



FOCUSED GROWTH

Portfolio Comments

March 31, 2023

Q1 - A Quarter to Make One's Head Spin

Furey Research's Jeff Burton put it well: "the first quarter of 2023 felt like a year." When all was said and done, the [Focused Growth](#) portfolio slightly outperformed the Russell 2000 Growth benchmark rising + 6.3% in Q1, compared with the + 6.1% for the benchmark.

In terms of attribution, the modest outperformance relative to the Russell 2000 Growth benchmark was a product of negative stock selection, counter-balanced by positive allocation, ending with a net positive effect. Sector-wise, net contribution was positive in Industrials, Financials, and Technology, while Consumer Discretionary, Real Estate, and Energy were detractors.

Below I discuss the largest contributors and detractors for Q1. This is followed by my Q1 commentary, outlook, content recommendations and closing comments. Note, I also asked ChatGPT's AI engine GPT-4 to write a Q1 commentary, outlook, content recommendations and closing commentary. Its version follows mine – and you might want to read that in addition to (or instead of) mine.

Attribution

The three largest relative contributors in Q1 were:

Axon (AXON) - Axon is a mission-driven company which sells products, platforms, and services designed to improve law-enforcement, reduce social conflict, enable a fair and effective justice system, all while aspiring to "obsolete the bullet" with its Taser non-lethal weapon. AXON shares rose 36% in Q1, contributing 207 basis points to performance. The company reported very strong Q4 results and guidance for 2023, and initiated 2025 financial targets that were ahead of street expectations. The company also demonstrated the new version of its Taser non-lethal weapon. The Taser 10 boasts materially increased range, accuracy, and efficacy. The company remains well positioned going after a very large opportunity and we maintain a large position in AXON shares.

HubSpot (HUBS) – HubSpot offers a platform that enables small, medium, and increasingly enterprise-size businesses to manage marketing (its original offering), selling, servicing, and conducting commerce with their customers. HUBS shares rose 48% in Q1, contributing 169 basis points to performance. The company reported in-line sales results but guided for better sales than some feared and significantly better profit margin expansion in 2023 relative to consensus expectations. While we trimmed the investment on strength, it remains a relatively large position in the portfolio.

Zeta Global Holdings Inc. (ZETA) - Zeta operates a marketing-technology platform that lets advertisers combine their own internal data with third-party data to attract, retain, and cross sell customers. ZETA shares rose 32% on strong Q4 results, guidance for 2023 that was ahead of consensus expectations, and yet still appears conservative as the company is gaining share. We currently hold a large position in ZETA shares.



The three largest detractors in Q1 were:

Enphase (ENPH) - Enphase is a leading provider of complete solar systems primarily for the residential power market. ENPH shares fell 21% in Q1, hurting performance by 141 basis points. The company reported good Q4 results and positive guidance, but the stock was weak in the wake of uncertainty around the impact of changes to solar credits in the State of California, higher interest rates, and a potentially softening economy. That said, Enphase is executing exceptionally well, has a strong position and a very large opportunity. We believe the stock has an attractive probability-weighted expected return and risk/reward and currently hold a mid-sized position in ENPH shares.

CoStar Group (CSGP) - CoStar Group has three broad operating segments: 1) Commercial Real Estate Information Services (CRE); 2) Multi-Family Residential Services (MFR - the most recognizable being the Apartments.com website); 3) Single Family Residential real estate (SFR) under the Homes.com umbrella site. CSGP shares fell 13% in Q1, hurting performance by 110 basis points as the company surprised the street (and us) with an exceptionally large 2023 investment in its SFR segment. We believe the company has a reasonable chance of competing well with and ultimately overtaking Zillow as the leader in this space. However, the scale of the investments CoStar is likely to make in 2023 and 2024 and concerns about growth in its commercial real estate division, have tempered our near-term expected return on CSGP shares, and we have cut the investment to a mid-sized position.

Azenta (AZTA) - Azenta provides instruments, consumables, and services for the life sciences industry. AZTA shares fell 21% in Q1, hurting performance by 115 basis points. The company reported soft FY Q1 (December quarter) but maintained full year guidance, which may be difficult to attain. Given this, despite the drop in AZTA shares, we modestly trimmed our position to a mid-sized holding.

