GLOBAL SMALL CAP

Portfolio Comments
March 31, 2022

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 3/31/2022, the Global Small Cap portfolio had the US underweight relative to the MSCI World Small Cap (net) benchmark, 54% versus 58%, primarily due to the valuation differential; Japan is the other meaningful underweight (4.6% versus 10%). Canada represents the largest country overweight relative to the benchmark (8% versus 4%).

With respect to sectors, the portfolio continues its substantial overweight position in Information Technology, 28% versus 12% for the benchmark. The portfolio is also overweight Healthcare (17% versus 9%). As is typical for the portfolio, the largest underweight positions continue to be in Real Estate (4% to 10%), Materials (2% versus 8%) and Financials (12% versus 14%). We have no exposure to Energy and Utilities.

Commentary

Market Environment

A tightening yield curve, spikes in oil prices, and inflation running at its highest level in 40 years have some worried we could be entering a period of stagflation. Other observers have pointed to the fact that higher oil prices and inverted yield curves have often preceded recessions. In fact, higher oil prices in 1987, 1996, 2011 or 2018 did not spark a recession, and in many cases a recession did not follow an inverted yield curve. Monetary policy is still eased, which could allow the economy to absorb some of the pain that comes from higher oil prices. Possibly one of the largest negatives today is the Ukrainian war. We’ve seen the short-term impact on oil supplies and pricing, but we cannot predict the longer-term implications.

Despite the litany of negative factors underpinning the economy, growth has been strong in the US, although it is beginning to weaken. As of March 21st, nominal retail sales were up 18%, and bank loans were taking off as people hurried to take advantage of low interest rates before the hike. There is $2 trillion in consumer excess savings from staying home during the pandemic. Unemployment claims are at an all-time low. We’ll have to wait and see which macro factors have the greatest impact on future results.

Performance Discussion

The first quarter of 2022 was another notable period where high-growth companies were penalized by the market. Higher interest rates and inflation resulted in a collapse in multiples, causing major changes in the prices of many of our secular, high growth companies. Granahan’s Global Small Cap strategy returned -12.26% in Q1, lagging the MSCI World Index benchmark’s return of -6.41%. Similar dynamics that impacted our Q4 2021 performance accelerated in Q1 2022. Our sector allocation was a detractor this quarter as Energy, Materials and Utilities, areas of the market we typically avoid, were the only sectors to post positive performance.

Stock selection in Consumer Discretionary helped relative performance the most during the quarter. The positive impact from the sector was broad-based including solid contributions from **Bright Horizons, Coats Group, Aritzia** and **Revolve Group**. The majority of the portfolio’s underperformance was driven by our underweight in Energy and stock selection in Communication Services and Industrials. Energy was the best performing sector in the benchmark (+35% vs the benchmark down -14%) as the oil price reacted to supply disruption caused by Russia’s invasion of Ukraine.

Our negative stock selection in Communication Services was exclusively tied to **S4 Capital** (Pioneer, Communication Services), an innovative, data-driven digital marketing agency. The company continues to be impacted by investors lack of appetite for high growth stocks as well as investor concern regarding profitability. S4 announced last quarter that it initiated a short-term investment program to maintain rapid growth in the business which we believe is necessary and transitory. In addition, because of a string of acquisitions the company announced that PricewaterhouseCoopers was unable to complete its audit by March 31st. As a result, S4 postponed the report of its first quarter results. Management announced that Q1 results were in line with expectations, disclosed a significant new win (Loreal), and commented publicly that the audit issue is not material and will be resolved shortly. As such, we continue to own the stock.

Stock selection in Industrials was primarily driven by **Raksul (Pioneer, Industrials)**. The innovative Japanese company operates a digital B2B platform that is disrupting the highly inefficient status quo in conventional industries such as commercial printing, ad buying and logistics. While the US has reopened, Japan continued to struggle with pandemic lockdowns. Inflation is also creating concern that gross profit margins will compress. Japan will eventually reopen, and we are confident that Raksul has the pricing power to manage through this inflationary environment. We maintain our position in the stock.

Other large detractors were **Netcompany** (Core Growth, Technology) and **Altus Group** (Special Situations, Real Estate), both of which we continue to own in the portfolio. Netcompany is a highly differentiated digital software consultant with a market leading position in the Nordics. The company recently made a significant strategic move by acquiring **Intrasoft**, a company that provides scaled entry into Europe. The integration has temporarily impacted the growth profile and profitability. We added to our position. Altus was a top contributor to the fund last quarter. The company has been executing a transformation of the business centered on a conversion to a cloud-based SaaS platform and has been experiencing accelerating growth and profitability. Surprisingly, the CEO that has orchestrated this successful transition over the last 18 months announced that he would be leaving the company, albeit remaining as a board member. The news created uncertainty that led to a selloff in the stock despite the company announcing better-than-expected Q1 results. We met with the new CEO (who worked with the outgoing CEO for the last 12 years on similar transformations) and have a great deal of confidence that the strategy and execution will continue. We are maintaining our position in the company given its attractive long-term growth profile.

