Small Cap Core Growth
Portfolio Commentary
4th Quarter 2020

U.S. markets posted another exceptional return in the 4th quarter. The markets were buoyed by several significant factors over the quarter: the cloud of uncertainty over the election was lifted, the FDA approved two vaccines and their subsequent initial roll-out started, and Congress finally passed another COVID-19 relief package.

The coronavirus pandemic has caused a rewiring and modernization of companies in surprising ways, serving up unexpected opportunities for some to prosper. The Granahan Small Cap Core Growth strategy was positioned to take advantage of this environment, and the composite returned +37.1%, net of fees, nicely ahead of the +29.6% fourth quarter return of its Russell 2000 Growth benchmark. Year-to-date, the strategy's +72.8% net-of-fee return is well ahead of the +34.6% return of the Index.

The portfolio's strongest performing company in the fourth quarter was **Magnite, Inc**. **(MGNI)** from the Pioneer LifeCycle category. MGNI's revenue comes from digital advertising, which is closely correlated with rising GDP growth. Experts forecast strong 2021 GDP growth with digital ads growing 2x-3x faster than traditional advertising. Valuation for MGNI is about half of its closest peer in the industry. We are trimming the name to due to position size. Holdings from the Core Growth LifeCycle category accounted for the rest of the top five names in the quarter: **Enphase Energy (ENPH)**, **Digital Turbine (APPS)**, **Vericel (VCEL),** and **Texas Capital Bancshares (TBCI)**. From the info tech sector, Enphase Energy and Digital Turbine continued the strength they exhibited in Q2 and Q3 into the fourth quarter. 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 Q3 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. Enphase Energy uses ASIC technology to intelligently adjust solar microinverters for each application, a breakthrough in the solar marketplace that has allowed them to take market share. We have trimmed these two holdings based on position size. From the healthcare sector, Vericel is a regenerative medicine company with commercial products for knee injuries and severe burns. VCEL's business was harmed during the lockdown and has since showed a significant recovery as people used the work-from-home (WFH) downtime to move forward with knee surgeries. On the burn side of the business, the company filed for a new burn treatment procedure that should be a material driver to long-term growth. Vericel's strong earnings recovery and improved long-term growth outlook served as catalysts for the stock price; and we maintain our position. Regional banks as a group recovered in Q4 from earlier depressed levels, as investors' credit concerns moderated. This positive credit background, coupled with the aggressive cost savings implemented by Texas Capital Bancshares' new CEO, has been viewed positively by investors. We added to the stock on weakness earlier in the year and maintain our weighting.

Four of our largest detractors this quarter were from the Healthcare sector: **Quidel (QDEL)**, **OrthoPediatrics (KIDS)**, **Esperion (ESPR)**, and **Pacira Biosciences (PCRX)**. Core growth company, Quidel, provides antigen testing that currently accounts for about 25% of COVID-19 tests today. The stock came under pressure in direct response to the approval of COVID vaccines. We have added to the stock on this weakness, as QDEL will be a major beneficiary when testing shifts to antigens, which will eventually account for 75% of overall COVID tests. The company also received approval for a combined flu and COVID-19 test with a much higher price point. OrthoPediatrics, a Pioneer holding, sells orthopedic equipment specifically designed for children. The company experienced a strong recovery from earlier in the pandemic, but the stock came under pressure as investors rotated to stocks that more directly benefit from the vaccine or economic growth; we are holding the stock. COVID-19 lockdowns and fewer in-person doctor visits have resulted in a lackluster new product launch for Pioneer company Esperion. We continue to hold the stock because the company has a unique medication to lower LDL-cholesterol that can serve a substantial patient population. Pacira sells Exparel, a non-opioid, post-surgical pain therapeutic that has seen increased adoption due to COVID. The stock of Pacira, a Core Growth company, came under pressure when the re-emergence of the coronavirus raised concerns of an associated negative impact on elective procedures. While we trimmed our position given the out-performance of the stock earlier in the year, we maintain our current weighting given the strong outlook for Exparel as non-opioid options displace opioids. Lastly, Special Situation, Limelight Networks, sold off after a disappointing quarterly report. LLNW is a content delivery provider with its own network that helps companies improve delivery of their programming over the internet – whether video games, music or video. While we have trimmed our position, we believe that the shift from cable to online streaming has moved forward due to the pandemic, and that it will continue given the increased content now available.

For the year 2020, Enphase Energy and Digital Turbine – both Core Growth info tech holdings – were the standout performers. In Consumer Discretionary, Core Growth holding **Etsy** (**ETSY** - online marketplace for handmade goods) joins Magnite as a top performer for the year. Pioneer Healthcare company, **Immunomedics (IMMU)**, was bought out by Gilead for 108% premium, thus becoming one of the year's top five performers. Immunomedics has been sold, and we have used strength in the stocks to trim the other four positions.

Four of five holdings that detracted from performance in 2020 were Special Situation companies: **Newmark Group** (**NMRK)** in real estate, **BGC Partners (BGCP)** in financials, and energy companies **Ring Energy (REI)** and **ProPetro Holding Corp (PUMP)**. Core Growth healthcare holding, **QUIDEL (QDEL)** was also in the bottom five for the year. We have eliminated the energy names, added to Quidel, and are maintaining our positions in the others.

Attribution

Q4: In the quarter, out-performance versus the Russell 2000 Growth benchmark was driven by broad-based positive stock selection. The Q4 return was led by strong selection in consumer discretionary and info tech, and assisted by industrials and financials. Selection was also positive in the energy, communication services, consumer staples, and materials sectors. Stock selection in healthcare weighed on performance for the quarter.

The portfolio's overweight positions in the info tech, industrials, financials, and energy sectors boosted relative performance in the quarter, as did the underweight positions in consumer discretionary, consumer staples, real estate, and materials. The lack of exposure to utilities was also a plus.

With respect to LifeCycles, the Pioneer and Core Growth categories soundly outperformed the benchmark, while Special Situations lagged.

YTD: Strong stock selection also attributed to the outperformance for the year 2020, led by outstanding selection in info tech and consumer discretionary, as well as strong selection in healthcare. Selection in industrials, communication services, financials, consumer staples, and materials also contributed nicely. Our overweight position in info tech boosted the year's relative return, as did our underweightings of consumer discretionary, healthcare, industrials, materials, consumer staples, and the lack of exposure to utilities. Stock selection and our overweighting in energy hurt the year's performance, while the negative from selection in real estate was more than offset by our underweight position here.

The Pioneer and Core Growth LifeCycle categories significantly outperformed the overall benchmark in 2020, while the Special Situation category lagged substantially.

Weightings

Since 9/30, the portfolio has increased its overweighing in info tech, now 38% versus 21% for the Index, with much of the increase due to outperformance of the sector. Industrials (15%) and financials (5%) have moved from slight underweights to small overweight positions. Energy has decreased its overweighting and is now 1% versus a negligible 0.15% for the Index. Healthcare has become the portfolio's largest underweighting, 26% versus 34%. The remaining sectors have maintained their relative weightings to the benchmark.

Trimming the strong performing Pioneer and Core Growth stocks has decreased the weightings of these two LifeCycle categories since 9/30/2020. Pioneers have decreased from 34% to 31%, while Core Growth holdings have decreased from 50% to 48%. With the addition of several new names, Special Situations have increased from 16% in September to 20% currently.

Themes

Companies driving outperformance in the Consumer sector of our portfolio over the last year have been from the internet and direct marketing industry: Magnite, Etsy, and Digital Turbine. We are trimming all three because of position size and stretched valuations, although Magnite's valuation is nowhere near peer companies.

Markets tend to perform similarly whether a Republican or Democrat is in office. From 1853 to 2015, average annual returns under a Democrat-controlled White House were 10.7%, compared to an average annual return of 10.5% for Republicans. And, looking at the last 12 presidential election years, only two have ended in negative territory, 2000 and 2008 (Furey Research Partners, December 2020). Given the Biden administration's strong stance on climate change, companies that are planet-friendly are likely positioned to perform well. We have stocks in our portfolio that have already benefitted and will likely continue to do so: Plug Power, Vicor, Argan, Chart Industries, Tetra Tech, Enphase Energy, and Casella Waste.

The ISM manufacturing survey's headline composite increased from 57.5 in November to 60.7 in December. The December figure beat expectations and was one of the highest readings reported in recent decades. While virus-related developments appear to be weighing on some parts of the economy at the end of 2020 and into early 2021, several manufacturing indicators have looked strong. The strength in the demand for goods benefits many of our industrial companies: RBC Bearings, Luxfer, ProtoLabs and Columbus McKinnon.

Semiconductor companies design or manufacture computer chips and related components. Chips enable most of the technology underlying a host of trends that have been accelerated because of the COVID pandemic. Many of these companies are extremely profitable and have been able to invest in research to develop new products and pursue new markets. The internet of things (IOT), 5G wireless, robotics, and artificial Intelligence are a few of the technologies that immediately come to mind. While there has been tremendous consolidation in the industry (most recently, the buyout of portfolio company Inphi), there are still plenty of small capitalization stocks to consider for investment. Beneficiaries in our portfolio that demonstrate technological strength include Enphase Energy, Brooks Automation, Onto Innovation, Teradyne, Ceva, Silicon Labs, Power Integrations, and Monolithic Power.

Macro

The stock market looks to the future, generally out at least 6 months. Despite the COVID-19 epidemic entering its most dangerous phase, and new lockdowns threatening many economies with further erosion of revenue, there are positive factors supporting the market. Containment of the COVID-19 virus is on the horizon with the distribution of vaccines, Congress has passed a relief bill, companies are reporting stronger-than-expected revenue and earnings in the U.S. and around the world, and the election is finally behind us. Of course, there could be vaccine distribution issues that cause delays in reopening economies that could make the market's rise premature. In addition, tightening regulation and potential tax hikes associated with the new administration and aligned Congress could weigh on investor sentiment.

Outlook

The backdrop for small companies has been getting better with earnings revision ratios at highs. M&A activity has picked up, and we have seen a huge rise in IPO activity – both with traditional and SPAC vehicles. When M&A has accelerated in the past, small caps generally posted above-average performance and beat the large caps. (Stephen DeSanctis, Jefferies, December 2020)

Over the course of the Russell 2000 Growth's history, there have been very few quarters where the Index has returned greater than 29%. In 2020, we have had two quarters above this outstanding return. Granted, the June quarter was off a steep decline, however, returns like this are rare. While Pioneers are still the best performing category in the portfolio, some valuations here are stretched, and we have been trimming and adding to other

LifeCycle categories where valuations are more reasonable. We reiterate what we wrote last quarter as there continues to be much talk about the performance divergence of small cap growth (SCG) stocks relative to small cap value (SCV) stocks, and the possibility of a bubble forming like the one in 2000. While SCG relative valuation remains elevated, it is nowhere near what it was at the peak of the Tech Bubble. With respect to sales growth, ROE, and cash flow margin differences across key areas, we continue to find SCG posting better numbers across the board, which is significantly different than the Tech Bubble fundamental case. As always, GIM will focus on selecting out the SCG companies across LifeCycles that demonstrate superior fundamental factors, and invest in the stocks of the companies when risk/reward is attractive.