Microcap Growth

Portfolio Comments

March 31, 2021

Distinguishing Features

GIM builds the Microcap portfolio from the bottom-up; sector weightings are secondary to stock selection. The telecommunications sector has moved to the largest overweighting in the portfolio versus the Russell Microcap Growth benchmark, now 7% versus 2%. The portfolio's one holding in the utilities sector results in an overweight position here, 3% to 1%. The largest underweight positions versus the Index continue to be consumer discretionary (6% to 10%) and industrials (7% to 10%). Healthcare remains slightly overweight versus the Index (47% versus 45%), as is technology (20% to 19%) and materials (2% to 1%). Consumer staples is equal-weighted at 3%, while the financials sector is slightly underweighted versus the Index, 3% versus 4%. The portfolio has no exposure to the real estate and energy sectors where the Index weightings in these small sectors are 2%, and 3%, respectively.

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, even as microcap stocks performed very well across the spectrum, the Russell Microcap Growth Index return of +16.9% meaningfully lagged the Russell Microcap Value return of +29.4%. Financials, energy and industrials stocks, a large component of Value Indices, surged based on the rise in interest rates and signs of inflation.

Performance Discussion

The Granahan Microcap Growth portfolio participated nicely in this environment, with its net-of-fee return of +18.9% outperforming the Russell Microcap Growth's +16.9% return.

For the 1st quarter, relative outperformance versus the Russell Microcap Growth benchmark was primarily due to stock selection, driven by selection in healthcare. Positive selection in consumer staples, utilities and industrials assisted, and our overweight position in utilities boosted good selection here. Selection in financials weighed on performance, though this was partially offset by our overweight position in this top performing sector for the benchmark. Selection in consumer discretionary, technology, basic materials, and telecommunications were also negatives, though our overweight positions in materials and telecommunications offset much of the weak selection here. Our lack of exposure to real estate and energy were also a slight drag on relative performance.

With respect to LifeCycles, the Core Growth LifeCycle category soundly outperformed the Index, while the Special Situation category also performed ahead of the benchmark. Pioneer category significantly lagged. Four of the quarter's top contributors were healthcare holdings: **Organogenesis Holdings** and **Vericel** (both Core Growth), plus **Affimed N.V.** and **Aerie Pharmaceuticals** (both Pioneers). Special Situation holding **NeoPhotonics** (technology) rounds out the top five.

The largest detractors in the quarter represented five sectors and all three LifeCycles: **LifeMD** (healthcare, Pioneer), **Radware** (technology, Core Growth), **Nautilus** (consumer discretionary, Special Situation), **James River Group Holdings** (financials, Core Growth), and **ShotSpotter** (industrials, Pioneer).

Outlook

The investment environment is likely to be very different in 2021 than 2020 for a number of reasons. We enter the year with the promise of vaccines allowing the reopening of the economy, excess savings at individuals and corporations, and a new era of massive deficit spending – all poised to drive economic growth, as well as higher inflation and interest rates. The investment landscape has changed relative to the past 5 years when the low interest rate environment favored long duration assets. In the near term, companies more tied to the GDP growth will see high earnings growth.

The stock market demonstrated in the mid-1960s that extreme fiscal and monetary policies were beneficial to stocks, especially small cap stocks. As bottom-up investors, we do not focus on making market calls; our focus is to identify companies that are positioned to benefit from growth drivers and invest when the respective stock trades at a discount to the company's intrinsic value. Stock selection drives performance for GIM strategies, particularly, stocks of agile companies providing the necessary products to thrive 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 and our LifeCycle categories.