



SMALL CAP CORE GROWTH

Portfolio Comments

March 31, 2023

Commentary

The turmoil in the banking sector brought a volatile end to the first quarter and a reappraisal of the Federal Reserve's policy priorities. Q1 served up highs and lows -- shifting positively on declining inflation numbers in January, then declining on fears of an overheating economy in February, and then shifting again to contend with banking stress and credit crunch fears in March. The Granahan [Small Cap Core Growth](#) strategy returned 4.7% lagging that of 6.1% for the Russell 2000 Growth Index.

Our biggest detractor this quarter was **Silicon Valley Bank (SIVB)**. We unfortunately were large shareholders in SIVB since the early part of the year. Originally, we viewed this as a unique opportunity to take advantage of big price drop in one of the best performing bank stocks in the last 25 years, as Venture capital firms that fund SIVB's start up customers were flush with cash, and the startups were running out of cash. Essentially, there was a major disagreement on valuation. With time, this would have to resolve itself one way or another, resulting in a slowdown in SIVB withdrawals, and eventually reversing as startup companies received more funding (at lower valuations). After Q4 results were released in January, the stock moved higher, and our thesis seemed to be playing out as the decrease in deposits showed signs of slowing down. We thought we invested in the stock just as things were getting better. Unfortunately, this improvement proved to be fleeting. As the company tried to de-risk its balance sheet and raise capital, they fueled a liquidity crisis and a bank-run at warp speed. Large deposits from their commercial banking clients totaling 25% of assets were withdrawn within hours; all initiated by online transfers. For context and by comparison, Washington Mutual, which went bankrupt in 2008, had 10% of its deposits redeemed over 3 weeks. SIVB was taken over by the FDIC less than two days after plans to raise capital were announced and the Granahan portfolio took a significant loss, turning a quarter that would have been one with outperformance into one with underperformance.

This was a humbling experience. SIVB and Signature Bank were two of the best growth banks of the last twenty years and they both failed. We are not interested in repeating the SIVB mistake, especially in a world where social media and digital banking can facilitate a liquidity crisis in a bank so quickly. One of the questions that we were asked after this collapse was whether we think taking large positions in the strategy is something we should continue. Our answer was a resounding yes. Over the history of our strategies, our large positions have had a very significant positive impact.

Other detractors for the quarter include Pioneer, **Azenta**, which is a leader in biological storage technology and services. The stock underperformed this quarter after outperforming last quarter. Earnings were in line, but the margin outlook was tempered due to inflation, a slower recovery in China, and the acquisition of B Medical. Moderating organic revenue growth and muted margins are weighing on the near-term outlook, however its healthy balance sheet has allowed the company to accelerate share repurchases. We have increased our position size. Special Situation, **Texas Capital** came under pressure with the quarter's banking crisis, despite being an attractively valued growth bank that has refocused its strategy on core banking services for companies in the Texas market. The restructuring, under a new CEO, has improved longer-term profitability while also positioning the bank well ahead of its peers in terms of robust capital ratios. Despite the strong positioning, we trimmed our position given the ongoing jitters in the banking sector which serves as an overhang on the stock. Core Growth company, **Kornit Digital** develops, designs, and markets disruptive digital printing solutions for the global textile industry. Long term secular trends, new product introductions, consumables and services are expected to fuel future growth. One of Kornit's top customers will not be making capital equipment



purchases in 2023, which delays the recovery in earnings until 2024. The company is focused on break even for 2023 and expects growth in 2024. We have increased our position size. Also in Core Growth, **Magnite** came under pressure after receiving conservative guidance from management due to macroeconomic uncertainty that is driving weakness in advertising demand. Management also pointed out that January and February seemed to pick up and the company has been taking share of the connected TV market which is a higher margin business. We have added to our position.

Positive contributors for the quarter include Pioneer name **indie Semiconductor**, which makes automotive sensors for advanced driver assistance systems that are gaining design momentum with leading Tier 1 and global car manufacturers. The company made an attractive acquisition, and we have trimmed on strength. Core Growth company, **Axon Enterprise** has a highly valuable installed base for law enforcement personnel. Their less-lethal weapons, body cameras and related software products are increasingly in demand to improve accountability and effectiveness in public safety. We are maintaining our position. Pioneer company, **SI-BONE** manufactures orthopedic devices used in the treatment of the sacroiliac joints, the joints that link the pelvis and lower spine. These minimally invasive implants deliver strong clinical outcomes, have attractive reimbursement and are increasingly being adopted by surgeons. The stock responded to the company's strong financial outlook for this year that demonstrates accelerating revenue growth and meaningful improvement in operating leverage. We added to our position given the attractive valuation and our outlook for strong growth over the next several years. Also in Pioneers, **Rapid7** provides security and data analytics solutions that have expanded into new arenas beyond its core vulnerability management segment into higher growth cloud workload protection market. The company is coming off a year of underperformance in 2022. Like many software companies, RPD is focused on more profitable growth and is still in what we believe are the early stages of ramping up its free cash flow and operating margin leverage. Valuation remains at a discount relative to its peer group. We have trimmed the position size. Core Growth company **Materion** is a specialty materials company that has expanded its advanced metals and composite materials into attractive secular growth markets like semiconductors, aerospace, and alternative energy. The company reported a very strong Q4 of 2022, despite the tough macro environment, as many of these newer markets have enhanced the overall company's growth and profitability. We maintained our position.

