Global Small Cap Opportunities

Portfolio Comments

June 30, 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 6/30/2021, the Global Small Cap portfolio continues its underweight for the US versus its MSCI World Small Cap (net) benchmark, 52% versus 58%. The portfolio's is also underweight Japan (7% versus 10%). The portfolio is overweight Canada (7% versus 3%) and Israel (3% versus 1%). Europe (excluding UK) is slightly overweight the Index (15% versus 14%) with higher portfolio weightings in Germany, Netherlands, and Ireland, all driven by stock selection. We are nearly equal-weight the UK at 6.5%.

With respect to sectors, the portfolio continues its substantial overweight position in information technology (30% versus 13%). The portfolio's healthcare sector weighting was reduced over the quarter, though remains overweight to the benchmark (15% to 12%). Industrials remains overweight the benchmark, 20% versus 18%. The largest underweight position continues to be in real estate (3% to 9.5%). Materials is also underweighted (1.5% to 7%), as is financials (9.5% to 13%) We have no exposure to the energy sector (benchmark weighting 2.5%) and utilities (benchmark weighting 2.5%).

Commentary

Market Environment

Performance for the three months of the 2nd quarter resembled a seesaw. After a decent start to the period, the global markets sold off in May as strong company earnings reports coupled with rising wage inflation and soaring commodity prices stoked fears about the possibility that profits have peaked. These dynamics, in addition to labor tightness and continued supply chain disruptions, are affecting foreign companies in a similar way as US businesses. In May, overseas markets started to experience an acceleration in COVID cases due to the rapidly developing Delta variant; the same spike did not occur in the US until the end of the quarter. In June, the Federal Reserve signaled its timing for raising interest rates may be earlier than expected, a development that has far-reaching implications across the world. Ultimately, the strong underlying fundamentals of the global economy (e.g., strong PMI, growing employment, rebounding consumer demand) outweighed these increasing risks and led to positive performance for the quarter; The MSCI World Small Cap Index (net), a benchmark without a Growth or Value bias, returned +5.0% in the quarter.

Performance Discussion

In this environment, the Granahan Global Small Cap composite slightly underperformed its MSCI World Small Cap (net) benchmark, returning +4.6% net-of-fees versus +5.0% for the Index. Year-to-date, the composite performance lags the benchmark, +13.0% versus +14.9%.

The under-performance in the quarter was primarily a result of weakness in the portfolio's US healthcare holdings versus those of the benchmark, and the portfolio's overweight position in the sector further weighed on relative performance. Selection in industrials, consumer discretionary, and materials also weighed on performance. On the positive side, the portfolio showed very strong selection in info tech, which was boosted by the portfolio's significant overweighting. Stock selection in financials was also a plus.

With respect to LifeCycles, the Pioneer category strongly outperformed the overall benchmark return, while the Core Growth and Special Situation categories lagged. Three of the five largest detractors were from the healthcare sector: **Veracyte** (Pioneer, US), **908 Devices** (Core Growth, US), and **Clinigen Group** (Core Growth, UK). One of last quarter's top performers was in the detractors this quarter – **Neo Performance Materials** (Special Situation, materials, Canada)**.** **Bright Horizons Family Solutions** (Core Growth, consumer discretionary, US) rounds out the bottom five.

On the positive side, four of the five top contributors were from the info tech sector: **Perficient** (Core Growth, US), **Nutanix** (Pioneer, US), **Money Forward** (Pioneer, Japan), and **Cloudera** (Core Growth, US; a buyout). UK company, **Sanne Group** (Special Situation, financials) rounds out the top five.

Positioning

The pace of reopening is more progressed in the US than other regions given progress on vaccinations. As such, valuations in the US are more extended relative to international markets. Given this dynamic, the portfolio is underweight the United States as we are finding a more compelling risk/reward situation internationally, particularly in Europe and Canada. For example, **Aritzia** (differentiated omnichannel woman's apparel retailer) is one of a mix of high-quality companies in Canada

Even as the low growth profile, governance and overall conservative nature of the Japanese market does not generally align with our investment philosophy, we do find attractive growth companies in our bottom-up research. **Money Forward** (cloud-based SaaS financial software for small businesses) and **Open House** (differentiated homebuilder that dominates in a niche market) are two that meet our investment criteria.

As a growth investors, the innovative areas of technology and healthcare will continue to be overweighted given the sectors' growth profiles and strong secular tailwinds. In industrials, we are also finding attractive businesses that are benefitting from secular growth driven by factory automation, digital transformation and energy transition. For instance, the portfolio's largest holding is **Kornit Digital**, an Israeli manufacturer of digital printers with a highly disruptive technology and business model.

Given that the Index is style neutral, the more value-oriented real estate sector is a large weighting in the benchmark (10%), and one that we will likely remain underweight due to low growth rates, high leverage, and competitive landscape. In addition to these factors, much of the sector is affected by work-from-home dynamics that are likely to continue for the office segment long after the pandemic.

Similarly, we are likely to remain underweight financials (9.5% to 13%) due to the large portion of the segment that is comprised of secularly challenged traditional branch-based banks. The shift to digital and the associated proliferation of alternative banking and payment platforms are hurting growth and returns in the banking industry, and this is where we seek opportunities. **Hypoport** in Germany is an example of a disruptive, high growth business-to-business marketplace for mortgage financing, insurance and other financial platforms.

Outlook

The cross currents in the macro-economic picture are strong. In the US, GDP has surged, re-openings have accelerated, manufacturing data is robust, and consumer confidence is increasing. Corporate earnings have surged. The pace of recovery Internationally continues to lag behind the US due to the emergence of COVID variants combined with lower vaccination rates abroad. The resurgence of cases across the world is leading to renewed restrictions on social activity in certain countries, weighing on market sentiment and leading to uncertainty regarding growth expectations. The Delta variant has increased the downside risk in the market. While economic growth is rebounding, stronger wage gains and soaring commodity prices are driving inflation rates higher than expected, causing many to re-think whether inflation is transitory. The Federal Reserve signaled a shift in its timing for an increase in interest rates as the strength of the economy reopening has surprised many. While we certainly pay attention to these changing economic and social dynamics, our investment process focuses on businesses that we believe can outperform in most market environments, including if more restrictive lockdowns are put back in place. **Netcompany**, a Danish IT consultant enabling digital transformations, and **IMCD**, a Dutch specialty chemical distributor with exposure to pharma, are examples of companies that have benefitted from the pandemic. On the other hand, the portfolio holds a number of stocks that we believe should benefit from a full recovery in consumer and industrial demand. Companies such as **CTS Eventim** (Germany; concert ticking platform and promoter) and **Coats Group** (UK; global leader in threads for apparel and industrial) are positioned to benefit from pent up demand post-COVID.

Valuations continue to improve driven by positive estimate revisions and flat stock prices. However, a large valuation disparity between the US and developed international markets remains, providing some interesting buying opportunities for high quality foreign companies.

Across sectors and LifeCycles, the GIM investment process separates companies from stocks. So whether global inflation is transitory or not, or given other macro dynamics, GIM first vets each company in search of those that we believe are well-positioned to do well in most market environments.