FOCUSED GROWTH

Portfolio Comments
June 30, 2023

Extremely Extreme

Granahan's Focused Growth portfolio returned +2.0% in Q2, underperforming the Russell 2000 Growth benchmark which was up +7.0%. Year-to-date the portfolio is up +8.4% but lagging the Russell 2000 Growth's 13.6% return over the same period. Put simply, the types of stocks we own are not the type the market has been wanting. Relative to the benchmark, we've lagged due to sector weighting and stock selection. We detail this below, but the bigger story of 2023 so far has been a market which has been very narrow and led by a few extremes.

One such extreme is the headline NASDAQ Composite Index is up +31%. Had I been given a sneak preview of this before the year started, I'd have expected that the Granahan Focused Growth portfolio would be up a whole lot more than it is year-to-date. That said, looking just a bit deeper into the NASDAQ Composite provides a perspective that is illustrative of the narrow/extreme market. The seven largest companies in the NASDAQ by market cap (Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla, and Meta) are on average up a stunning 89% year-to-date. The remaining 3,521 stocks are up just 5% (source: Furey Research).

That's not to say we've executed perfectly. We have not. In terms of attribution relative to the benchmark in Q2, the underperformance was a product of negative stock selection (-561 basis points), somewhat counter-balanced by allocation (+77 basis points). Sector-wise, the portfolio was hurt by Health Care (-214 basis points, mostly due to the portfolio not owning stocks in Biotech and Devices,) Consumer Discretionary (-200 basis points, primarily Etsy, see below), and Industrials (-104 basis points, -159 of which was due to Axon, a large holding which fell -13%).

So net, a tough relative quarter due to mixed stock selection and pockets of strength in the benchmark outside of the areas in which we typically invest.

Q2 Stock Attribution

The Three Largest Relative Contributors in Q2 Were

- ***SPS Commerce*** (SPSC) - *SPS is a cloud-based supply chain management software connecting retailers and their suppliers. SPSC shares rose +26.3% in Q2, contributing 119 basis points as the company posted strong Q1 results and raised its near-term growth outlook based on the broad strength in omnichannel retailing. The stock rise is also despite long-time CEO Archie Black, who has guided SPS through exceptional growth over the past 25 years, announcing his planned retirement. We have trimmed but continue to hold a large position in SPSC shares.*

- ***Kornit (KRNT)*** - *Kornit has a suite of products leading the shift from analog to digital printing in the garment, apparel and textile industries. KRNT shares rose 52% contributing +108 basis points to performance on investor enthusiasm for the company's new Apollo direct-to-garment printer. We added to the position early in the quarter in part due to optimism about the Apollo and have since cut it back after the big move in the stock. We hold a mid-sized position in KRNT.*

- ***Toast, Inc.*** *(TOST) - Toast offers a platform for small, medium, and increasingly larger restaurant chains to operate and manage their business. The stock rose 27% in Q2, contributing 90 basis points to performance. The company reported strong Q1 results with revenue rising 53%, well ahead of expectations. Guidance was also strong both for the top and bottom lines. TOST remains a top 5 position in the portfolio.*

The Three Largest Relative Detractors in Q2 Were

- ***Etsy*** *(ETSY) - Etsy operates a global online marketplace connecting sellers and consumers of unique and creative goods. ETSY shares fell 24% in Q2, impacting performance by -179 basis points. Coming out of four difficult quarterly comparisons, my expectations were that gross merchandise volume (the value of transactions being conducted on the Etsy marketplace) was likely to accelerate in Q2. While the company has yet to report, this does not appear to have been the case. Why? Well, this question has become a raging debate between Etsy Bulls and Etsy Bears. The Bulls believe it is largely attributable to a temporary spending shift away from goods (such as home furnishings and gifts) to services (such as travel, restaurants, and entertainment). The Bears meanwhile postulate that Etsy's shining growth phase has ended—and that growth from here will be much slower and more expensive to attain. This question is crucial to the success of ETSY shares going forward. I do believe growth will reaccelerate – driven by opportunities the company has to increase buyer frequency (branding, better search in part driven by AI, etc.) and geographic expansion. However, my conviction in this scenario has declined and accordingly so has our position size.*

- ***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, and aspirationally – with its Taser non-lethal weapon – to "obsolete the bullet." AXON shares fell 13% in Q2, contributing -159 basis points to performance. The company reported strong Q1 results and guidance overall, but gross margins were a bit light causing the stock to react negatively. It remains a top 10 position in the portfolio.*

- ***Zeta Global Holdings Inc****. (ZETA) - Zeta operates a marketing-technology platform that allows advertisers to combine their internal data with third-party data to attract, retain, and cross sell customers. Shares fell 21% despite reporting good Q1 results. The stock was down due to disappointing guidance related to a recent acquisition. We used the weakness to add to our position and maintain* a large position in ZETA shares.

