to be widely distributed and available before mid-2021. That, together with the fact that C-19 particles transmit much more effectively in the cold and indoors, suggests caution with respect to the virus over the next 6-8 months. However, based on what I heard from Commissioner Gottlieb, the outlook appears encouraging from mid-2021 and beyond. Based on prospects for both potential vaccines and treatments, it appears likely that 12 months from now we will be entering the cold season in much better shape than we are today.

A "K" Economy - And the Right Leg is Worrisome

I'm not sure who labeled the current economy as a "K" Economy, but it strikes me as apropos. The K's upper right arm consists of the wealthy, those in the digital economy, those who own stocks, those lucky enough to work from home or whose jobs have not been impacted, and those who have their health and health insurance. While perhaps suffering from Zoom fatigue, these folks are doing relatively just fine. The K's lower right leg, not so much. It represents those whose jobs or businesses have been hit directly or indirectly by C-19, those who may not have savings let alone own stocks, those who may even have had COVID or other health issues and in too many cases don't have health insurance. A recent analysis by the US Bureau of Labor Statistics found that 61.5% of those in the top quartile of earners could work from home, compared with 9.2% of those in the bottom quartile of earners. And C-19 has affected Hispanics and Blacks disproportionally, as well as those with less education compared with the more educated. This is very concerning. But even more so is the prospect that things are likely to get worse, not better, for those in the right leg over the coming months.





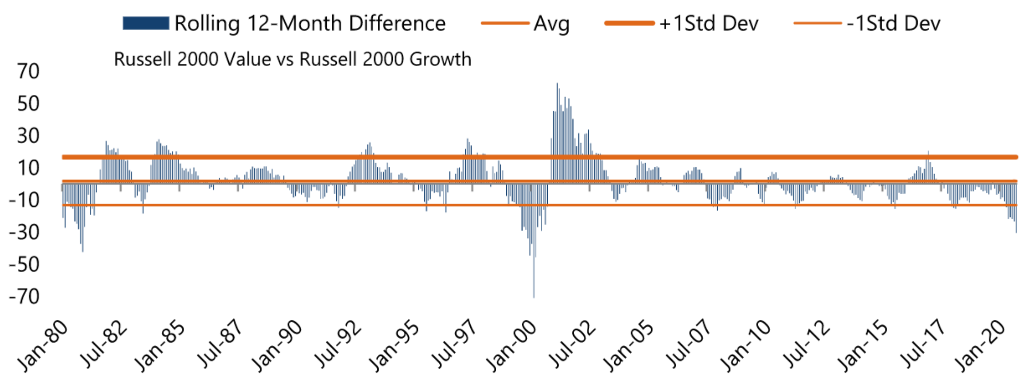
Source: Wall Street Journal, Oct. 6, 2020

As discussed in the Q2 letter, C-19 is accelerating many secular trends that were underway well before the pandemic. Car sales are moving online and so are insurance sales. Movie theaters and restaurants are closing. And there is, of course, the shift in retail from offline to online. While this is not new (Jeff Bezos founded Amazon over a quarter century ago), C-19 has accelerated the shift, tipping companies like Niemen Marcus and Lord & Taylor into Chapter 11. These trends are resulting in job losses and what economists call "frictional unemployment." Even when the economy recovers, the car lot salesperson is not likely to get an equivalent job selling cars. She or he will have to find other employment, which can be difficult, and in many cases the new opportunities will pay less and often require retraining. This period of adjustment will be a substantial drain on the economy for some time to come – even after a vaccine, better treatments, or cure for C-19 are found.

A "K" Stock Market - Some Thoughts About Growth vs. Value

One could similarly refer to the equities market as evolving into a "K" stock market in which growth stocks are represented by the upper right arm and value stocks by the lower right leg. This disparity has been in place for most of the past 12 years since the Global Financial Crisis. And, as noted above, the style spread between growth and value is the widest it has been in 20 years. Many have been predicting the styles will "revert to the mean." Others dare to utter the four most feared words on

Wall Street: "This time is different." I don't know for certain that this time is different, nor do I know for certain that it is not different. But I do believe strongly that we cannot consistently add value attempting to call when to invest in growth versus value, or vice versa. Luckily, our investment process doesn't require it.



Source: Jefferies & Co.

A Desert Island Trilogy

I have discussed the virtues of investing in secular growers (aka Desert Island-worthy companies) in many a quarterly letter. Yet, I haven't shared *how* I came to believe in this philosophy so strongly. It began fifty years ago, in October of 1970, when I received a single share of stock in The Limited Stores as a birthday present. Over the next 10 years, Leslie Wexner guided The Limited through tremendous growth. In concert, my single share of stock went up and to the right, splitting many times. I think it multiplied around 20X. Sadly, my memory isn't precise, and neither Bloomberg nor Factset data go back far enough for me to verify. But whether it was 18X, 20X, or 22X, that stock was a gift that kept on giving, as it: 1) taught me the power of compounding; 2) allowed me to witness how a seemingly expensive growth stock can turn out, in hindsight, to have been great a value; and 3) provided an experience that propelled me to a career in investing.

In my early 20's, I was a sell-side analyst for Advest, a regional investment firm. While there, I was fortunate to be the first sell-side analyst to cover Blockbuster Video just as Wayne Huizenga was taking over the helm in 1988. The experience with Blockbuster echoed my experience with the early years of The Limited. Despite the fact that many bears viewed Blockbuster shares as perennially overpriced (*Barron's* was loudly and consistently in this camp), in hindsight the stock turned out to have been a great value, rising more than 20X over the next six years as Huizenga expanded Blockbuster to 9000 stores around the globe.

During my 35 years working in the investment industry, I've seen numerous "Limiteds" and "Blockbusters." I've invested in many, but many I've missed. Netflix is a standout example of a miss. I failed to invest in Netflix despite repeated efforts by one of my then team members, Ken Winston, to convince me to do so. And as of today, I still haven't "figured it all out." This year, during the early phase of C-19, I came close to initiating a position in Peloton, a company on the Desert Island monitored list. Close, but no cigar, because my calculated "Expected Return" was insufficient. Sadly, the stock is up 5X just six months later.

CoStar Group serves as a prime example of a growth stock that in hindsight was cheap all along. In 1998, I met with CoStar CEO/Founder Andy Florance as the company was preparing its IPO. CoStar – a provider of critical information for the commercial real estate industry – went public at $9 per share. I have long believed that CoStar has an exceptional business model, and Florence has steered the company spectacularly over the past 22 years. The stock has never split and recently traded at $875 per share – *up 97X from the IPO*. Thankfully, while I have traded around the position, CoStar has remained in most of the portfolios I have overseen since 1998. Over much of the holding period, the stock appeared "expensive" on current earnings. However, in hindsight, we now know that the stock was valued attractively all along. CoStar remains on the Desert Island list and in the portfolio. I believe the company's business position is stronger than ever, with global opportunities even as very little revenue today comes from outside the U.S. And I believe the stock's expected return and risk/reward are attractive. Thus, we remain investors in the stock despite the fact that its market value is now in midcap territory.

What is the point of dragging you up and down this memory lane? Well, today many stocks are expensive on near-term and even intermediate-term earnings. And as noted, there is much debate about valuations and if/when the pendulum will swing to favor value stocks. I don't engage in this debate because I don't believe that I can consistently add alpha by doing so. Thankfully, as I mentioned, our process doesn't require me to do so. As a reminder, the process has four parts:

1. Company Analysis --Is the company Desert Island worthy?
2. Stock Analysis -- Valuation analysis centered on Expected Return and Risk/Reward;
3. Portfolio Construction -- Assemble and manage a portfolio of roughly 40 stocks from the Desert Island monitored List of 100 companies;
4. Risk Management – Risk management is integral to each of the first three steps, and there are a number of additional checks and balances.

Probability plays a key role in each step of the Focused Growth process. For example, in 1970 if I had known for certain that The Limited Stores would go up 20X over 10 years, I'd have mortgaged my house and put all the money into the stock (OK, I was a kid, so maybe I'd have mortgaged my bike). Of course, one never "knows" a stock will go up, let alone rise 10X or 20X or 97X. So, we try and "stack the deck in our favor," as my mentor Nick Battelle used to say. Each step in the process is important, but it starts with concentrating only on companies that we believe are "Desert Island" worthy – i.e., we believe the company can achieve high compound growth over the next 5-10 years. These companies tend to have very large market opportunities, they often have network, flywheel and/or scale effects, they are investing in their employees and tend to have strong cultures and missions, and they tend to have solid financial underpinnings. While I view steps 2, 3 and 4 of the process to be important components in the pursuit of strong and consistent returns, the *most* important part of the process is step 1. Our list of 100 Desert Island monitored companies does not turn over at a high rate – only 10% or so per year. This low turnover allows us to get to know each company well – including their management team, their competitors, and the dynamics around the company's stock. This deep familiarity is important during any market environment, but particularly so in times of enhanced volatility and uncertainty, such as Q1 of this year when the world was just starting to contend with the pandemic.

Returning to the question at the beginning of this section about current valuations – when will the pendulum swing to favor value rather than growth? Well, of course, no one knows. When we do get substantive good news about a vaccine or treatment for C-19, I suspect that Airline, Hotel, Oil & Gas, and Restaurant stocks will have their day in the sun. However, I have high conviction that if we can successfully identify Desert Island companies that will compound 20%-25%-30% or more annually over the next 5-10 years, we'll be able to combine this with the other steps in our process to generate attractive returns for our investors over that time period.

Which stocks in the portfolio today appear expensive, yet are really value stocks? Might it be Axon (Body Cameras, Taser non-lethal weapons, and an aim to be the AI-powered ERP system for law enforcement worldwide)? Sprout Social (the leading platform for brands to manage their social presence)? Pluralsight (the leading technology skills and engineering management platform)? It could be any, none, or all of the above. While we don't know, we try and "stack the deck in our favor" by investing in roughly 40 stocks in the Focused Growth portfolio--all of which we believe have good odds of being Desert Island compounder winners over the next 5-10 years.

Some Content to Take Your Mind Off the Election, COVID, & the Economy

Two Podcasts Worth Listening to:

- Invest with the Best - Host Patrick O'Shaughnessy has a rich discussion with Michael Mauboussin about "The Great Migration Public to Private Equity."
- Prof G Show - Scott Galloway's solo weekly podcast is worth subscribing to. It's full of terrific insights. This one centers around the virtues of breaking up "Big Tech."

Two Books Which Help Understand a Bit of Where We Are and How we Got Here

- The Warmth of Other Suns - Isabel Wilkerson's story about the epic and under-told story of America's great migration.
- White Fragility - Robin Deangelo's book gives those of us born with white privilege a glimpse at the pervasive structural elements of our society and how ill-equipped most of us are to understand and appreciate it – which are pre-cursors for meaningful change.

Two Worthwhile Netflix Documentaries

- The Social Dilemma – Deeply disturbing, but a "must-watch" documentary. As the film's tag line states, "Never before have a handful of tech designers had such control over the way billons of us think, act and live our lives."
- My Octopus Teacher - A beautiful documentary about the year-long friendship between a South African diver and an octopus.

Summary

As always, on behalf of the entire team at Granahan Investment Management, we thank you for your continued interest in our equity offerings. Please note that our client assets are managed alongside of our own. 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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