GRANAHAN INVESTMENT MANAGEMENT INC

SMID SELECT

Portfolio Comments
March 31, 2023

Distinguishing Features

GIM builds the SMID Select portfolio from the bottom-up; sector weightings are secondary to stock selection. At quarter-end, the SMID Select portfolio remained overweight in Technology and Communication Services versus the Russell 2500 Growth benchmark. We are equal weight the benchmark in Consumer Staples and continue to be underweight in all other sectors. We have no exposure to Real Estate or Utilities

Performance & Attribution

The Granahan SMID Select strategy returned +3.4% in the quarter, trailing the +6.5% return of its Russell 2500 Growth benchmark. Our overweight in Technology and underweight in Energy contributed positively to the strategy's relative performance for the quarter. Strong stock selection in Health Care and Consumer Staples were also positives. Challenges in Q1 were largely tied to Financials, which is discussed in more detail below, but we also saw penalties from selection in Industrials, Communication Services and Consumer Discretionary.

With respect to LifeCycle categories overall, Pioneers were far and away the outperformers this quarter. Special Situations also nicely outperformed the benchmark, while Core Growth names lagged.

The largest contributors this quarter were Pioneer, **indie Semiconductor** (Technology) and four Core Growth names: **Vita Coco** (Consumer Staples), **Array Technologies** (Technology), **Axon Enterprise** (Industrials), and **Euronet Worldwide** (Financials). The largest detractors were all Core Growers: **SVB Financial Group** (Financials), **Magnite** (Communication Services), **Kornit Digital** (Industrials), and Technology names **Enphase Energy** and **Digital Turbine**.

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.

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. In fact, as bad as SVB was for the portfolio in Q1, one of our top positions, **indie Semiconductor**, more than offset the losses from SIVB for the quarter. With a 4,1% total effect return in the first quarter, indie finished as our largest position in the strategy. We continue to be very excited about the future return profile of this stock given its growth prospects and valuation.

Macro

It is still too early to have a confident view on the implications of the current banking turmoil for the US economy, but we maintain that inflation is likely to continue going down over the course of 2023. We saw a slowdown of this trend in the early part of the year and the bond market suffered some serious indigestion (contributing to SIVB's demise), but we are likely to see further pressure on inflation as credit is tightening even outside the Fed's rate increase. The bad news is that the landing is getting harder, meaning there will be even more downward revisions. We, however, are still hopeful that as inflation does drop and lower valuation increases will more than offset reduced earnings.

Our investments continue to remain focused on places where growth can be strong or accelerating. For the former we favor names like indie that is taking market share in the fast-growing automobile semiconductor market, and names like First Solar and Array technology that are positioned to be major beneficiaries of the Inflation reduction act. For the latter, we think our digital advertising names Magnite and Digital Turbine have a very good chance of showing improved growth as we go throughout the year. This improvement is more speculative, but the valuations of these companies could move meaningfully higher even if there is a modest improvement in the market as they both trade at EV/EBITDA multiples below 10x.

Outlook

With earnings estimates down, and recession remaining a possibility, we think it's important to remember that 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.