So, What Now? Remain Focused

Macro uncertainties persist, and as noted above, certain sectors and types of stocks have had extreme moves year-to-date. Nonetheless, we remain sanguine about the outlook for the Focused Growth portfolio. After the substantial decline in multiples for growth stocks towards the end of 2021 and the first half of 2022, I have held the belief that multiples for the kinds of desert-island worthy secular growth stocks that we own were unlikely to experience further significant contraction.

During that same period, various macro events have unfolded, such as rising interest rates, a banking crisis, the threat of a U.S. government debt default, and ongoing conflict in Ukraine. The consensus on an imminent recession has shifted to a more uncertain stance.

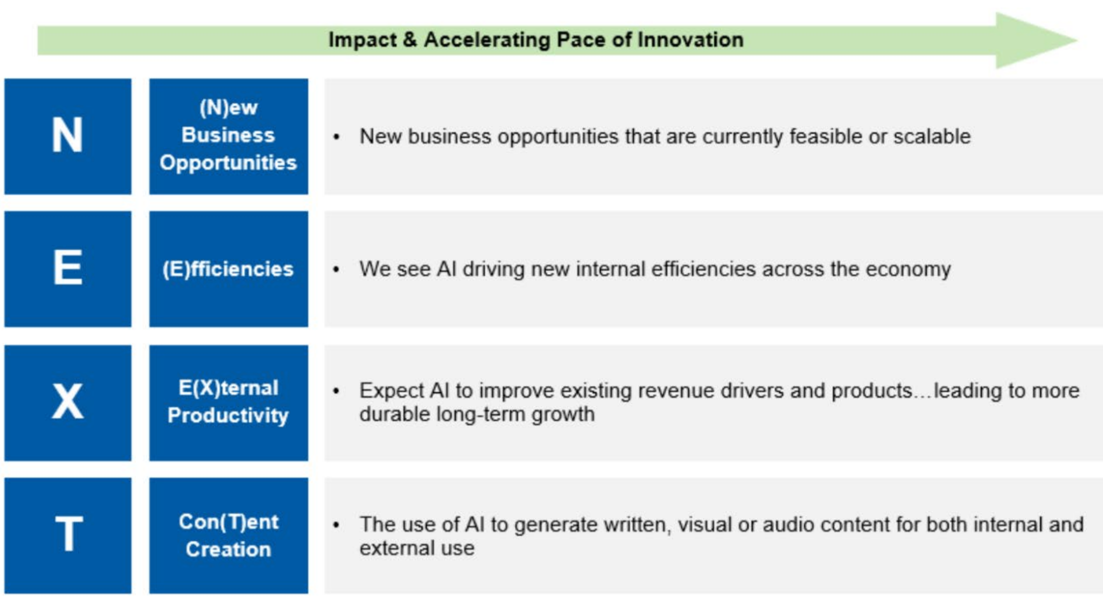
Nevertheless, the market has steadily climbed despite these concerns. Over the past year, the R2G Index has achieved an impressive 18.5% return, demonstrating yet again the challenges and risks associated with attempting to time the market. During this period, the Focused Growth portfolio has generated approximately a 25.2% return, roughly in line with the underlying earnings growth of the portfolio in aggregate.

While the business environment has become more challenging, the overall prospects for the companies in which we invest remain favorable, not only in the intermediate and long term, but also over the next 12 months. This combination of valuations and projected growth leaves me of the opinion that the portfolio's expected return remains quite attractive. Additionally, it's worth noting that neither GDP nor the profits of the average small-to-mid-sized U.S. company are growing at a rate anywhere close to the 20%+ growth exhibited by the companies in our Focused Growth portfolio.

We remain intent on executing our investment process, which involves identifying companies capable of sustaining top-line growth of 15%+ while expanding margins, diligently applying our expected return and risk/reward discipline, carefully constructing the portfolio, and managing risk. I believe that adhering to this philosophy and process provides a good probability of enabling the portfolio to deliver good absolute and relative investment results over most intermediate and long-term market environments.

Checking in on AI and Wall Street Diversity - Three Years After George Floyd's Murder

If AI is a flash in the pan, its day in the sun has lasted at least more than a quarter. But, as I discussed in the Q1 letter, I believe AI is far from a flash in the pan. Further, while there are undoubtedly both potential risks and rewards facing companies across the economy, so far, I think there are more potential rewards than risks for the companies in the Focused Growth portfolio over at least the near term. We have been and will continue to dig into, evaluate, and debate AI's impact. As you ponder AI, you might find the simple framework below from Morgan Stanley to be helpful.