Attribution

Far and away the largest penalty to performance this quarter was our ownership of Silicon Valley Bank. We are underweight the benchmark in Financials, holding mostly specialty insurance companies, however, we do own Texas Capital Bancshares, as mentioned above. Our underweighting in Consumer Discretionary, Industrials and Utilities was a penalty. We outperformed the index in our Healthcare stock selection, but our overweight in this woefully underperforming sector hurt in the first quarter. Stock selection In Energy, Consumer Staples and Basic Materials was a positive, but we were underweight all three sectors. Our overweight in Technology was a positive to attribution, but our stock selection was not.

In terms of LifeCycles, Core Growth was the strength in the portfolio followed by Pioneers. Special Situations were a drag on performance.

Weightings

Sector weightings for the strategy have not changed much since last quarter, with the exception of Financials where we are now at 5%, 150 bps less than last quarter and 100 bps below the Index. Year-over-year changes are more dramatic. The Energy weighting in our portfolio has remained flat at 3%. A year ago, we were underweighted by 1%. The Index' weighting has expanded to 7% so we are now underweighted here by 4%. Our Technology weighting is up from last year by 2% and the Index' weighting is down by 3%, increasing our overweight by 5%. Healthcare in the Index is down by 3%



and we have maintained our weighting – increasing our overweight to 6%. We have increased Basic Materials by 1.5% and are equal weight with the Index.

Core Growers have remained flat both year over year and quarter over quarter. Pioneers are up in both time periods while Special Situations are down.

Themes

With Chat GPT and generative AI getting a lot of media coverage, we thought it prudent to discuss how it affects our portfolio companies. While many of our companies have been using artificial intelligence for several years, new methodologies will ultimately be a tailwind for several categories of software. We own cloud-native market leaders who quickly embrace technology and use their data as a competitive advantage such as **Okta** and **Confluent**. **PROS software** has been using Data Science/AI for decades. According to Gartner “their technology for configuring price quotes (CPQ) delivers more AI-driven guided selling capabilities than any other product evaluated for this magic quadrant”. **Guidewire** and **Hubspot** are vertical software providers we anticipate will accelerate share gains by using generative AI. A Radware spin off, **Skyhawk Security**, is the first cloud security company to embed ChatGPT functionality into the threat detection process. AI is used with image and video processing for recognizing patterns and identifying objects. Both **CEVA**, which sells AI processor cores, and **Ambarella**, which has AI vision processors fit into this category. These solutions are used in automotive, security, consumer, and industrial applications. **Veritone** is an AI operating system that allows organizations to analyze, process and extract insights from large amounts of data, including audio, video, and text. And lastly, **Veracyte** offers its biopharma partners unique capabilities to optimize biomarkers through in-depth analysis of patient oncology samples. Veracyte uses proprietary artificial intelligence and databases to advance precision medicine that helps to improve clinical outcomes in patients.

A recent in-depth survey done by Roth Capital on spending trends of millennials has provided some interesting data. They surveyed 2,500 men and women between the ages of 22-42 in the US in November 2022. The survey includes findings on a variety of mostly consumer-related habits of millennials. Companies we own in our portfolio, like **Vita Coco**, **thredUP**, **Etsy**, and **Lovesac**, are well-positioned to capitalize on this generation’s spending, as their products cater to the millennial preference for sustainable, socially responsible, technologically advanced, and unique products. Vita Coco, a leading coconut water brand, appeals to health-conscious millennials, while thredUP, an online consignment and thrift store, addresses the demand for sustainable fashion. Etsy, a global marketplace for handmade and vintage items, resonates with millennials' appreciation for uniqueness and individuality, and Lovesac, a furniture company specializing in modular seating with or without embedded technology and eco-friendly materials, aligns with their technological requirements and environmental concerns. As millennials continue to prioritize these values, we believe these companies are likely to experience substantial secular growth.

In life sciences, proteomics (the study of the structure and function of proteins) brings research closer to disease states with the unparalleled insight into biological processes. In our portfolio, **Olink** and **Quanterix** are both companies that offer protein detection technologies, but they differ in their approach and offerings. Olink’s PEA technology enables the detection of hundreds of proteins in a single sample, while Quanterix’s Simoa technology enables the detection of individual protein molecules with high sensitivity and specificity. Additionally, Olink primarily offers preconfigured panels of protein biomarkers, while Quanterix offers instruments and consumables that can be used for a variety of applications. Both approaches have strong use cases.



Macro

It is still too early to have a confident view on the implications of the current banking turmoil for the US economy. Our expectation, however, is that reduced credit availability will prove to be a headwind, which may help the Fed with its lower growth/ lower inflation goals, despite rising real income and better global growth. The risk of recession has risen, given the Fed's steep interest rate increases and their impact on banks and lending. Investors have moved money away from regional banks and into higher yielding money market funds. Lack of deposits forces banks to lend less, and what they do lend comes at higher rates.

Outlook

Earnings estimates have come down significantly for many companies, as recession remains a possibility. However, history shows that the stocks of small capitalization companies are likely to start moving up before many of us know for sure that the economy has begun growing again. We believe significant innovation is currently undervalued. Key growth drivers of digital transformation, biotechnology breakthroughs and sustainability are powerful forces. We also know that in 2008-2009, over 50% of our monitored universe of companies were able to grow their revenues by a minimum of 15% through innovation and productivity enhancing products.

We believe returns are generated through deep fundamental research, specialized teams of highly experienced investment professionals, and investment strategies constructed through research-based conviction in individual companies. Our investment process and professionals are singularly focused on helping clients achieve their investment objectives. The success of our processes over our 38-year history reflects our research-based conviction in secular growth companies that create long-term economic value.

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