Future Pathways

Portfolio Comments
June 30, 2023

Distinguishing Features

GIM builds the Future Pathways portfolio from the bottom-up; sector weightings are secondary to stock selection. At quarter-end, the Future Pathways portfolio was overweight Industrials and Information Technology and underweight the Russell 2500 Growth benchmark in all other sectors. The portfolio has no exposure to Utilities, Communication Services, Financials, Real Estate, or Materials.

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 & Attribution

The Granahan Future Pathways strategy returned +8.1% in the quarter, outperforming the +7.9% return of its Russell 2500 Growth benchmark. Strong stock selection and allocation in Industrials was a positive this quarter. Challenges in Q2 were largely tied to selection in Information Technology, Energy, and Health Care.

With respect to LifeCycle categories overall, Core Growth and Special Situations outperformed the benchmark this quarter while Pioneers lagged.

The largest contributors this quarter were **Chart Industries** (Industrials, Special Situation), **Kornit Digital** (Industrials, Core Growth), **Monolithic Power Systems** (Info Tech, Core Growth), **Pure Storage** (Info Tech, Core Growth), and **Quanterix** (Health Care, Pioneer).

The largest detractors were **Enphase Energy** (Info Tech, Core Growth), **SoundThinking** (Info Tech, Pioneer), **Etsy** (Consumer Discretionary, Core Growth) **Grid Dynamics** (Info Tech, Special Situation), and **Castle Biosciences** (Health Care, Pioneer).

Positioning

While the market in the U.S has been strong since inception, it has been dominated by the largest companies in the index. Unfortunately, the most significant risk to our broad benchmark is our overweight in companies that we classify as Clean Energy companies. While this group of stocks represented approximately 37% of the portfolio holdings in the quarter, they did not offer any real positive return making it very difficult to outperform in the quarter. However, we remain very bullish on this space as the Inflation Reduction Act is just starting to work into the fundamentals of these companies, with the anticipated benefits increasing over time. For example, we believe that U.S. manufacturing credits earned by Enphase in 2025 will provide close to a 30% boost to profits to where they are now. While demand for solar projects has diminished somewhat because of higher interest rates, we think the economics for prospective clean energy projects remain healthy enough for our green energy companies to benefit for at least the rest of this decade.

We can't predict the path of interest rates, but we do think that the visibility into strong earnings growth will improve soon. We don't expect the lack of interest in clean energy stocks, or the significant outperformance of the largest technology companies to be sustainable over the long term.

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.