Source: Morgan Stanley

Many of the portfolio companies we've spoken with are already benefiting from efficiencies due to improved engineer productivity. You may also recall a couple of examples I mentioned in the Q1 letter Bumble (dating app, better profiles + better pictures + better algorithms = better matches) and First Watch Restaurants (potential for AI predictive software to help sales and labor forecasting). Think too of Etsy, for whom as noted above the "holy grail" is increasing buyer frequency. Several of the ways Etsy can influence buyers are AI driven. The most obvious being helping buyers find better matches –a use case ideally suited to a site which sells 2.2 million different items many of which can be better described through AI natural language tools. Etsy also introduced a photo search tool in late 2022 which enables buyers to snap a photo of an item they see anywhere and search all of Etsy marketplace for similar items.

In my Q2 2020 letter, in the wake of George Floyd's murder, I discussed Wall Street's "too white, too male" problem and pledged to periodically provide an update. I have an anecdotal sense of this which I'll provide below, but I figured I would also ask Google's AI tool Bard. Below is the less-than-satisfying (in multiple ways) response that I got:

Wall Street has made some progress in terms of diversity since George Floyd was murdered in 2020. The following are some of the changes that have been made:

- Increased hiring of Black employees. In the wake of Floyd's death, many Wall Street firms made commitments to hiring more Black employees. For example, JPMorgan Chase pledged to hire 4,000 Black employees by 2025.
- Increased focus on diversity and inclusion initiatives. Many Wall Street firms have also increased their focus on diversity and inclusion initiatives. This includes things like unconscious bias training, mentorship programs, and scholarships for Black students.
- More Black representation in leadership positions. There has also been some progress in terms of Black representation in leadership positions on Wall Street. For example, in 2021, Jane Fraser became the first Black woman to be CEO of a major Wall Street bank.

However, there is still more work to be done. The percentage of Black employees on Wall Street is still relatively low, and there is a lack of Black representation in senior leadership positions. It will take sustained effort to create a truly diverse and inclusive Wall Street […]. At this point it droned on with a bunch of platitudes which I'll spare you from.

So, both AI and Wall Street diversity have a ways to go, though I'm cautiously optimistic on both fronts. In terms of the latter, my anecdotal sense is that a number of firms have continued to make diversifying their workforce a priority. Less anecdotal, you might recall that Granahan and a few other firms formed the Wall Street Diversity Accelerator (WSDA) program three years ago to help address a "top of the funnel" problem of bringing more Black individuals and overall diversity to Wall Street. We recently completed the fourth class of summer internships – typically rising sophomores and juniors in college from underrepresented communities getting their first exposure to the financial industry. I am quite encouraged by the results on two vectors:

1. **Participation of Interns and Firms**
   After starting in the summer 2020 with seven interns at five participating firms, in 2023 we had 25 interns and 20 participating firms. The feedback from WSDA alumni and sponsoring firms has been excellent and it feels like we've struck a positive chord across the board.

2. **A Slight Dent in the Wall Street Universe**
   We are starting to see results which help that "top of the funnel" problem. Several members of the first class of seven interns have graduated and gotten jobs on Wall Street at great firms such as Morgan Stanley, Barclays, PwC, and Wolfe Research. We're encouraged by their progress and the continued enthusiasm and caliber of students engaging with the program. The future here looks bright.

Content Recommendations: A Book About Probabilistic Thinking, Two Excellent Memoirs, and an Excellent Novel Set in the World of Video Games (don't let that dissuade you).

The Yellow Pad: Making Decisions in an Uncertain World - Robert Rubin - In 2004, Robert Rubin released his book *In an Uncertain World*. It covered how Rubin employed probabilistic thinking during his time as Treasury Secretary and at Goldman Sachs where he rose to Co-Chairman. I thought it was excellent. I read Rubin's recently released book The Yellow Pad. While I thought it was worth reading, I don't think it is as good as In an Uncertain World. That said, if you're looking for a graduation gift for a student you could do a lot worse.

Tell Me Everything - Minka Kelly - Whether or not you're a fan of the outstanding TV series Friday Night Lights, I think you'll be a fan of Kelly's. She tells her own story and narrates the audiobook in an unusually honest and vulnerable voice, which takes her from a very rough upbringing as the only child of a usually broke, single Mom with many problems, to a woman who through grit, toughness, intelligence and a bit of luck becomes a nurse, and ultimately a very successful actress and philanthropist.

Surrender: 40 Songs, One Story - This is a terrific book--and you need not be a U2 fan to enjoy it. Bono tells the story about his journey from the north side of Dublin to lead singer of mega-group U2 and social activist. He's a terrific storyteller and one not shy with his opinions nor sharing his foibles. The book also provides valuable perspective about leadership and team (for example, did you know the four band members and their manager split earnings equally 5 ways?) Here again, I recommend the audiobook as it is read (and occasionally sung) by the author (*thanks for the recommendation, Ian*)!

If you are looking for a good novel, I really enjoyed Gabrielle Zevin's Tomorrow and Tomorrow and Tomorrow. It's an interesting story, with well-developed characters, all taking place within the backdrop of the video game industry.

Thank You
Finally, 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, which is managed alongside our own.

Sincerely,

Drew

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