MICROCAP GROWTH

Portfolio Comments
March 31, 2022

Distinguishing Features

GIM builds the Microcap Growth portfolio from the bottom-up; sector weightings are secondary to stock selection. As of 3/31/2022, the Microcap Growth portfolio was overweight versus the Russell Microcap Growth benchmark in Technology, Health Care, Telecommunications and Utilities. The portfolio is underweight Consumer Discretionary and Industrials, and we are in line with the benchmark for Financials. We continue to have no exposure in Energy, Real Estate, and Basic Materials.

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 can't 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 remarkable 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 Microcap Growth strategy returned -9.28% in Q1, outperforming the Russell Microcap Growth benchmark's return of -13.7%.

Our overweight and selection in Technology and Health Care helped relative performance during the quarter. Selection in Consumer Discretionary was also a positive. Our overweight and selection in Telecommunications and Utilities along with a lack of exposure to Energy were this quarter's detractors.

With respect to LifeCycles, the Special Situation and Pioneer categories nicely outperformed the benchmark. Core Growth underperformed during the quarter.

The largest detractors during the quarter were Pioneer companies **BioLife Solutions** (Health Care) and **Pulse Biosciences** (Health Care). Core Growth's **Radware** (Technology) and Special Situation holdings **iCAD** (Healthcare) and **AXT, Inc.** (Technology) round out the bottom five.

On the positive side, the largest contributors to the strategy were two Special Situation names, **Limelight Networks** (Technology) and **Lovasac Company** (Consumer Discretionary). Three Pioneer Health Care names round out the top five: **Castle Biosciences, Aerie Pharmaceuticals,** and **Kezar Life Sciences.**

Positioning

Despite the market performance last quarter, we have been encouraged with recent information about underlying fundamentals for many of the healthcare stocks within the portfolio. The macro environment and Covid disruption to hospitals and physician practices have led to historic underperformance of the healthcare sector relative to other sectors within the benchmark. As the disruption from the pandemic recedes, there are many stocks that should benefit from a recovery as patients seek healthcare services. Valuations and financial expectations are attractive for companies like AERI, KIDS, VCEL and SIBN. We have been using the market volatility to increase our positions in what we believe are the most attractive stocks. Given the relative outperformance of many industrial stocks during the quarter, we have trimmed some of our industrial positions while increasing our weighting in our healthcare stocks. We believe the valuations of these stocks have become increasingly attractive on a historical basis while the long-term fundamentals are compelling.

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 small-cap managers, both growth and value, were among the top performers. Furey has also done work that shows small cap companies usually outperform~~ing~~ 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.