Granahan Small Cap Focused Growth Strategy
Portfolio Manager Commentary
2nd Quarter 2021

The Quarter That Felt Like Two Eighths

In the June 2021 quarter, the market let its schizophrenic qualities shine once again – particularly in small caps. From March 31st to May 10th, the Russell 2000 Value Index rose 3.1% while the Russell 2000 Growth Index fell -4.0%, as investors spurned growth-oriented stocks to seek out and bid up prices of value and pandemic recovery stocks. Then, as the clock struck midnight on May 11th, Mr. Market apparently decided that the recovery/value party was over for now and took an Uber back to the Growth Hotel. From May 10th to June 30th, the Russell 2000 Growth rose 8.2% while the Russell 2000 Value was up just 1.0%.

It is rarely possible to pinpoint the precise cause of such market moves. Certainly, the characteristics and momentum of "reopening" stocks that did well in Q1 (e.g., hotels, airlines, restaurants) carried through the first half of Q2. So why the reversal? Again, difficult to pinpoint, but much of the shift appeared to be related to two factors: 1) the lofty stock valuations of many reopening beneficiaries appeared to be discounting strong recoveries well into 2022 and beyond; and 2) investor concerns that the COVID Delta variant might derail such a recovery. By June 30th, when all was said and done for the three months, the two Indexes were almost on par for the quarter with each rising about 4.0%.

The Granahan Focused Growth strategy performed well during the quarter, rising +12.0% compared to the +3.9% return of the Russell 2000 Growth Index. Through the first six months of 2021, the portfolio rose +12.0%, ahead of the benchmark's return of +9.0%. Over the six months, the Focused Growth portfolio of secular growth stocks battled and withstood the fierce "value" headwinds, with the portfolio's Q2 outperformance almost entirely due to strong stock selection. Sector allocation was overall benign. Selection was particularly strong in technology and industrials, while selection in consumer discretionary weighed on performance. Please see below for the largest detractors and contributors:

Largest Relative Contributors

- **Cricut** (CRCT, technology) - Cricut makes and sells a DIY craft-making platform. The platform consists of a hardware cutting machine, integrated accessories and materials, and cloud-based design software. The company went public in March 2021. The stock rose in Q2 as investor exposure broadened and the company reported strong Q1 results along with a rosy outlook. We hold a good-sized position in CRCT shares as we are bullish on the company's potential and believe the stock's risk/reward remains attractive.

- **Kornit Digital** (KRNT, industrials) – Kornit sells digital printers and ink to the large t-shirt and broader textile industry, disrupting legacy textile printing processes. Investors bid up KRNT shares as the company reported strong results and introduced several exciting new products. We continue to hold a large position.

- **Axon** (AXON, industrials) – Axon is a leader in law enforcement technology, including smart devices (such as Taser non-lethal weapons and body-worn cameras), and workflow cloud-based intelligence and software (e.g., records management systems, dispatch). AXON shares recovered from a sharp decline in Q1. Axon reported strong Q1 results, 2021 guidance, and as an indication of the robust demand and lengthening contract terms, gave early revenue guidance for 2022. We continue to hold a large position in AXON shares as we believe the company's opportunity remains open-ended and the stock risk/reward is attractive.

Largest Relative Detractors:

- **Magnite** (MGNI, technology) – Magnite operates a sell-side ad-tech platform. The firm's legacy CTV revenue (excluding the recently acquired SpotX business) was soft in March, which weighed on the stock price. We expect this business to rebound and are bullish on the combined company's position as the leading CTV SSP; we are holding the shares.

- **Bright Horizons Family Solutions** (BFAM, consumer discretionary) – Bright Horizons is the largest operator of daycare centers in North America, and it also has centers in the U.K. and Holland. BFAM stock declined early in the quarter as investors realized that President Biden's American Families Plan would not help Bright Horizons as much as initially expected. The shares recovered after the company reported strong Q1 results, but ended down for the quarter. We are holding shares.

- **Etsy** (ETSY, consumer discretionary) – Etsy owns and operates three online marketplaces (Etsy, Reverb, and newly acquired Depop). ETSY shares fell sharply on the heels of strong Q1 results that were diminished over fears of the difficult comparisons in the coming four quarters. We have our own concerns about near-term comparisons and have scaled back our position, but we remain bullish about Etsy's intermediate and long-term prospects. We retain a significant position in the stock.

Compounding and Other Virtuous Investment Practices

The sharp style reversal the market displayed in Q2 reminded me, yet again, that attempting to time the market is something none of us should try at home (or in the office, or on Zoom). On May 7th, I sent out a special mid-quarter letter, something I have only done a couple of times over my 25 years of managing portfolios. But the moment seemed to merit comments given the extreme nature of the portfolio's relative underperformance (over 9% from Feb 12th to May 7th). As I noted in that letter, "every severe downdraft feels like the worst one ever while in the midst of it. This one is no exception." And, while such drawdowns are painful, I noted that experience tells me that we should "stay the course."

It turns out the letter was almost perfectly timed. Literally one trading day later, sentiment shifted and the portfolio started to perform very well, recapturing all of the relative underperformance and more. Ahhh….Brilliant market timing on my part?? Absolutely not!

What brilliant **luck** on my part! The odds of my getting that timing right 10 times in a row are no more likely than flipping a coin 10 times in a row and having it come up heads every time (1 in 1024 to be exact). Thus, I'll continue to heed the advice of legendary investors Warren Buffett, Peter Lynch, and John Bogle, and refrain from attempting to time the market.

