January 6th, 2021 - A Day for the History Books

As this commentary was going to press, I woke up to news that Georgia's run-off election was likely to give the Democrats control of the US Senate. This was very welcome in my opinion. While much of Wall Street worries that Democrat control of both the White House and Congress will lead to rising taxes, more regulations, and higher interest rates, I think these concerns are overblown. Moreover, in my mind, they are far outweighed by the prospect of a return to competency, decency, predictability, and stability throughout the Federal Government.

The morning's optimism turned to sadness, anger, and fear later that day as a mob assaulted the US Capitol in an unprecedented threat to our democracy. Extreme wealth disparity and a myriad of economic and social challenges has left America ripe for populist extremism and tribalism.

I am hopeful that we as a nation "hit bottom" on that dark day and that this, combined with the election results, will serve as catalysts for us to do the hard but necessary work to improve our versions of democracy and capitalism. Perhaps this will enable our nation to not just survive, but to allow all Americans—irrespective of economic and social status—to participate in its fruits.

Time will tell, but I am more (though still cautiously) optimistic about our country's direction *than I've been since the day after the 2016 US Presidential Election.*

Drew Beja
January 7, 2021

Granahan Small Cap Focused Growth Strategy
Portfolio Manager Commentary
4th Quarter 2020

2020: Very Strong Results, Partly Attributable to Good Luck

2020 Full Year Attribution

Sometimes it's better to be lucky *and* good. The Focused Growth portfolio reflected some of each in 2020, resulting in exceptionally strong performance both on an absolute basis, rising 82.7% net-of-fees, and relative to its Russell 2000 Growth benchmark, which rose 34.6%.

Throughout 2020, I've written about what we've all dealt with during the year with the pandemic, so I'll try not to repeat myself too much here. But I will say that we at Granahan are lucky to be healthy, to have jobs that can be done effectively from anywhere, and to have great health insurance. We realize far too many are not so fortunate.

Alongside our fortunate situation at Granahan, the Focused Growth portfolio was also lucky in that the COVID-19 pandemic was a particular long-tail event that happened to provide benefits to many of the companies in which we are invested.

Attribution Outliers

Drilling down into the year's attribution, the pandemic provided pluses and minuses to virtually every company in the portfolio. I say virtually every company because there were exceptions. On the positive side, the most notable exception was **Teladoc (TDOC)** – the leader in telemedicine, which benefitted unequivocally from the pandemic. Teledoc entered 2020 with strong business momentum (revenue +27% in Q4 2019), and that growth spiked upward as the pandemic accelerated telemedicine adoption (revenue +85% in Q2 2020). TDOC shares rose significantly in concert, and based primarily on valuation, we exited our position in Q3.

Conversely, **OneSpa World (OSW)**, an operator of health spas on cruise ships, saw its business and stock price fall out of its cabin bed in early 2020, as cruise sailings came to a halt. In June, the company raised $72 million, which should help it bridge the gap until sailings resume. We purchased some shares in Q2 and Q3 and continue to hold a position in OSW.

Portfolio Puts and Takes

While Teladoc and OneSpa World are extreme outliers, for most of the companies in the portfolio and on our Desert Island Monitor, the pandemic came with both puts and takes. On the whole, for the companies in the portfolio there were more puts (i.e., benefits) than takes. Among these were a host of cloud computing companies such as **LivePerson (LPSN)**, **Hubspot (HUBS)** and **Workiva (WK)**, each "work-from-anywhere" beneficiaries.

Another example was **Etsy (ETSY)**, which operates a two-sided marketplace that enables sellers and buyers of specialty and handmade goods to conduct commerce. Early in the pandemic, sales on Etsy fell sharply, with individual sellers reporting declines of 20%-50%. However, in early March, the winds shifted abruptly, and the fierce headwind became a fierce tailwind due in part to Etsy's sellers pivoting to creating and selling masks. Etsy's business remains very strong, and the company's management team has deftly utilized the strength in its business to invest in a variety of areas that we believe will pay long-lasting dividends for the company. ETSY shares have risen significantly, and although we have taken profits along the way, the stock continues to be in the portfolio.

2020 Attribution
With respect to performance attribution for the year 2020, the portfolio's outperformance was due to strong stock selection in most sectors. The strongest stock selection came from Technology and Consumer Discretionary, with relative performance in both sectors further boosted by our overweight positions versus the benchmark. The sectors with negative selection were Financials, Healthcare, and Telecommunications.

