MICROCAP GROWTH
Portfolio Comments
June 30, 2022

Distinguishing Features

GIM builds the Microcap Growth portfolio from the bottom-up; sector weightings are secondary to stock selection. As of 6/30/2022, the Microcap Growth portfolio was largely overweight versus the Russell Microcap Growth benchmark in Technology and Health Care and carried a modest overweight in Communication Services. The portfolio is underweight Consumer Discretionary, Industrials, and Materials and we are in line with the benchmark for Financials and Consumer Staples. We continue to have no exposure in Energy, Real Estate, and Basic Materials.

Commentary

Market Environment
Everything we read today talks about record breaking negative macro-economic indicators, or at least things we haven't seen in 40 or 50 years. When the Chairman of the Federal Reserve stated that "there's no guarantee of a benign outcome" referring to tightening and the possibility of creating a deep recession, markets declined sharply. The Fed hiked interest rates by 50 basis points in May and 75 basis points in June, which was its largest single hike since 1994 - the only other year in 50 years where, like 2022, both stocks and bonds delivered historically low first half returns. Small business sentiment is the lowest in 48 years and consumer sentiment is close to its all-time low of 1991. While the news is not good with a war, high inflation, higher interest rates, a strong dollar and negative GDP growth, we should remember that the stock market is a leading indicator. The small cap growth market has been declining since May of 2021, forecasting the negative macro-economic news and the resultant pressure on earnings growth rates. If GDP growth is as negative this quarter as it was last quarter, we will technically already be in a recession - an odd recession though, as the unemployment rate is still quite low at 3.6%.

Performance Discussion
The first half of 2022 has been the worst period of small cap performance since 1973. During this selloff, the innovative areas of Health Care and Technology have been heavily penalized and subsequently have been the largest detractors to overall performance through June. Granahan's Microcap Growth strategy returned -26.9% in Q2, lagging its Russell Microcap Growth benchmark's return of -22.40%.

The strategy's underperformance has been driven by numerous macro-related concerns; however, we believe there continues to be significant progress in the fundamentals and development of transformative products from companies in these sectors. The Technology and Health Care sectors continue to make up nearly 50% of the Microcap portfolio. In our opinion, the risk/reward tradeoff has rarely looked more attractive than it does today.

With respect to LifeCycles, Core Growth, Pioneers, and Special Situations all underperformed this quarter.

The largest detractors during the quarter were Special Situations **Edgio** (Technology) and **Lovesac** (Consumer Discretionary and three Pioneer names, **Castle Biosciences** (Health Care), **DermTech** (Health Care), and **EverQuote** (Communications).

On the positive side, the largest contributors to the strategy were Core Growth names **Vita Coco** (Consumer Staples) and **James River Group** (Financials) along with Pioneers **908 Devices** (Health Care), **CryoPort** (Health Care), and **Xenon Pharmaceuticals** (Health Care).

Positioning

While it is difficult to call a bottom in the small cap market, there are numerous encouraging signs that have historically led to strong forward returns. Several sentiment surveys are now at the lowest level seen in decades (The University of Michigan Consumer Sentiment and AAII Bullish-Bear Survey). We believe valuations are now extremely attractive on a forward basis, both in terms of absolute level and relative to large-cap stocks. What we do know is that returns from bear market bottoms have been exceptionally strong historically, and it's not uncommon for the market's best days to soon follow the worst.

We continue to embrace our bottom-up investment process focused on the innovative areas of the market. During the quarter, we reduced our weight in Industrial, Special Situation stocks and reallocated to more attractive opportunities in Core Growth and Pioneer stocks within the Technology, Health Care, and Consumer Discretionary sectors. We initiated a new position in **Olink**, an innovative life sciences company that is helping accelerate the study of proteins to better understand human biology. Genomics, plus the emergence of proteomics, holds the opportunity to identify disease at much earlier stage of development and allows more tailored therapies for treatment. We also added **Xencor** to the portfolio recently. This emerging biotechnology company has established itself as a premier antibody design company with its technology validated through partnerships with Amgen and Johnson & Johnson.

Outlook

The current small-cap bear market has coincided with a period of solid company fundamentals and growing profits. Small-cap growth profits grew significantly over the last twelve-month period in which the small-cap growth index fell 33%. This divergence has led to a significant reduction in small-cap valuations. The market is forecasting a slowdown in revenue and earnings growth for the next several years, but even cutting growth rates significantly from the 66% we have seen over the last year to 20%, valuations look extremely interesting. The Russell 2000 Growth Index now has a lowered average PE on the next twelve months earnings estimates of 17.5x, down from its 32.5x valuation a year ago. We are adding to stocks in the portfolio that have no need for a lift in valuation, as the compounding of their earnings growth should bring positive results to their stock prices. The risk, of course, is that we could be wrong on our earnings estimates.

At the forefront of many investors' minds are questions concerning inflation, Fed policies, recession and when will the market recover. Based on our decades of investment experience, a market low is impossible to predict, and frankly, trying to answer these questions may be counterproductive. Our focus is on talking with the management teams at our companies to ensure they have strong secular growth prospects.

As always, we appreciate and thank you for trusting Granahan with the management of your capital.

Jeff

Jeff Harrison
Portfolio Manager

<u>*Disclosure:*</u>

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