Small Cap Select Opportunities

Portfolio Comments

December 31, 2020

Distinguishing Features

GIM builds the Small Cap Select portfolio from the bottom-up; sector weightings are secondary to stock selection. As of 12/31/2020, the Small Cap Select portfolio continues its significant overweight position to the info tech sector versus the Russell 2000 Growth benchmark, 36% compared to 21%, as well as its substantial underweighting in healthcare, 18% versus 33.5%. The overweighting in the consumer discretionary sector continues, 22% versus 14%. In the energy sector, the portfolio is now at 3% versus <1% for the benchmark. The industrials, financials, and communication services sectors are all near equal-weighted to the benchmark. The real estate sector remains underweighted versus the Index, <1% to 3.5%, and consumer staples are also underweighted, <1% versus 3%. The portfolio continues to have no exposure to the material, and utilities sectors, where the benchmark weightings are 2% and 1.5%, respectively.

Commentary

Market Environment

US 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 began, 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.

Performance Discussion

The Granahan Small Cap Select strategy was positioned to take advantage of this market environment and returned +52.3% net-of-fees in the 4th quarter, well ahead of the +29.6% return of its Russell 2000 Growth benchmark. Year-to-date, the strategy's outstanding +126.6% net-of-fee return is substantially ahead of the +34.6% return of the Index.

Outperformance in the quarter was a result of strong broad-based stock selection, particularly in the consumer discretionary and information technology sectors. Our overweighting in consumer discretionary slightly offset the strong selection here, while the overweight position in info tech boosted relative performance. Industrials, financials, real estate, consumer staples, energy, and communication services also showed positive selection, and the effect of our relative weightings in these sectors added to relative performance. Selection in healthcare weighed on performance, as did our underweighting of the sector. The lack of exposure to the materials and utilities sectors was a positive to relative performance.

With respect to LifeCycles, the Pioneer LifeCycle category significantly outperformed the Index, and the Core Growth category also showed substantial outperformance. The Special Situation LifeCycle category lagged. Consumer Discretionary Pioneer, **Magnite, Inc.**, was by far the top performer in the period. Three info tech holdings from the Core Growth category were in the top five performers in the quarter: **Enphase Energy, Digital Turbine**, and **Euronet Worldwide**. **Chart Industries, Inc.** (Special Situation, industrials) rounded out the top five.

On the negative side, the largest detractor in the quarter was **Limelight Networks** (Special Situations, info tech). Two consumer discretionary stocks were also in the bottom five: **Nautilus Inc.** (Special Situation), and **Stamps.com Inc.** (Core Growth). Two Core Growth healthcare names – **Quidel Corporation and Ligand Pharmaceuticals** – were also in the bottom five.

Positioning

While there are no guarantees in the investment business, it'd be hard to argue that 2021 is likely to be very different than 2020, for a variety of reasons. Investors are getting excited that the "great rotation" from growth to value is imminent; after all, growth has dominated in the last few years. This is not an unreasonable opinion. As bottom-up investors, however, we do not put too much faith in our ability to make these types of market calls. Instead, we work to maintain a portfolio that can allow stock selection to shine. That said, we do believe that the global economy is likely to see accelerating growth in the coming year, especially with the first COVID-19 vaccines being distributed worldwide. Using our LifeCycle diversification tool, in the fourth quarter, we have sought to re-invest some of the profits that we realized from our top performing Pioneer and Core Growth holdings into Special Situation names that should benefit from a stronger economy. This has led to the portfolio now being more balanced across LifeCycles than it was in the middle of the year. We think this is valuable. While the stocks of many well-run and fundamentally strong Special Situations companies have significantly underperformed in the recent years, we do suspect that many of these companies are positioned to outperform in the coming year, especially as valuations for many Pioneers and Core Growth names have become stretched.

A recent position we initiated is **Kulicke & Soffa Industries (KLIC)**, a semi-conductor capital equipment provider, and a classic Special Situation. After suffering a rare two-year downturn in volumes, the semiconductor industry is poised for a much stronger 2021, fueled by 5G Phones as well as an anticipated recovery in the Auto industry. With Q3 earnings, KLIC has already exhibited an important inflection point in its business. The company is not only well-positioned for a cyclical recovery in 2021, but it also has a couple of new growth drivers – Mini-LED and Advance Packaging – that should offer meaningful revenue opportunities over the short and long-term. Our view is that KLIC is poised to have a much stronger year than what is anticipated in the Street consensus estimates, and the stock trades at a discount to its earning potential. KLIC is a good example of the type of company we seek for the Special Situation LifeCycle category. We diversify the portfolio across the three LifeCycles to position the portfolio to capitalize on the disparate performance drivers of the three categories, as we also seek to mitigate risk in changing markets.

Outlook

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's return was off a steep market decline; however, returns like this are rare. Pioneers have been the best performing category in the portfolio, and valuations are stretched here; 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.