Small Cap Advantage

Portfolio Comments

June 30, 2021

Distinguishing Features

As of 6/30/2021, after the annual rebalancing of the Russell Indices, the Small Cap Advantage portfolio saw an increase in its overweight position in industrials compared to the Russell 2000 Growth benchmark, now 21% versus 14%. The portfolio remains overweighted in technology, now 26% versus 19.5% for the Index. The Index re-balance included a decrease in the the Russell 2000 Growth healthcare weighting, so the portfolio's healthcare sector is less underweighted to the benchmark, 27.4% versus 29.7%. Consumer discretionary (15% to 17%) and financials (3.5% to 5%) are also underweight the benchmark. Several smaller sectors are near equal-weight the benchmark: energy and basic materials (both 2% compared to 3%), and real estate (equal-weighted at 3%). The largest underweight positions to the Index are where we have no exposure – consumer staples and telecommunications – and the Index weights are 3.3% and 2.4%, respectively. We also have no exposure to the small utilities sector, where the Index weighting is 1%.

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, easing inflation concerns. The Russell 2000 Growth Index ended the quarter up +3.9%.

Performance Discussion

In the 2nd quarter, the Granahan Small Cap Advantage composite returned +7.0%, net of fees, ahead of the +3.9% return of its Russell 2000 Growth benchmark. Year-to-date, the strategy is nicely outperforming with a net-of-fees return of 12.9% versus 9.0% for the benchmark. The out-performance in the quarter was due to strong stock selection led by industrials and technology. The portfolio's overweight position in technology boosted relative performance, while the overweighting in industrials offset some of of this sector's positive stock selection. Energy and basic materials also showed good stock selection. Selection in consumer discretionary was the largest detractor in the quarter, and selection in financials and real estate also weighed on performance. Our lack of exposure to consumer staples and telecommunications were negatives to relative performance while no exposure in utilities was a positive.

With respect to LifeCycles, the Special Situation LifeCycle category soundly outperformed the overall Index return, and the Core Growth category also nicely outperformed. The Pioneer category performed inline with the overall benchmark return. Four of the top five contributors in the quarter were from the Core Growth category, including two industrial holdings **(Kornit Digital** and **Axon Enterprise)** and two technology names **(Cricut** and **Workiva)**. **LivePerson** (Special Situation, technology), a detractor in Q1, rounds out the top five in the 2nd quarter.

On the negative side, three of the five largest detractors were from the Pioneer category: **Magnite** (technology, and a top contributor in Q1), Veracyte (healthcare) and Clean Energy Fuels (consumer discretionary). **Executive Network Partnering Corp** (Special Situation, financials) and **908 Devices (healthcare)** were also in the bottom five.

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 surged. Stronger wage gains and soaring commodity prices are driving inflation rates higher than expected, causing many to re-think whether inflation is transitory. 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. For the Russell 2000 Growth Index, 2021 earnings-per-share estimates continue to rise, while 2022 estimates are ticking lower. 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.

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