Climbing the Wall of Macro Worries

As noted above, Q1 was a quarter that felt more like a year. During the quarter, a full-blown banking crisis piled on top of an already substantial list of macro concerns (e.g., interest rates, inflation, a potential recession, and a war), providing further rationale for many to steer clear of equities - let alone longer duration small/mid growth equities. And yet, the Russell 2000 Growth benchmark and most other equity indices rose nicely in Q1. In fact, the Russell 2000 Growth index has quietly climbed the "wall of worry" since 6/15/22, rising 12.0% through 3/31/23. The Focused Growth strategy is up +22.3% over the same period. Are we through the woods? Impossible to know. But we do know that *when* the time comes that we *are* through the woods, stocks will very likely have discounted it well before. This is almost always the case.

We also know that attempting to time the woods' darkest hour - and by extension the moment the market hits bottom and is time to buy - is *not* a repeatable winning strategy for investing.

Thus, plan sponsors create and adhere to asset allocation plans, and we at Granahan adhere to an investment philosophy and process that is not reliant on knowing the optimal moment to venture out of the woods. That is, we don't try and guess. Rather, when the world and heads seem to be spinning out of control, it is particularly important to focus on executing our process which we believe *is* a repeatable and winning strategy. We are disciplined in investing our time and your money in companies we believe are desert island-worthy, and whose stocks have attractive risk/reward and probability-weighted expected returns.

As I discussed in the Q4 letter, it is my belief that whereas we saw a significant contraction in valuation multiples in the first few months of 2022 (i.e., think of the "P" in the "P/E" (Price/Earnings) multiple), we are in a market where the key variable is the "E"--i.e., the "Earnings" in the Price/Earnings equation. While growth expectations have come down over the past twelve months, we are nonetheless forecasting earnings growth of 21% for the



Focused Growth portfolio in 2023, compared with 10% consensus growth expectations for the Russell 2000 Growth. Yet, investors are largely shunning our version of higher secular growth small/mid growth stocks and the Focused Growth portfolio is generally zigging when others are zagging, and vice versa. As a result, the portfolio's expected return is attractive, despite the fact that stock-by-stock we are incorporating what I believe are relatively conservative estimates of growth, generally no expansion in multiples, and higher than normal chances of "negative scenarios" in our probability-weighted expected returns. At some point, investors will return to such stocks and multiples have room for expansion. In the meantime, earnings growth should drive performance.

But What About AI?

If you haven't been living on a desert island for the past few months, you are no doubt aware that AI has burst into the mainstream. Many such phenoms quickly fade and don't amount to much. I'm of the camp that AI will not suffer this fate. I believe it is going to be very impactful to business and our lives - in many ways for the better and no doubt in some ways for worse.

The potential negative ramifications are very concerning to many. The [Future of Life Institute](#) has called for an immediate six month pause in training of AI systems more powerful than GPT-4 stating that "Advanced AI could represent a profound change in the history of life on Earth, and should be planned for and managed with commensurate care and resources." The [open letter calling for a pause](#) now has over 50,000 signatories including Elon Musk and Steve Wozniak, who were among the original signatories. Though it would be impossible to universally enforce, I think a pause is a good idea (and have signed Future of Life's letter) as I believe we'd all benefit from a concerted broad discussion of the A.I.'s ramifications risks, and ways to manage and mitigate the risks. If you haven't given [Chat-GPT a whirl for yourself, you should definitely do so here](#).

In the meantime, pause or no, at Granahan we are thinking about and analyzing the potential ramifications and ripple effects of AI on the companies we invest in. Such implications are wide ranging and include expanded and/or accelerated revenue opportunities, better customer experiences, meaningful cost reductions, and of course threats to both revenues and moats. Consider **Axon** (AXON) for example. The company has been using AI for a number of years to reduce the "paperwork burden" on police officers and to enable them to spend more time in the community. The company is also working to pair its on-officer body worn cameras, with facial recognition and powerful AI-powered databases to give police officers real-time information that could mean the difference between life and death when interacting with perpetrators. Or for a less dramatic example, **First Watch Restaurants** (FWRG), a breakfast and lunch restaurant chain, which will increasingly be able to improve labor scheduling through daily/hourly sales forecasting driven by AI enhanced models incorporating weather, historical sales, traffic, and holidays, etc. Or dating app **Bumble** (BMBL) being able to consistently improve dating matches through AI - or on the other hand, might AI reduce the company's "moat" by making it easier for other apps to compete with Bumble's scale? And of course one can use ChatGPT to improve one's dating app profile as [Business Insider's Lakshmi Varanasi did here](#) or almost go on a date as writer [Anita M. Harris wrote about here](#) in the New York Times.

