SMID Select Opportunities

Portfolio Comments

June 30, 2021

Distinguishing Features

GIM builds the SMID Select portfolio from the bottom-up; sector weightings are secondary to stock selection. Over the 2nd quarter, the largest shifts in sector weightings versus the Russell 2500 Growth benchmark were due to GICS reclassifying Magnite, a high conviction holding, from consumer discretionary to communication services. Thus, the portfolio's 10% overweighting in consumer discretionary in Q1 now moved to an underweight (it is currently 13% versus 16% for the Index), while the weighting in communication services increased substantially from its equal-weighting last quarter to its current 11% position versus 3% for the benchmark. The SMID Select portfolio retains its overweighting in the info tech sector, now 35% versus 26%. The portfolio continues an underweighting in healthcare, 19% versus 24%. Materials is underweighted to the benchmark, 1% to 4%. The industrials and energy sectors are nearly equal-weight the benchmark at 13% and 2%, respectively. The remaining sectors are within 2% of the benchmark weighting: financials 3% to 5%, real estate 1% to 3%, and consumer staples 2% versus 3%. The portfolio continues to have no exposure to the utilities sector.

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 2500 Growth Index ended the quarter up +6.0%.

Performance Discussion

In the 2nd quarter, the Granahan SMID Select strategy posted a return of +5.0%, behind the Russell 2500 Growth Index' 6.0% return. Year-to-date, the SMID Select Strategy retains its significant outperformance to the benchmark, +21.5% versus +8.7%.

Stock selection typically drives performance for the SMID Select strategy, whether positive or negative, and the 2nd quarter is no exception. The largest detractor in the quarter was poor selection in the communication services sector. Selection in health care and energy also weighed on performance, though the relative weightings in the sectors – overweighting in energy and underweighting in healthcare – offset some of the negative effect here. Selection in consumer staples also hurt in the quarter. On the positive side, the industrials sector showed robust selection. Selection in real estate, financials, info tech, and consumer discretionary was also positive. The info tech relative performance was boosted by our overweighting here. Our underweight position in materials was a plus, as was the lack of exposure to utilities.

With respect to LifeCycles, both the Special Situation and Core Growth categories outperformed the overall benchmark, while the Pioneer category notably lagged. Three of the quarter's largest detractors were top performers in the first quarter: **Magnite** (Pioneer, consumer discretionary), **Digital Turbine** (Core Growth, info tech), and **Ligand Pharmaceuticals** (Core Growth, healthcare). **Veracyte** (healthcare, Pioneer) and **Canadian Solar** (Core Growth, energy) were also in the bottom five.

On the positive side, three Core Growth names were in the top five: **Kornit Digital** (industrials), **Cricut, Inc**. and **Enphase Energy** (both info tech). **Kulick & Soffa Industries** (Special Situation, info tech) and **Chicken Soup for the Soul Entertainment** (Pioneer, consumer discretionary) round out the top five contributors.

Positioning

As of mid-April, the 2nd quarter was shaping up to be a poor one, both on an absolute and relative basis. At that time, many of our highest conviction names were trading at significantly lower valuations than we believed were warranted, and we were cautiously optimistic that the stock prices would move to better reflect the fundamentals. There were several large positions in the strategy that we trimmed in the first part of the year, and we found ourselves adding back to our positions at much lower prices during the second quarter. In addition, we found new opportunities in some of our favorite health care companies that we had been reluctant to purchase because of valuation in 2020 and the first part of this year, which enabled us to increase our healthcare weighting for the first time in quite a while. **Veracyte (VCYT)** is one of the healthcare companies that we finally turned into a "major leaguer" in Q2 after initiating a small position in the fourth quarter of 2020 and watching it appreciate quickly. During the 2nd quarter, we were able to build our position at prices even below our first purchases, and with much higher conviction in the investment case than when we originated our holding. The second half of the quarter proved better than the first, making up much of the lost ground from the first 6 weeks of the quarter.

We have made one major change to our top positions in the quarter by dramatically reducing our position in **Kulicke and Soffa (KLIC)**. While KLIC (semi-conductor capital equipment manufacturer) has been a top contributor as a beneficiary of the current semi-conductor cycle, as growth investors, we have a basic strategy for investing in this industry. This strategy, formulated over many semi-conductor cycles, dictates that we buy the stocks in this industry "early," even before we have confidence that a strong positive inflection point is in place; and subsequently, we sell the stocks "early" while business is still strong. If the semi cycle continues to have a robust ride all the way through 2022, we may have acted prematurely, and we still like the prospects for KLIC for their new product initiatives in Mini-LED and Advanced Packaging. Nevertheless, we felt it was prudent to take profits, as sentiment changes in this industry are typically swift and powerful, as we have witnessed over many cycles in our careers.

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. 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 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.