While the bulk of the year's performance was due to stock selection, the effect from sector allocation was also positive overall with most of our relative weightings providing a benefit. The main allocation detractor was Healthcare, as it was a strong performing sector in which the portfolio was significantly underweight.

Q4 Attribution
The fourth quarter was extraordinarily strong in terms of performance across U.S. indices, and the Focused Growth portfolio had robust performance with a return of +36.9% net-of-fees. Even as Growth-oriented stocks trounced Value stocks for the year (in small cap, the Russell 2000 Growth returned +34.6% versus +4.6% for Russell 2000 Value), in Q4, small cap Value led with the Russell 2000 Value Index up +33.4% versus +29.6% for the Russell 2000 Growth Index.

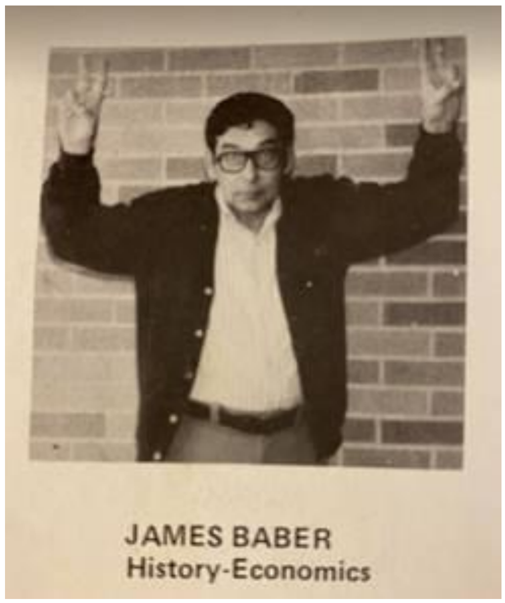
That said, the benchmark's +29.6% return in one quarter is nothing to sneeze at. Aside from Utilities (+12%), every sector in the benchmark climbed at least 20% during Q4. Leading the Index's return was Energy, a sector that rose 125%, driven by a 140% gain in the Alternative Energy subsector.

Given the broad strength in the Index, it was particularly difficult for active managers to beat the benchmark in Q4, with only 16% able to do so (Stephen DeSanctis, Jefferies, January 2021). The Focused Growth portfolio managed to exceed the benchmark return, with the outperformance primarily attributable to overweight sector allocations in Energy and Technology, and the extraordinary strength of two stocks – **Magnite** (MGNI **-** technology) and **Enphase Energy** (ENPH – energy).

Notably, three of the portfolio's four biggest detractors in Q4 actually had *positive* returns in the quarter: **CoStar (CSGP), LivePerson (LPSN),** and **Bright Horizons (BFAM)**. The fourth meaningful detractor was **eHealth (EHTH)**, which was down in the quarter.

Looking Back and Looking Forward – Are *Robinhood & The Retail Renaissance Red Flags?*
The returns that most asset classes achieved in 2020 would have been extraordinary in normal times. That they were so strong and so broad-based in the midst of a terrible global pandemic is surprising (understatement). What were some of the contributing factors? Certainly, unprecedented levels of government stimulus did not hurt. Nor did near 0% interest rates. In addition, retail investors returned to the markets in a way we haven't seen in a generation – sparked in part by easy-to-use sites such as Robinhood, and the ability to trade for free and to buy portional shares. This retail renaissance was no doubt encouraged by the market's upward momentum after mid-March, and the fact that many people had a whole lot of time on their hands and fewer sporting events to watch (and bet on). It is worth noting that, historically, retail investors "piling into the market" has often been a contrary indicator. Another historically contrary market indicator is the level of margin debt, which hit a record in November (Wall Street Journal, 12/27/2020).

This harkens me back to middle school and Mr. Baber's *Introduction to Economics.* Mr. Baber was a fantastic teacher who taught me a lot of lessons about economics and investing – many of which I lean on to this day. One that heavily resonated with me – then and now – relates to investing on "margin." Margin investing uses leverage to buy stocks, where the stock purchased serves as collateral for the borrowing to purchase the stock. This all can work out beautifully – as long as the stock being purchased goes up. But it can get very ugly, very fast if the environment shifts from risk acceptance to risk aversion. If stocks go down, investors can be forced to sell in order to cover their margin requirements. This can pressure prices, in turn causing further margin selling and creating a viscous downward spiral.



Mr. Baber drilled into us as adolescents that the seeds of virtually every market crash can be traced back to margin leverage. He preached this in 1975 – before the '87 stock market crash, the dot.com bubble, and Global Financial Crisis provided three more painful instances of the danger of buying stocks on margin. Similarly, 2020 saw a robust IPO market and a record number of SPAC (Special Purpose Acquisition Company – AKA "Blind Pool") new issuances. These factors conjure up market frothiness which occurs amidst a host of macro uncertainties including: A new Presidential administration, a shift to a Democratic-controlled Congress, the prospect of higher taxes and more regulation, economic saber rattling between the US and China, Brexit finally happening, and lest we forget … a raging global pandemic. While help is on the way with COVID-19 vaccines, there is much uncertainty about the how, timing, and ultimate reality of the "new normal."

Therefore…

Should we all take our money and put it under the mattress (another of Mr. Baber's favorite lines)? I don't think so. For starters, neither I nor anyone else knows what the market is going to do in 2021, 2022, or 2023. After all, who would have forecasted that the Russell 2000 Growth would rise 121% from March 18, 2020 to December 31, 2020? The rotation from Growth to Value that began in Q4 has thus far continued into 2021. This shift may persist for a while, as was the case for about six weeks during Q4 2016 after the Trump election … or it may not.

The Focused Growth portfolio contains companies we believe are "Desert-Island worthy" – that is, we expect them to be much, much larger in 5-7 years – and whose stocks we believe have an attractive risk/reward profile. While some giveback after the extraordinary returns of 2020 would not be surprising, I believe our philosophy and process can continue to generate attractive returns in most market environments. That said, as always, it is critical to make sure one's asset allocation plan is sound and being adhered to.

Boardroom Diversity Efforts Gain Momentum - Long Overdue
In December, the Nasdaq, Inc. announced moves intended to bring more diversity to U.S. corporate boards. The Exchange filed a proposal with the SEC that would require listed companies to have at least one woman on their boards in addition to a director who is a racial minority or self-identifies as lesbian, gay, bisexual, transgender or queer. Companies that do not meet that standard will have to explain why this is the case in order to remain listed on Nasdaq. Foreign companies and smaller reporting companies will have additional flexibility in satisfying this requirement with two female directors. The Nasdaq stated that its goal for the proposal was to "provide stakeholders with a better understanding of the company's current board composition and enhance investor confidence that all listed companies are considering diversity in the context of selecting directors."

Capitalism is in many ways a wonderful thing. But reminiscent of Churchill's famous line about democracy being "the worst form of government except for all others," capitalism is far from perfect. The empirical evidence of the state of corporate boards in the U.S. shows that progress on the diversity front has been at a snail's pace. My experience having met with thousands of companies during 35+ years of investing is consistent with this. Simply put, U.S. Boards are too male and too white. My experience also confirms that board diversity is not only a good thing from a social justice perspective, but also a good thing in that it brings diverse opinions and experiences to the board room. A group of 55–70-year-old straight white men is bound to have a lot of blind spots. Given the self-perpetuating cycle of most boards (i.e., directors tend to nominate directors from their own social circles), the pace of change is likely to remain glacially slow. Net, I welcome the Nasdaq's initiative.

Some Books/Shows/Movies/Podcasts Worthy of Your Time

Books:

- Poor Charlie's Almanac - Edited by Peter Kaufman and illustrated by Ed Wexler, Poor Charlie's Almanac is a great coffee table addition compiling a whole lot of gems from Warren Buffett's elder investing partner.
- Between the World and Me - Ta-Nehisi Coates' gripping memoir of his experience of being black, told as a missive to his son.

Podcasts:

- It Was Said - Acclaimed historian Jon Meacham's podcast about some of the most important public speeches in U.S. history. I've enjoyed each of the first six episodes I've listened to so far, but this one on President Barack Obama's speech after the white supremacist's tragic massacre at the Emanuel AME Church in Charleston, South Carolina is exceptional.

TV Series:

- Ted Lasso - Longtime Saturday Night Live cast member Jason Sudeikis stars as an American football coach who brings his unique and endearing persona to London when he is hired to manage a Premier League football club.
- Babylon Berlin - I loved being transported back to Berlin during the Weimar Republic in the fun and visually stunning Netflix series. I can't wait for the pandemic to end so production on Season 4 can begin!

Summary

On behalf of the entire team at Granahan Investment Management, thank you for entrusting us with the management of your capital alongside our own. I wish you a safe, fulfilling, and fruitful 2021. Please don't hesitate to reach out if you have any questions, comments, or Desert Island-worthy ideas.

Sincerely,

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