While no shortage of ink has been spilled on AI of late, here are links to a few articles and podcasts that you might find useful if you want to explore or think more about AI:

- [NY Times Tech Columnist Keven Roose on his unsettling conversation with Bing's Chatbot](#), and the [deeply disturbing full transcript of that conversation here](#) where Bing's dark counterpart Sydney declares her love for Roose and urges him to divorce his wife.
- [Kara Swisher interview with OpenAI CEO Sam Altman on GPT-4 and the A.I. Arms Race](#)
- [Ezra Klein dives deep into AI](#) and its ramifications, pointing out that GPT-4 can pass the bar exam in the 90th percentile and score in the 88th percentile on the LSAT.



- And if you want to check out the O.G. AI HAL, go back to the future and watch the Stanley Kubrick's masterpiece adoption of Arthur C. Clarke's [2001: A Space Odyssey](#). A film released 55 years ago that is not only scarily prescient but also holds up as a movie.

Finally, if You've Had Enough about AI, here's a Bit More (non-AI) Content:

A Few Recommendations...

An Article:

Wall Street Journal Opinion Column - [Former FDIC Chairman William M. Isaac puts forth a simple, common sense solution](#) to avoiding moral hazard to solve future bank failures.

A Book:

[Principles for Dealing with the Changing World Order: Why Nations Succeed and Fail](#) - Ray Dalio zooms way out to give us a different and highly valuable perspective on the 50–70-year cycles nations go through. Spoiler Alert: He paints a rather spoiling picture of the U.S.

A TV Series:

[Shrinking](#) - If, after reading Dalio's *Changing World Order*, you need a shrink or a funny TV show to lighten your mind, enjoy Jason Segel, Harrison Ford, and Jessica Williams in this Apple TV series.

A Movie:

[Portrait of a Lady on Fire](#) - This film has it all--a captivating story, excellent performances, and is visually and artistically stunning from start to finish. Not surprising it ranks #30 on *Site & Sounds' Best Films of All Time*.

An Audio Book:

Daisy Jones and the Six is a novel written by author Taylor Jenkins Reid about a fictional 1970's rock band of the same name which is loosely based on Fleetwood Mac. You could watch the TV series, buy the album, or read the book, but I recommend listening to [the audiobook version](#) which has a cast of 11 led by Jennifer Beals' portrayal of Daisy Jones.

And One Pan...

I have to admit, I just didn't get the appeal of [Everything Everywhere All at Once](#) - though clearly others did as it practically swept the Academy Awards this year. Oh well, as they say in our business, that's what makes markets.

As always, on behalf of the entire team at Granahan Investment Management, I'd like to express my gratitude for entrusting us with the management of your capital. Please note that it is managed alongside our own.

Sincerely,

A handwritten signature in black ink that reads 'Drew Beja'. The signature is fluid and cursive, with the first name 'Drew' being larger and more prominent than the last name 'Beja'.

Drew Beja, CFA
Portfolio Manager



APPENDIX

Below is GPT-4's crack at the Q1 commentary, outlook, content recommendations and closing valediction:

GPT-4 Prompt: Compose an investment letter discussing a macro environment that includes the following factors: a banking crisis; rapidly rising interest rates; high inflation; fears of a recession; war between Russia and Ukraine. Note: We don't believe we have a macro crystal ball and our investment process focuses on U.S. small cap secular growth stocks worthy of taking to a desert island for 3-7 years. Also, we generally do not invest in banks or dividend paying equities.

Subject: Navigating Uncertainty with U.S. Small Cap Secular Growth Stocks

Dear [Client's Name],

We hope this letter finds you well. In light of the current macroeconomic environment, we wanted to provide you with an update on our investment strategy and perspective on the markets. As you know, we don't claim to have a macro crystal ball; instead, our investment process focuses on U.S. small cap secular growth stocks that we believe are worthy of holding for 3-7 years, regardless of market conditions. We generally do not invest in banks or dividend-paying equities, which affords us some insulation from certain risks in the current landscape.

The global macroeconomic climate has become increasingly complex, with several factors creating a high level of uncertainty. These include a banking crisis, rapidly rising interest rates, high inflation, fears of a recession, and the ongoing war between Russia and Ukraine. In this letter, we will discuss how our investment strategy remains focused on small cap secular growth stocks amid these challenges.