Thankfully, the Focused Growth philosophy and process are not dependent on such luck since our emphasis is on “Desert Island”-worthy compounders. As a reminder, these are companies capable of sustaining growth of 15% or more for many years. Desert Island companies are typically on the right side of disruption, have large open-ended opportunities, and have strong management teams and corporate cultures. Most are profitable but are also currently "under-earning" as they invest and strive to capture these large opportunities. When we identify such Desert Island compounders, we put the company on a Desert Island monitored list that comprises about 100 companies. The Focused Growth portfolio is made up of a subset of +/-40 companies whose stocks we believe have an attractive expected return and risk/reward.

Taking Stock of Today and Tomorrow: Suddenly We're Back!

What a strange journey we’ve had over the last 17 months. While at times one can forget, we should forever be thankful for the vast numbers of doctors, nurses, police, firefighters, teachers, and retail, delivery, transport, construction, warehouse, food chain, and other essential workers who put their lives at risk and worked tirelessly on behalf of all of us. Similarly, I am also incredibly grateful for, and give credit to, the pharmaceutical companies for developing and delivering incredible vaccines in record time. And finally – for lack of a better term – the collective Internet complex (software, service, and infrastructure) that enabled so much of society to work so effectively during the pandemic.

It is remarkable how quickly and in so many ways the world has transformed to a new normal. In many regards, the *new* normal resembles the *old* normal. Yet in other important ways, it is likely that life has permanently changed. From an investment perspective, the early returns during the pandemic were driven by companies benefitting from society's adjustments. Likewise, as noted above, the stocks that rose from October through early May were those positioned to benefit from the recovery. But that was yesterday, and a relatively short period. What about tomorrow and, in particular, the long-term?

The investment team at Granahan is spending a good deal of time thinking through this. None of us have been here before, and shockingly, my crystal ball remains elusive. I'm also fully cognizant that future scenarios include those in which there is a relapse either from the COVID Delta variant or otherwise. However, I believe the Focused Growth portfolio is generally well-positioned to generate good returns under most scenarios that I can envision. For example, cloud computing is an area that was in the midst of an extended period of secular growth long before COVID struck. The pandemic not only gave individuals and employers comfort that they could conduct and enjoy (or conduct and not enjoy) Zoom calls with their loved ones and colleagues, but also that cloud computing could enable all sorts of improvements in efficiency and efficacy across the enterprise. Similarly, I think it is pretty clear that even as offices open up, we are likely to see a work force that permanently has more flexibility to work from anywhere. These trends are accelerating the tailwinds behind many cloud-computing providers, including such Desert Island companies as **Workiva, Domo, SPS Commerce,** and **Paycom**.

Another secular growth segment that we believe has been permanently accelerated is Ed-Tech. Trends toward e-learning and hybrid learning began many years ago but were accelerated by the pandemic, and Desert Island companies like **2U** and **Chegg** should benefit for years to come.

E-commerce is certainly not new to rapid growth (Amazon just entered its 25th year as a public company). Yet despite its middle age, the pandemic *accelerated* long-term trends in e-commerce, benefitting Desert Island companies such as **Etsy** (online marketplaces), **Overstock** (e-commerce) and **Lovesac** (omni-channel seller of home furniture), as well as platform vendors such as **LivePerson** whose digital engagement platform is helping a wide variety of B2C businesses.

Content Worth Reading, Listening To, or Watching

A Book: *The Premonition* - Michael Lewis is one of the best and most important storytellers of our time. Here he tells the story of a few heroes, assessing risk/reward for society, and having the courage to, in effect, conduct our nation’s pandemic response when the Trump White House, the CDC, and other Federal and State officials refused to do so.

Another Book: *Richer, Wiser, Happier* - Veteran financial journalist William Green has profiled dozens of investing leaders. In this book he shares "best of" stories and habits of the likes of household names such as Warren Buffett, John Templeton and Peter Lynch, as well as from those that aren't such as Mohnish Pabrai, Nick Sleep and Laura Geritz.

Two Pieces Related to Axon (one of our Desert Island companies):

1) Peggy Noonan on Policing Challenges in the U.S. - Long-time readers know I'm a big fan of Peggy Noonan. In this column Noonan addresses some of the core issues facing America's shortage of police. She doesn’t mention Axon, but her perspective is spot-on and virtually every point is consistent with Axon's mission and raison-d'etre.

2) Training - While we're on the topic of Axon and challenges facing policing, one of the company's newest areas of expansion is into VR Training for police (and fire and EMT). This 90 second video will give you a sense of it.

A Podcast: Capital Allocators host Ted Seides interviews Charles Ellis about Yale's legendary CIO David Swensen who passed away in May of this year. Terrific insights into one of the pension industry's all-time greats.

Promo Video: The Ford Electric F150 Lightening Intro Promo Video - The Ford F150 is the #1 selling vehicle (not just truck) in the U.S., and has been for each of the past 39 years! Ford is coming out with an electric version in 2022. By the end of this video I not only had goosebumps, but was almost ready to put my $500 deposit down to get one! Here's the 4 1/2 minute version, and if you want more here's the 33 minute version.

And a short Funny Commercial for Dr. Pepper Zero.

As always, on behalf of the entire team at Granahan Investment Management, thank you for entrusting us with the management of your capital. Please note that it is managed alongside our own. I hope you enjoy your summer.

Sincerely,

Drew

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