# Granahan Small Cap Discoveries

**Portfolio Comments**

**June 30, 2021**

## Distinguishing Features

GIM builds the Small Cap Discoveries portfolio from the bottom-up; sector weightings are secondary to stock selection. As of 6/30/2021, the Small Cap Discoveries portfolio continues its overweight position in industrials compared to the Russell Microcap Growth benchmark, now 20% versus 12%. The portfolio's healthcare weighting moved from nearly equal-weight versus the Index to an overweight (48% versus 45%). With the annual re-balance of the Russell Indices, the Russell Microcap Growth benchmark's technology weighting went down substantially, and the sector moved from the portfolio's largest underweight position versus the Index to an overweighting, now 13% versus 11%. Conversely, the Russell re-balance saw a large increase in the benchmark's consumer discretionary weighting, so this sector is now the portfolio's largest relative underweight, 8% to 18%. Several sectors are within 2% of the overall Index weighting: utilities (3% to 1%), basic materials (3% to 2%), real estate (equal-weighted at 2%), and financials (1% to 2%). The portfolio continues to have no exposure to the energy, telecommunications, and consumer staples sectors where the Index weightings are 4%, 2.5%, and 2%, respectively.

## 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

In the 2nd quarter, the Small Cap Discoveries composite returned +3.2% net-of-fees, in line with the Russell Microcap Growth Index return of +3.2%, and behind the +3.9% return for the Russell 2000 Growth Index. Year-to-date, the strategy's net-of-fee return of +22.9% is ahead of the Russell Microcap Growth Index return of 20.6%, and it is significantly outpacing the Russell 2000 Growth's +9.0% return.

For the 2nd quarter, the slight outperformance versus the Russell Microcap Growth benchmark was mostly attributed to sector allocation, specifically the lack of exposure to the energy sector and underweight position in financials. The portfolio had strong stock selection in the healthcare and industrials sectors, while basic materials, real estate and technology also had positive selection. The selection in utilities and consumer discretionary weighed on performance, offsetting the positive selection of the other sectors. The portfolio's underweight position in consumer discretionary hurt relative performance, as did the lack of exposure to telecommunications.

With respect to LifeCycles, the Special Situation category soundly outperformed the Index. The Core Growth category significantly lagged while the Pioneer category performed nearly in line with the overall Index return. Four of the top five names in the quarter were from the healthcare sector, including two from the Core Growth LifeCycle (**Harvard Bioscience** and **Kindred Biosciences**) and two Pioneers (**Intellia Therapeutics** and **Beam Therapeutics**). **Kornit Digital** (Core Growth, industrials) rounds out the top five.

The five largest detractors in the quarter included three healthcare names: **Veracyte** (Pioneer), **908 Devices,** and **Vericel** (both Core Growth; Vericel was a top performer in Q1). **Columbus McKinnon** (Special Situation, industrials) was also in the bottom five. The largest detractor in the quarter was the portfolio's utilities holding, **Sharps Compliance** (Special Situation).

**Positioning**

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 one of the portfolio's top contributors from last June through April, and a large detractor from April to June as investors harvested profits. The stocks of **Vericel (VCEL)**, **908 Devices (MASS), Affimed (AFMD),** and **SI-Bone (SIBN)** have also pulled back on no fundamental news.

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 surged. 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.

*represent an account's entire portfolio and in the aggregate may represent only a small percentage of an account's portfolio holdings.*

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