From a regional perspective, Sweden was our largest contributor followed by Norway and the US, all driven by strong stock selection. A key contributor in the US was **HealthEquity** (Core Growth, Healthcare) which added 130bps due to rebounding healthcare services post-COVID and higher interest rates. The outperformance in Sweden is attributed to **Fortnox** (Core Growth, Technology), a recent addition to the portfolio that is discussed below. The UK was the largest detractor at -138bps driven primarily by the selloff in S4 Capital. Japan, Canada, and Israel all underperformed by at least 100bps. The valuation compression contributed to underperformance in Japan and Israel as our largest positions are in high growth companies such as **Kornit** and **Money Forward**. These businesses continue to post strong fundamentals. In Canada, Altus Group, which accounted for most of the poor result, sold off after the CEO announced he was leaving the company.

With respect to LifeCycles, the Core Growth category was in line with benchmark returns. Special Situation underperformed mainly due to stock specific reasons (e.g., Altus Group, RWS). Not surprisingly, given the rotation away from high growth stocks that are unprofitable or underearning, Pioneers significantly underperformed during the quarter.

This quarter's largest detractors were Pioneer companies **S4 Capital** (Communication Services), **Raksul** (Industrials), and **Veracyte** (Health Care). Core Growth's **Netcompany Group** (Technology) and Special Situation holding **Altus Group** (Real Estate) round out the bottom five.

On the positive side, the top five contributors were all Core Growth names: **HealthEquity** (Health Care), **Pure Storage** (Technology), **Fortnox AB** (Technology), **Silvergate Capital** (Financials), and **Euronet Worldwide** (Technology).

Positioning

After a somewhat lagged economic expansion globally in 2021, we have seen regional divergence in the first few months of 2022 driven by Russian's invasion of Ukraine, continued COVID lockdowns in Asia and differing actions by central banks. Higher energy and commodity prices threaten to stifle consumer demand and business investment. Meanwhile, the tightness in the labor market continues to be a challenge for further growth in certain industries. While no country is immune to these dynamics, the fear of recession is more acute in Europe than the US. As such, the gap in valuation between the US and Europe has reached the highest level since 2005; US 19x P/E vs Europe 14x (Kepler Cheuvreux, March 2022). Headlines have shifted to the war, inflation, and central bank policy, but certain areas of the world continue to struggle with the pandemic. While the Western economies have reopened, for the most part, Japan continued to implement restrictions to stem the rise in COVID cases during the quarter.

Investors continue to flee what we believe are some of the best growth companies in the market, many of which have seen literally little change in fundamentals, due to the fear of rising interest rates and the related impact on valuations. We remain focused on buying what we believe are the best-positioned companies with durable business models and are finding compelling ideas that, in some cases, are trading at multiples that are half what they were just a few months ago. Top 5 contributor, Fortnox, was a case where the pressure on growth stocks gave us the opportunity to buy it at a much lower multiple than it had in September 2021. We are attracted to their business model (SaaS-based ERP for small and medium sized business) and believe they have significant growth potential by continuing to add new customers, as well as by offering complementary products and services to their existing customers.

While these market dynamics are helpful in explaining the most recent quarter, they have limited impact on our investment process. We are not trying to determine what factor or style is currently in favor this month. We cannot predict how macroeconomic factors will play out in the future and we find it pointless to try and guess what the Fed will do or when inflation will peak. We prefer to spend our time and effort tracking down innovative, resilient businesses with secular growth drivers that we believe can outperform in most markets. Certain aspects, such as inflation, have us reconfirming that we own businesses with pricing power and therefore a lower risk of margin deterioration. The war in Ukraine has led us to evaluate our companies' exposure to that part of the world. We remain highly focused, disciplined, and committed to identifying the best growth companies globally and actively managing the risk/reward of the businesses that we own in the portfolio.

Outlook

Furey Research examined what worked the last time the U.S. went through a protracted stagflation (1974-1982) when inflation ran at nearly 9% per year while GDP grew at only 2% per year. The good news is that many small-cap managers were among the top performers. Furey has also done work that shows small cap companies usually outperforming large caps during rising bond yield environments. (Furey March 9, 2022) Technically, the Russell 2000 Growth Index has experienced a bear market, as the low of March 11, 2022 marked a 31.1% decline from November 8, 2021. All the gathering dark clouds surrounding macroeconomic change have caused investors to re-evaluate their stock ownership. Investors haven't had to contend with high inflation in decades, and a war in Europe has only added to uncertainty.

What we do know right now is that valuations for companies in our portfolio have come down significantly since the November 2021. Evercore ISI Research has postulated that the stage is possibly set for small cap outperformance because of "attractive valuation with the next twelve-month P/Es now below average in a market still generally expensive." (Evercore 3/7/22) Earnings growth rates have come down slightly in many of our companies as they have decided to spend more on future growth while they too are experiencing higher prices in labor and materials. Companies with strong competitive positions are able to pass along higher prices, but of course, there is a lag. We remain patient, strategic growth investors focused on our process with the goal of providing long-term outperformance for our clients.