1. **Banking Crisis:** While the banking crisis poses significant risks to the broader market, our investment process generally avoids banks and other financial institutions. This allows us to concentrate on small cap secular growth companies in other sectors, with strong fundamentals and promising long-term prospects.
2. **Rapidly Rising Interest Rates:** In a high-interest-rate environment, growth stocks can face headwinds as borrowing becomes more expensive, and investors may shift their focus to more conservative investments. However, we remain steadfast in our focus on companies with solid balance sheets, low debt, and robust cash flows, which we believe will be better positioned to weather these conditions.
3. **High Inflation:** Inflationary pressures can erode the purchasing power of consumers and increase input costs for businesses. Our strategy emphasizes companies with strong pricing power and the ability to pass on increased costs to consumers, thus preserving their profit margins. Additionally, we target businesses with a high degree of operational efficiency, allowing them to better manage inflationary pressures.
4. **Fears of a Recession:** Although the possibility of a recession looms, our long-term investment horizon allows us to maintain our focus on high-quality small cap secular growth companies. We believe that these companies will not only survive a downturn but emerge stronger and more competitive in their respective industries.
5. **War between Russia and Ukraine:** The ongoing conflict has created uncertainty and volatility in global markets. While the war may have indirect effects on



the companies we invest in, we continue to prioritize those with limited exposure to geopolitical risks and a strong domestic focus.

In conclusion, our investment process remains committed to focusing on U.S. small cap secular growth stocks with strong fundamentals and long-term growth potential. Despite the challenging macroeconomic environment, we believe our approach will continue to provide attractive returns and help you achieve your financial objectives.

As always, we appreciate your trust and confidence in our team, and we are here to answer any questions or concerns you may have.

Warm regards,

[Your Name] [Your Title] [Your Company]

GPT-4 Prompt: I like to add interesting content (i.e., books, newspaper articles, tv shows, podcasts) at the end of my investment letters to clients. Do you have some suggestions?

Certainly! Below, you'll find a list of diverse and engaging content spanning various formats. Feel free to select any that you find interesting and relevant to include in your investment letter.

Books:

- "The Psychology of Money" by Morgan Housel - This book offers insightful perspectives on personal finance and the behavioral aspects of money management (editor's note: This is an excellent recommendation which I included in the Q3 2022 letter)
- "No Rules Rules: Netflix and the Culture of Reinvention" by Reed Hastings and Erin Meyer - An inside look at Netflix's innovative corporate culture and how it drives the company's success.
- "The Deficit Myth: Modern Monetary Theory and the Birth of the People's Economy" by Stephanie Kelton - A thought-provoking exploration of modern monetary theory and its implications for economic policy.

Newspaper Articles:

- "In a High-Pressure Economy, the Winners Adapt Fast" - The Wall Street Journal - An analysis of how businesses are adapting to the rapidly changing economic landscape.
- "The Great Resignation: Why Millions of Workers Are Quitting Their Jobs" - The New York Times - An examination of the factors driving the surge in employee resignations and its potential impact on the labor market.

TV Shows:

- "Billions" - A Showtime drama series that delves into the high-stakes world of finance, following the intense rivalry between a hedge fund manager and a U.S. Attorney.



- "Shark Tank" - An ABC reality show where entrepreneurs pitch their business ideas to a panel of potential investors, offering insights into the decision-making process of seasoned investors.

Podcasts :

- "StartUp Podcast" by Gimlet - This podcast chronicles the ups and downs of starting a business, sharing stories from various entrepreneurs and industry experts.
- "The Indicator from Planet Money" by NPR - A short, daily podcast that provides quick insights into work, business, the economy, and everything else through engaging stories and interviews.
- "Masters in Business" by Bloomberg - Hosted by Barry Ritholtz, this podcast features interviews with prominent figures in the world of finance, economics, and business, discussing their experiences and insights.

Feel free to choose from these suggestions or use them as inspiration to find other interesting content that might resonate with your clients.

Editor's note:

For what it's worth, I think my "edge" over GPT-4, if there is one, is more pronounced in the "content" section than the "commentary" section. Food for thought.

Disclosure:

The information provided in this commentary should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. The securities discussed do not represent an account's entire portfolio and, in the aggregate, may represent only a small percentage of an account's portfolio holdings.

It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein.