Global Small Cap Opportunities

Portfolio Comments

March 31, 2021

Distinguishing Features

GIM builds the Global Small Cap portfolio from the bottom-up; country and sector weightings are secondary to stock selection, with the US allocation at least 50% of the overall portfolio. As of 3/31/2021, the Global Small Cap portfolio was underweight the US versus its MSCI World Small Cap (net) benchmark, 53% versus 58%. The portfolio was also underweight Japan, 6% versus 10%. The portfolio's largest country overweightings were Germany (5% to 2%) and Ireland (4% to 1%). Exposure to stocks in Canada, Israel, Norway, and Iceland, and India brought those country weightings to about 2% over the benchmark each. Holdings in United Kingdom, Netherlands, Bermuda, Singapore, Switzerland, and Denmark stocks brought the portfolio within 1% of the Index weighting for each country.

With respect to sectors, the portfolio continues its substantial overweight positions in information technology (25% versus 13%) and healthcare (21% to 12%). Industrials is also overweight the benchmark, 22% versus 19%. The largest underweight positions are in real estate (3% to 9%), consumer discretionary (9% to 14%), and materials (2% to 7%).

Commentary

Market Environment

Following the depths of the market downturn last March, the technology and healthcare bias of the Growth Indices drove exceptional outperformance versus their Value brethren as the pandemic suddenly changed companies' day-to-day operations and procedures. In a reversal, in Q1, value-oriented and core indices significantly outperformed their Growth counterparts. Financials, energy and industrials stocks, a large component of Value Indices, surged based on the rise in interest rates and signs of inflation. The MSCI World Small Cap Index (net), a benchmark without a Growth or Value bias, returned 9.5% in the quarter.

Performance Discussion

In this environment, the Granahan Global Small Cap composite underperformed its MSCI World Small Cap (net) benchmark, returning +8.1% net-of-fees versus +9.4% for the Index.

The under-performance in the quarter was a result of weakness in the portfolio's US holdings versus those of the benchmark, reflecting weak stock selection in the US info tech stocks. The overweight position in info tech was also a negative. Stock selection in consumer discretionary also weighed on performance, including holdings from Italy, the US, and the UK; our underweight position in the sector was also a negative. On the positive side, strong selection in the healthcare sector, led by holdings in Germany and the US, more than offset the effect of our overweight in this poor performing sector for the Index. Selection in Canadian stocks in the materials and communication services sectors also contributed nicely.

With respect to LifeCycles, the Core Growth and Special Situation categories performed in line with the overall benchmark, while the Pioneer category lagged. The five largest detractors were all from the info tech sector with four of the five from the US: **Rapid 7** and **Nutanix** (both Pioneers), and **Cloudera** and **Euronet** (both Core Growth). An Israeli holding, **CyberArk Software** (Core Growth) rounds out the bottom five.

On the positive side, three healthcare holdings were top contributors: **Vericel** (Core Growth, US), **Affimed N.V.** (Pioneer, Germany), and **CryoPort** (Pioneer, US). Two Special Situation holdings round out the top five: **Columbus McKinnon** (industrials, US) and **Neo Performance Materials** (materials, Canada).

Two sectors in which the portfolio is consistently underweight, financials and energy, were strong performing sectors for the benchmark the first quarter. As a bottom-up investor, these structural underweights are indicative of the sectors having few high-quality stocks that exhibit strong, sustainable enterprise growth. Our investments across the global small cap universe, no matter the sector or country, reflect companies that benefit from attractive secular drivers.

Outlook

The investment environment is likely to be very different in 2021 than 2020 for a number of reasons. As vaccinations proceed, economic growth forecasts continue to rise in most parts of the world; however, the pace of recovery among regions has recently diverged. The main drivers of the US recovery, the pace of vaccinations and fiscal stimulus, should be similar for Europe and Asia. However, Europe has been particularly slow in its execution of these programs, a stark contrast to the progress in the US. As of early-April, the share of population having received a first shot was 36% in the US versus Western Europe around 15%; the UK is the exception at 47%. Japan and Australia are even worse at less than 4%. With cases on the rise again, the continued lockdown measures are weighing down economic growth in Europe relative to the US. In addition, the EU's €750B Recovery fund has yet to pass as it continues to be held up in the courts. We believe that synchronized global growth will occur later in the year. This lag in developed markets outside of the US presents some interesting opportunities to invest in quality businesses, resilient to the macro environment, in which valuations are attractive vis-à-vis similar companies in the US.

Stock selection drives performance for the GIM strategies, particularly, stocks of innovative, financially sound, and agile companies that provide the necessary tools and products for businesses to stay relevant in the changed, post-pandemic world. Our portfolio remains concentrated to drive outperformance from the best growth stocks, yet it is diversified with balance across sectors, countries, and our LifeCycle categories.