Granahan Small Cap Core Growth
Portfolio Commentary
2nd Quarter 2021

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 impact on future earnings from inflation-driven wage increases and soaring commodity prices; the markets posted negative performance in May. In June, the market resumed higher, despite the Federal Reserve's suggestion that they were considering raising rates as early as 2023. By quarter's end, the sentiment seesaw leaned back towards re-opening optimism, as the Fed continued to assert that inflation is transitory.

The GIM Small Cap Core Growth strategy also ended on the "up" this quarter with a 2Q return of +4.4% net-of-fees, outperforming the Russell 2000 Growth Index return of +3.9%. Year-to-date, the GIM Small Cap Core Growth portfolios have handsomely outperformed the benchmark, +15.3% net-of-fees versus +9.0% for the Index.

Four of the portfolio's top five contributors in the 2nd quarter were from the info tech sector, though the top contributor in the quarter was an industrial holding, **Kornit Digital**. Kornit, from the Core Growth LifeCycle category, reported strong Q1 results at its virtual investor summit, where it also announced a significant partnership with Alibaba. The company's 5-year plan for digital printing includes new products that expand its TAM, new automated technology, and prospects for increased recurring revenues from a higher consumable mix of products; we are maintaining our position. The info tech contributors include **Nutanix** (Pioneer), **Cricut** and **Cloudera** (both Core Growth), and **Kulicke & Soffa** (Special Situation). **Nutanix** is a hybrid cloud platform vendor whose new cost-conscious CEO is driving better scale and efficiency in the financial model. At its recent analyst day, the company projected accelerating growth, and a clear path to free cash flow and profitability that is well ahead of consensus expectations. We added to the holding earlier in the quarter and are maintaining our current position. **Cricut** provides crafters with new tools (cutting machines, materials & accessories, digital content) to enable and enhance their creative pursuits. The company went public this quarter into a market that doubted post-pandemic growth. The earnings report for the first quarter was very strong and expectations for the year were raised; we continue to hold the stock. **Cloudera**, an enterprise cloud data platform, was bought out by private equity (KKR and Clayton, Dubilier & Rice) for $16 per share in cash. **Kulicke & Soffa** manufactures wire bonders needed for semiconductor manufacturing. There have been large positive revisions in company's earnings, as the underinvestment in semiconductor capital equipment over the last several years has collided with unforeseen end-market demand for semiconductors today. We are reducing our position on the strength in this cyclical stock.

Two names from the Pioneer LifeCycle category were the largest detractors in the quarter – **Veracyte** (healthcare) and **Magnite** (communication services). **Veracyte** is a next-generation cancer diagnostics company that provides genomic classifier tests. After a period of strong performance, Veracyte's stock came under pressure amid shifting investor sentiment toward more cyclical companies over life sciences companies. The company has tests addressing seven of the top ten cancers. Veracyte's tests use a tissue sample to determine the risk of a tumor metastasizing into a more aggressive form of the disease, and the company's new nasal swab test has created excitement as it can avoid lung biopsies to classify patients with lung nodules. The growth outlook for Veracyte is compelling, and we used the volatility in the stock price to increase our position. **Magnite** reported strong first quarter results, and investors have been taking profits due to valuation. Magnite's revenue comes from digital advertising, which is closely correlated to rising GDP growth. Economic forecasts for 2021 include high GDP growth, with digital ads growing 2x-3x faster than traditional advertising. We have been using the stock price weakness to add to our position. Three Core Growth companies round out the bottom five: **908 Devices** (healthcare), **James River Group** (financials), and **Digital Turbine** (info tech). **908 Devices** is an emerging life sciences company with differentiated offerings and innovative technology to address biologic drug development and applied science testing. We believe 908 Devices can leverage existing mass spectrometry technology to dramatically increase its usability through the company's handheld and desktop devices. Adoption of the company's products is in its infancy, and we expect their significant disruption of the $20bn addressable market will lead to compelling long-term growth; we have added to our position. **James River Group** is an insurance carrier focused on the attractive excess and surplus segment of the insurance industry. The company surprised the market with a capital raise and large increase in its reserves in order to address the remaining risk of a legacy business. We used the weakness to add to our position given the strong growth outlook for the company's core business and the fact that the capital raise eliminated an overhang on the stock. Digital Turbine offers a software platform to mobile carriers that allows for apps to be pre-installed on a phone when it is activated, whether it is a new phone or a used phone. Google recently announced that, starting in August, advertisers wishing to publish across different "app stores" and devices will need to use a separate format for the Google Play Store. While this change could lead to some extra legwork, Digital Turbine has already been supporting this new bundle format since 2019. We have added to our position on the weakness.

For the six months year-to-date, Kulicke & Soffa has been our best performing company, followed closely by Kornit Digital. While Digital Turbine and **Organogenesis** (skin substitutes for wound care) have pulled back this quarter, year-to-date they are two of our strongest performing stocks. **Vericel** is a regenerative medicine company that utilizes a patient's own tissue to heal knee cartilage damage and large burns. While the stock did not make it into the top five performers this quarter, Q1 performance was very strong. We believe there is still a solid runway of growth with products in the early stages of adoption, however, we have trimmed our position given the valuation more fully captures this opportunity.

Veracyte, 908 Devices, and James River are on the roster for year-to-date detractors. Also on the list is **Bright Horizons Family Solutions** (day care centers), which retreated because the company's back-up-care division had lackluster results for the quarter and expectations for the future were lowered; we are holding our position. **Euronet** is flat on the year versus the Index. Euronet is a recovery play on global travel resuming, and there continues to be COVID-related fits and starts affecting European and Asian travel. We are maintaining the position.

