SMALL CAP ADVANTAGE

Portfolio Comments
December 31, 2022

Distinguishing Features

GIM builds the Small Cap Advantage portfolio from the bottom-up; sector weightings are secondary to stock selection. As of December 31, 2022, the Small Cap Advantage portfolio was overweight its Russell 2000 Growth benchmark in Technology, Real Estate and Health Care. We are equal weight in Financials, Consumer Discretionary, Basic Materials, and Utilities, and underweight the benchmark in all other sectors. The portfolio continues to have no exposure to Telecommunications or Consumer Staples.

Commentary

Market Environment

The economy has shown signs of slowing, with inflation easing from a summer peak. On the labor market front, initial jobless claims, the unemployment rate, and non-farm payrolls continue to look strong. The recent declines in job openings indicate that the labor market is adjusting, with the jobs-workers gap declining towards the level that may be necessary to prevent the labor market from overheating. US retail spending and manufacturing weakened in November and December. The Federal Reserve (Fed) raised its benchmark interest rate 0.5% to a 15-year high and signaled that it would continue lifting rates through the spring of 2023. Fed officials have increased rates at the fastest pace since the 1980's in an attempt to cool inflation. Many companies, and even individuals, are acting strategically - planning for a road ahead that may be more difficult to traverse, with higher interest rates, the housing slump, ongoing inflation, and the possibility of a recession.

Performance

The Granahan Small Cap Advantage returned +1.7% in the fourth quarter, lagging the +4.1% return of its Russell 2000 Growth benchmark. Positive selection in Industrials drove relative performance, but we were penalized by our underweight. Selection and underweights in Energy, Financials and Health Care were the largest detractors this quarter. With respect to LifeCycles, Core Growth, Pioneer and Special Situation categories all lagged the benchmark.

The largest contributors to the strategy this quarter were Core Growth names **Axon Enterprises** (Industrials) and **Etsy** (Consumer Discretionary) along with Pioneers **Olink Holding** (Health Care), **Azenta** (Technology) and **Everquote** (Technology).

Top detractors during the quarter were Core Growth holdings: **Silvergate Capital** (Financials), **Paycom Software** (Technology), and **Definitive Healthcare** (Technology). Pioneer Health Care holdings **908 Devices** and **BioLife Solutions** round out the bottom five.

Outlook

The strategy leverages Granahan's team of experienced portfolio managers who are also sector specialists. We remain committed to our process for finding great long-term growth opportunities by identifying companies early in their lifecycle with disruptive products addressing large markets. The value creation process for these types of companies plays out over years, making patience and opportunistic position-sizing key components of our investing process. Currently we are seeing valuation metrics for our portfolios that are at historic lows. Earnings estimates have come down, however, growth in our companies is expected to far outweigh that of the general economy.

While the strategy's performance during the fourth quarter and year of 2022 was disappointing, we believe our process will yield relative outperformance on a multi-year basis. Against a backdrop of unprecedented moves in Treasury yields during the past few years, we are not in a position (nor have we ever been) to predict near-term market performance. We do however have much higher conviction that as we enter 2023, the risk-reward tradeoffs for our holdings are more attractive than they have been in years, affording us the opportunity to tilt the portfolio modestly toward names with value-creating catalysts on the near-term horizon.

As always, thank you for trusting Granahan with the management of your capital. It is managed alongside our own.