Small Cap Select Opportunities

Portfolio Comments

June 30, 2021

Distinguishing Features

GIM builds the Small Cap 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 2000 Growth benchmark were due to GICS reclassifying Magnite, a high conviction holding, from consumer discretionary to communication services. Thus, the portfolio's 5% overweighting in consumer discretionary in Q1 now moved to an underweight (it is currently 12% versus 15% for the Index), while the weighting in communication services increased substantially from its equal-weighting last quarter to its current 10% position versus 3% for the benchmark. As of 6/30/2021, the Small Cap Select portfolio continues its significant overweight position to the info tech sector versus the Russell 2000 Growth benchmark, 31% compared to 21%. The portfolio has reduced its 10% underweighting in healthcare with a current weight of 24% versus 30% for the Index. The industrials sector is near equal-weight the benchmark at 13%, as is energy at 2%. Financials is slightly underweight (4% versus 5%). The portfolio continues to have exposure of 1% or less to the real estate, materials, and consumer staples sectors, where the benchmark weightings are 3%, 3%, and 3.5%, respectively, and there is no exposure to utilities.

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 this environment, the Granahan Small Cap Select composite outperformed its Russell 2000 Growth benchmark, returning +4.6% net-of-fees versus +3.9% for the Index. Year-to-date, the Small Cap Select strategy remains significantly ahead of the benchmark, +23.0% net-of-fees versus +9.0% for the Russell 2000 Growth Index.

In the quarter, the strategy's outperformance was attributable to both the portfolio's relative sector weightings and stock selection. Robust stock selection in industrials led performance. Info tech also showed strong selection, which was boosted by the significant overweight position here. Selection in consumer discretionary and real estate was also positive. On the negative side, selection in communication services and healthcare were the largest detractors, though our relative weightings in each – overweight communication services, underweight health care – reduced the overall negative effect. Selection in the energy sector also weighed on performance though was partially offset by our overweighting here. The portfolio's underweighting in the financials and consumer staples sectors hurt relative performance.

With respect to LifeCycles, as in the 1st quarter, the Special Situation category soundly outperformed the overall benchmark. The Core Growth category also outperformed while the Pioneer category notably lagged the overall Index return. Even as the Special Situation holdings led performance, only one was in the quarter's top five contributors, **Kulicke & Soffa Industries** (info tech). Three Core Growth names were in the top five: **Kornit Digital** (industrials), **Cricut, Inc**. and **Enphase Energy** (both info tech). A Pioneer, **Chicken Soup for the Soul Entertainment** (consumer discretionary) rounds out the top five.

On the negative side, 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). Two more healthcare names round out the bottom five: **Veracyte** (Pioneer) and **iCAD** (Special Situation).

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.