Attribution

In the quarter, the outperformance was attributable to both the portfolio's relative sector weightings and stock selection. Very strong selection in info tech and industrials drove the outperformance for the quarter, and the selection in info tech was boosted nicely by our overweighting of the sector. Selection was also positive for real estate and materials. Selection in the healthcare sector was the quarter's biggest detractor. Selection in financials, communication services, and energy also weighed on relative performance, though our overweighting in energy (the top performing sector for the Index) partially offset the negative selection. Consumer discretionary and consumer staples were also slight negatives to the quarter's performance.

The Special Situation category soundly outperformed the overall benchmark, and the Core Growth category also outperformed. The Pioneer category slightly underperformed the overall Index return.

Weightings

GIM's bottom-up process leads us to continue our significant overweight in information technology, and we are also overweight versus the benchmark in industrials, communication services, and financials. We are underweight the index in all other sectors with consumer discretionary our largest underweighting, followed by materials, consumer staples, and real estate. We have added to our healthcare weighting over the last six months, bringing the portfolio more in line with the Index and have done some selling of strong performers in the information technology sector bringing that weighting down by 4%.

Lifecycle changes in weightings reflect good fishing grounds in the Pioneer category. We have increased the weighting to 33%, up from 29% last quarter and 28% at year end. We have sold some of our better performing Special Situations, which has brought the weighting to 21%, down from 24% last quarter, but not as low the January weighting of 19%. Core Growth remains flat at 45%, though down from 51% at the start of the year.

Themes

Each year, the last Friday in June marks a change for investors measured against the FTSE Russell, as this entire family of domestic index products is rebalanced to reflect changes in the U.S. equity markets over the prior year. The annual rebalance updates the market capitalization and style profiles of the indices, which in turn drives shifts in the underlying sector and industry weightings within the benchmarks. While Granahan Investment Management is benchmark "aware," we do not manage our portfolios to the index sector weights, whether it be FTSE Russell or MSCI GICS. As we have talked about often, many of the growth companies we buy have large technology components, and, for instance, while the end market for a company's product is consumer retail, the security may well be tagged as technology. One of the benefits of using LifeCycle designations for our portfolio companies is that our investment decisions are not confined by sectors and industries, but instead by performance drivers. After June's rebalance, the largest company in the Russell 2000 Growth Index is $10 billion, down from $21 billion. The weighted average market cap has declined by 17% to $3.8 billion, and the median market cap is up by 12% to $1.5 billion. The most significant weighting changes are in healthcare (down by 2.3%) and energy (up by 1.9%).

The COVID-19 pandemic accelerated the need for remote access and drove many enterprises to ramp up their cloud infrastructure adoption. Cloud migration initiatives remain a top enterprise spending priority. The need to better manage and secure the increasing volume of cloud workloads continues to drive demand for innovative solutions. Many of our portfolio companies are well positioned to benefit from this secular trend: Zscaler, Rapid7, Qualys, Radware, Cyberark, Nutanix and New Relic. Two of our portfolio company beneficiaries, Cloudera and Proofpoint, were bought out this quarter.

Two major events were positive news for the healthcare sector in the quarter: 1) the FDA approved Biogen's drug, Aduhelm, for Alzheimer's Disease, and 2) Intellia Therapeutics released data that demonstrated the company's capability to genetically edit cells inside the liver with its CRISPR gene-editing candidate; this data provided the first-ever clinical data supporting the safety and efficacy of in-vivo CRISPR genome editing in humans. Granahan Investment Management was a beneficiary of both events – as an investor in Intellia Therapeutics and related

CRISPR technology stocks, and via our investment in Quanterix, a diagnostic company whose leadership in blood-based neurology biomarkers will be used for Alzheimer's screening.

Further, the healthcare market continues its torrid pace of IPO issuance – there were 68 IPOs through 2Q21 raising $17.5b, which compares to 76 IPOs for all of 2020 that raised $17.5b. The equity returns for this year's issuance, however, are well below the IPOs for 2020 (3.3% vs 41.5%), as it appears investors have become more valuation sensitive. Despite the lower YTD returns for the 2021 class of IPOs, the volume demonstrates that investors remain charged over new modalities and science innovations that, in our opinion, will create the next "Intellia Therapeutics" investment opportunity for our clients.

Macro

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. 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.

Outlook

Revenue and earnings reports from the first quarter were extremely strong. According to Mike Goldstein, Empirical Research investment strategist, the Q1 earnings season was exceptional, where S&P 500 numbers were up +47% on a broad-based revenue gain of +12%. Booming revenues produced the highest incremental pre-tax margins in more than a decade, as both SG&A and capex were flat to down last year. For the Russell 2000 Growth Index, 2021 earnings-per-share estimates continue to rise, while 2022 estimates are ticking lower. This is a likely reason for the lackluster stock price response to the glowing earnings reports last quarter. According to Furey Research, 2021E EPS estimates have been revised upward by 17.7% since the year began, and by 9.1% since 1Q21 ended. Year 2022 EPS estimates are up 12.3% since '21 began, and up 5.2% since 1Q21 ended. A strong bull argument is that COVID forced greater corporate efficiencies, which will in turn result in stronger margins as the economy fully recovers.

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 outperform in most market environments. We seek to invest in in the stocks of innovative, well-positioned companies that we believe will be able to raise prices as costs increase, and therefore be better able to withstand inflationary forces and interest rate increases.

Disclosure:

The information provided in this commentary should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. The securities discussed do not represent an account's entire portfolio and in the aggregate may represent only a small percentage of an account's portfolio holdings.

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.