Microcap Growth

Portfolio Comments

June 30, 2021

Distinguishing Features

GIM builds the Microcap Growth portfolio from the bottom-up; sector weightings are secondary to stock selection. With the Russell Indices re-balance at the end of the 2nd quarter, the Russell MicroCap Growth benchmark saw two significant changes in sector weightings, with technology moving from 19% to 11%, and consumer discretionary from 10% to 18%; the strategy weightings are now 21% in tech (10% overweighted) and 4% in consumer discretionary (14% underweighted). The telecommunications sector retains its overweight position at 7% versus 2%. Healthcare remains slightly overweight versus the Index (45% versus 44%), as does consumer staples (3% to 2%), and financials (3% to 2%). The portfolio's one holding in the utilities sector results in an overweight position here, 3% to 1%. Other than consumer discretionary, the next largest underweight positions versus the Index are our lack of exposure to energy and real estate, where the Index weightings are 4% and 2%, respectively. The portfolio is underweight in basic materials (<1% versus 2%) and industrials (11% to 12%).

Commentary

Market Environment

Performance for the three months of the 2nd quarter resembled a seesaw, ending the quarter on the "up" side. After a good start to the quarter, very strong company earnings reports at the end of April roused investor fears that profits may have peaked due to the potential impact of inflation-driven wage increases and soaring commodity prices on future earnings; the markets posted negative performance in May. In June, the Federal Reserve signaled its timing for raising interest rates may be earlier than expected. The Russell MicroCap Growth Index ended the quarter up +3.2%.

Performance Discussion

The Granahan Microcap Growth portfolio underperformed in the quarter, with its net-of-fee return of -1.4% trailing the Russell Microcap Growth's +3.2% return. Year-to-date, the portfolio is up +17.2% net-of-fees, behind the benchmark return of +20.6%.

For the 2nd quarter, underperformance versus the Russell Microcap Growth benchmark was primarily due to stock selection, particularly poor selection in healthcare, telecommunications, utilities, technology, and consumer discretionary. The portfolio's overweight position in telecommunications and technology partially offset the negative selection here, while the underweight position in consumer discretionary further weighed on relative performance. On the positive side, basic materials, industrials, financials, and consumer staples all showed positive selection. The lack of exposure to energy was also a boost to relative performance.

With respect to LifeCycles, all three LifeCycle categories lagged the overall Index return, with the Special Situation category showing a substantial shortfall. The largest detractors in the quarter included **Sharps Compliance** (utilities, Special Situation), **LifeMD** (healthcare, Pioneer), **NeoPhotonics** (technology, Special Situation), **Akoustis Technologies** (telecommunications, Pioneer), and **908 Devices** (healthcare, Core Growth).

On the positive side, the top five contributors in the quarter included three Pioneers: **ShotSpotter** (industrials), **Neuronetics** and **OrthoPediatrics** (both healthcare). Two technology names in the Core Growth category round out the top five: **Perficient** and **Radware**.

Positioning

The portfolio's healthcare sector was up 97% between July 31, 2020 (the strategy's composite inception) and the end of April 2021. This compares to the Russell Microcap Growth healthcare sector return of 32% for this period. In the May-June period, there was a shift in investor sentiment to more biotech-oriented stocks while the strategy portfolio is tilted towards med devices and diagnostic stocks, which tend to have lower volatility in most markets, particularly in the MicroCap sector.

Since the end of April, the portfolio's healthcare holdings have given up relative performance as the stock prices of some of the strategy's largest winners have retreated, even as the fundamentals have remained intact. **Organogenesis Holdings (ORGO)** is a good example as the portfolio's top contributor from inception through April, and then the largest detractor from April to June as investors harvested profits. The stocks of **Affimed (AFMD), SI-Bone (SIBN)** and **908 Devices (MASS)** have also pulled back on no fundamental news.

We added to many of our high conviction healthcare names during the last two months as the stock prices moved lower and valuations became more attractive. During the year, we made timely sales on ORGO given its expanded market cap, though we did not increase our position on the pullback as its current market cap remains above our buy limit. We will continue to vet our all our healthcare companies, and use market volatility to initiate or add to positions as a company's fundamentals dictate and the stock's risk/reward warrants it.

Outlook

The cross currents in the macro-economic picture are strong. While most believe that vaccinations should keep hospitalizations low, equities look to be trading on the perception that the Delta variant of COVID-19 has increased the downside risks in the market. GDP has surged, re-openings have accelerated, manufacturing data is robust, and consumer confidence is increasing. Corporate earnings have been robust as well. Stronger wage gains and soaring commodity prices are driving inflation rates higher than expected, causing many to re-think whether inflation is transitory. Labor shortages and supply chain issues are leading to cost pressures for many companies. 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.

Revenue and earnings reports from the first quarter were extremely strong. Absolute forward valuation for small caps continues to tick downward as the earnings forecasts grow into the valuation while the stock prices move sideways. According to work done by Furey Research, the forward valuation for small-caps relative to large-caps looks extremely attractive.

Across sectors and LifeCycles, the GIM investment process separates companies from stocks. So whether inflation is transitory or not, GIM first vets each company in search of those that are well-positioned to do well in most market environments. We seek to invest in in the stocks of innovative, well-positioned companies that we believe have the ability to raise prices as costs increase, and therefore be better able to withstand inflationary forces and interest rate increases.

It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein.