MICROCAP GROWTH
Portfolio Comments
December 31, 2022

Distinguishing Features

GIM builds the Microcap Growth portfolio from the bottom-up; sector weightings are secondary to stock selection. Since last quarter, the Microcap Growth strategy maintained a significant overweight in Health Care and added to overweight Technology versus the Russell Microcap Growth benchmark. We are also overweight Consumer Discretionary. The portfolio is equal weight to the benchmark in Telecommunications, and we are underweight in all other sectors. The portfolio has no exposure to Utilities, Energy or Real Estate.

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 Discussion

2022 was a difficult year for small cap investors as the unwinding of fiscal and monetary actions of the past several years created a risk-off environment that impacted small cap growth stocks particularly hard. The small cap correction began in late 2021, as an abrupt change in the forecast for future interest rate increases was required to address emerging inflation. In 2022, the Fed raised interest rates at a historic pace leading to a meaningful re-rating in stocks. For small caps overall, 2022 saw the 10th biggest decline on record. It was also the 3rd worst year for small cap growth stocks. Several key sentiment indicators ended the year at record low levels while more than half of the trading days in 2022 were down matching prior year records. According to Jefferies, small cap stocks represent 4% of US equity market compared to historical average of 7%. The last time small cap stocks represented this little of the market was back in the 1930s.

For the quarter, the Granahan Microcap Growth strategy returned -6.3%, lagging the Russell Microcap Growth Index return of +2.7%. For the full year 2022, the strategy's performance was -35.0% versus the Index' -29.8%.

The less growthy or lowest valued stocks were relative outperformers along with industry groups like Energy, Consumer Staples and Utilities in 2022. The lowest P/E stocks were clear relative outperformers while the highest growth and non-earning stocks were the worst performers. All three of our LifeCycle categories underperformed the benchmark this quarter.

In Q4, the best performing stocks in the strategy were Pioneers **EverQuote** (Technology) and **ShotSpotter** (Industrials). Special Situation names, **Columbus McKinnon** (Industrials), **Alta Equipment** (Consumer Discretionary), and **Stoneridge** (Consumer Discretionary) round out the top five.

Conversely, the largest detractors this quarter were three Pioneers, **908 Devices** (Health Care), **SI-BONE** (Health Care), and **Cryoport** (Industrials), and two Special Situation Technology holdings, **Edgio** and **AXT, Inc**.

Healthcare technology stocks performed poorly in 2022 given fundamental weakness as hospitals struggled under financial strain and there was a rotation to value stocks from growth stocks due to higher interest rates. The Health Care IT sector of small cap stocks declined almost 60% from its peak pre-pandemic levels, with multiple compression the main source of most of the downside. However, we believe some of these companies offer incredible value to organizations that are seeking different ways to drive revenue growth and manage costs especially with ongoing staffing challenges.

Health Catalyst (HCAT) is a leader in the hospital data and analytics market offering solutions that are helpful to hospitals under increased financial pressures. HCAT's solutions have a strong return on investment profile and allow hospitals to outsource IT functions that is particularly appealing in period of staffing challenges. The stock historically traded around 6x enterprise value to revenue since its IPO in 2019; however, today the valuation is 1.5x revenue, down 50% from the trough of the Covid sell-off, and down 85% from its peak.

Outlook

Several key sentiment indicators for small caps sit at all-time lows, including the Michigan Consumer Sentiment Index, NFIB Small Business Economic Outlook, and the AAII Bull-Bear Spread. Despite the challenges of 2022 and current sentiment, we remain excited about the outlook in 2023. The strategy leverages our 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 rates for our companies are 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's invested alongside our own.

Disclosure:

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