SMALL CAP ADVANTAGE

Portfolio Comments
June 30, 2023

Distinguishing Features

GIM builds the Small Cap Advantage portfolio from the bottom-up; sector weightings are secondary to stock selection. As of June 30, 2023, the Small Cap Advantage portfolio was overweight its Russell 2000 Growth benchmark in Technology and Health Care. We are equal weight in Financials, Real Estate, Utilities, Consumer Discretionary and Basic Materials and underweight the benchmark in all other sectors. The portfolio continues to have no exposure to Telecommunications or Consumer Staples.

Commentary

Market Environment

The second quarter of 2023 ushered in a U.S. debt-ceiling negotiation that kept investors around the globe apprehensive. With concerns about a US default behind us for at least the next two years, forecasts still call for a slowing economy in the second half of the year. Secular forces including "greenflation", labor shortages, and deglobalization are drivers for upward inflationary pressure. According to Jamie McGeever at Reuters, the U.S. money supply is falling at the fastest rate since the 1930’s which is bringing inflation down cyclically and inverting the yield curve significantly. These factors generally take a year or more to negatively impact economic growth. Yet, with this slowdown, there may not be a recession – there is much positive news in the economic mix. Job growth and positive housing data keep pushing the start of a recession further and further out. Social Security payments were boosted by the largest amount since 1981, and there is $2 trillion of spending lined up from three legislative bills passed over the last two years (the Infrastructure Investment and Jobs Act, the Creating Helpful Incentives to Produce Semiconductors and Science Act, and the Inflation Reduction Act). Also, technology and competition apply downward inflationary pressures.

Performance

The Granahan Small Cap Advantage strategy returned +2.5% in the Q2, lagging the +7.0% return of its Russell 2000 Growth benchmark. Selection in Real Estate, Technology, and Utilities contributed positively for the quarter along with our underweight in Telecommunication and Energy, and overweight in Health Care. The largest detractors for the quarter came from stock selection in Health Care, Consumer Discretionary, Financials, and Industrials.

With respect to LifeCycles, Core Growth, Pioneer and Special Situation categories all underperformed the benchmark this quarter.

The largest contributors to the strategy this quarter were **Quanterix** (Health Care, Pioneer), **SPS Commerce** (Technology, Core Growth), **Kornit Digital** (Industrials, Core Growth), **Toast** (Technology, Pioneer), and **CoStar Group** (Real Estate, Core Growth).

Top detractors during the quarter were **Etsy** (Consumer Discretionary, Core Growth), **Axon Enterprises** (Industrials, Core Growth), **Castle Biosciences** (Health Care, Pioneer), **Repligen** (Health Care, Core Growth), and **Zeta Global Holdings** (Financials, Pioneer).

Outlook

The banking crisis, fears about recession, and the AI mania have put mega-cap technology back on top versus small-cap and generally versus all stocks. "But extreme valuation differentials, a bear market, the prospect of improving relative fundamentals for small and (ultimately) the breakdown in blue-chip growth create the conditions required to usher in a new era of small-cap outperformance" (Jim Furey, About That Breakdown in Mega Cap Tech Leadership 6/16/2023). While we can't predict the macro-economic outlook with certainty, we can recognize when valuations are disconnected from fundamentals and, in many cases, look irrational, and then act accordingly by buying the stocks. Our portfolio EV/Sales ratio has moved up slightly as earnings results from the first quarter, in many cases, were better than expected, enticing some investors to get involved.

There is a dramatic phenomenon going on in the stock market: a bifurcated, have and have-not dynamic. This is playing out at a market cap and sector level. While this generally is the case in the capital markets on some level, we observe that the degree of bifurcation is in many cases disproportionate to what we have seen historically and to what is justified fundamentally. We believe this is creating attractive investment opportunities for Granahan's strategies, and we are positioning accordingly. In our experience, as fundamentals play out favorably in the form of strong quarterly results and attractive new products, stocks that are being penalized on these transient issues tend to be future strong outperformers.