Microcap Growth

Portfolio Comments

September 30, 2021

Distinguishing Features

GIM builds the Microcap Growth portfolio from the bottom-up; sector weightings are secondary to stock selection. As of 9/30/2021, the Microcap Growth portfolio maintains its overweight position in technology versus the Russell Microcap Growth benchmark, now 22% versus 11%. The portfolio is also overweight relative to the Index in several smaller sectors: telecommunications (6% versus 2%), utilities (4% versus 1%), consumer staples (4% versus 2%), and financials (4% versus 3%). Consumer discretionary continues to be the portfolio's largest underweight, 4% versus 17% for the Index. The portfolio is also underweight compared to the benchmark in industrials (10% versus 13%) and is nearly equal-weight health care (43%). We continue to have no exposure in energy and real estate, and we eliminated our position in materials during the quarter.

Commentary

Market Environment

Mounting concerns over higher inflation, and the threat of a more contagious COVID variant spreading around the world, weighed on global markets this quarter with some areas seeing their first downturn since the start of the pandemic. Supply chain issues have caused uncertainty and, coupled with the disarray in Washington D.C., has prompted investors to harvest some profits. U.S. markets were down this quarter, and the Russell Microcap Growth Index ended the quarter down sharply at -9.1%.

Performance Discussion

In this negative environment, the GIM Microcap Growth composite underperformed its Russell Microcap Growth benchmark with a return of -15.4% net-of-fees, versus -9.1% for the Index. Year-to-date, the strategy lags the benchmark, -0.8% net-of-fees versus +9.6% for the benchmark. Selection in healthcare accounted for most of the underperformance in the quarter, even as the sector was also the largest negative contributor for the benchmark. Selection in technology and telecommunications also weighed on performance in the period. Selection in consumer discretionary and utilities detracted, though our underweighting in consumer discretionary more than offset the negative selection to provide positive attribution. The portfolio's overweight position in utilities was a negative, as was our lack of exposure to the energy sector. On the positive side, both consumer staples and industrials showed strong selection, and selection in financials was also positive.

With respect to LifeCycles, the Core Growth category was a substantial outperformer versus the overall benchmark. The Pioneer and Special Situation categories both significantly underperformed the Index. The five largest detractors include three healthcare holdings: **Neuronetics** and **LifeMD** (both Pioneers), and **iCAD** (Special Situation). **Airgain** (telecom, Special Situation) and **EverQuote** (info tech, Pioneer) round out the bottom five.

Although the healthcare sector and the Pioneer LifeCycle category both detracted from the portfolio's overall performance, healthcare Pioneer **Intersect ENT** was the top contributor in the quarter. Three of the remaining top five contributors were from the Core Growth LifeCycle category: **Echo Global Logistics** (industrials), **Perficient** and **Radware** (both technology). Special Situation **Chefs' Warehouse** (consumer staples) rounded out the top five.

Positioning

We expect increased volatility given the uncertainties created by the COVID Delta variant and its impact on the healthcare and consumer sectors, while the current supply chain and logistics problems will likely have ripple effects through many sectors of the economy. The short-term influence of these issues also provides opportunity due to price dislocation, and we will continue to initiate or add to positions as a company's long-term fundamentals dictate and the stock's risk/reward warrants.

The Microcap Growth strategy seeks to invest in the stocks of innovative microcap companies, and we continue to find compelling investment opportunities in healthcare, technology, and industrials.

Outlook

Year-to-date, for the Russell 2000 Growth Index of small cap companies, profitable companies are up +14%, while loss-making companies are down at -10%. (Furey Research Partners, October 5, 2021; Q321 Letter). Divergences like this can also be viewed through LifeCycle diversification, the tool that also tends to bolster the portfolio in uncertain markets. Pioneers are on their way to earnings growth but much of the time are not profitable and can be under pressure in "risk-off" markets, while Core Growth and Special Situation names generally show strong earnings growth. At this time, we see earnings projections rise for the portfolio while valuations have come down. Absolute valuations are near long-term medians for the Russell 2000 Index at 17X, and relative valuations versus large cap indices are at a two-decade low. Many names that are under pressure in the Microcap portfolio continue to have strong fundamentals, and we are adding to these positions.

With conflicting macro factors swirling around, it can be difficult for investors to clear through the clutter to make investment decisions. The GIM team continues to focus on secular trends that drive earnings growth. At Granahan Investment Management attention is on the fundamental drivers of our companies' businesses. It has always been the focus of our repeatable processes and has provided success for our clients over time.