GLOBAL SMALL CAP

Portfolio Comments
June 30, 2023

Distinguishing Features

GIM builds the Global Small Cap portfolio from the bottom-up; sector and geographic weightings are secondary to stock selection. Since last quarter, the Global Small Cap portfolio maintained an overweight in Information Technology, Health Care, and Industrials versus the MSCI World Index Small Cap benchmark. The strategy is equal weight the benchmark in Telecommunications and Communication Services and underweight in all other sectors. The portfolio has no exposure to Utilities, Consumer Staples, or Energy.

Market Environment

The second quarter of 2023 ushered in a U.S. debt-ceiling negotiation that made investors around the globe apprehensive. With concerns about a U.S. default behind us for at least the next two years, forecasts still call for a slowing economy in the second half of the year. Slowing growth is not just a domestic issue but one that all developed markets are experiencing. At this point, the economic weakness in Europe appears to have started sooner or been more severe, or both. Japan might have the best chance to avoid recession as the late opening post-COVID, less aggressive monetary policy and weaker Yen are helping stabilize economic activity.

Secular forces including “greenflation”, labor shortages and deglobalization are drivers for upward inflationary pressure. However, inflation is coming down cyclically in the wake of unprecedented monetary tightening by the Federal Reserve and other central banks around the world. This type of rapid hiking of rates is something not seen since the 1930s, inverting the yield curve significantly. These factors generally take a year or more to negatively impact economic growth, the effects of which will vary by country. The inflationary pressures are not viewed quite the same way in other regions. In Europe, CPI ex. Energy and Food reached the same peak growth of 6.6% that the US did, but has not declined as much (i.e., remains above 6%). Brexit is partly responsible for higher prices in the UK (+8.8% at peak). After decades of consistent deflation, Japan certainly is not as unhappy with rising costs as other developed countries and may just have been the boost needed to finally reach the government’s 2% inflation target.

Yet, with this slowdown, there may not be a recession. There is still a notable amount of 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). Public spending to stimulate growth and address climate change in other regions is increasing as well although lagging the US programs. Also, technology and competition apply downward inflationary pressures. Overall, while the probability of a soft landing has improved ever so slightly, the macroeconomic remains as uncertain and unpredictable as ever. As such, we continue to remain laser-focused on finding and evaluating superior companies with attractive long-term growth opportunities.

Performance Discussion

The Granahan Global Small Cap strategy returned -0.9%, underperforming the Index return of +3.2%.

Positive allocation of 148bps was driven mostly by our overweight positions in Technology and Healthcare. However, stock selection detracted from performance by 554bps, due to an extremely narrow market, negative sentiment related to generative AI risks in several holdings (Keyword Studios, Fiverr, WNS, Future), and repercussions from the banking crisis (Altus Group, S4 Capital, Future).

While growth did outperform value this quarter, the type of stocks we own are not the type the market has been wanting. With fears of recession and rising interest rates, the market has preferred larger companies and avoided long duration.

The largest contributors this quarter were:

- **Pure Storage (PSTG US)** – Pure Storage, a leader in solid-state, all-flash storage, rallied in the quarter given excitement about the company's recently released products (e.g., solutions at Meta; its AI-clusters).

- **Vericel Corp (VCEL US)** – Vericel reported a strong quarterly result that drove increased confidence in the outlook for procedures for knee cartilage and burn patients. Last year was impacted by COVID and staffing-related disruptions.

- **Kornit Digital (KRNT US)** – After several quarters of disappointing growth due to tough COVID comparisons and a challenging macro environment, Kornit experienced the first signs of a recovery in demand for digital printers this quarter.

The largest detractors for the quarter were:

- **Keyword Studios (KWS LN)** – Despite positive estimate revisions, the stock sold off as generative AI garnered significant attention in Q2. As an outsourcer for game development and testing, investors are overly concerned regarding the near-term impact of AI on the services it provides.

- **Castle Biosciences (CSTL US)** – A diagnostics company improving health through innovative tests that guide care decision for patients with cancer received an adverse reimbursement decision for one of its new tests. While the news was disappointing, the stock was materially impacted as investors speculated the company's main skin cancer test for melanoma could also be impacted. We increased our position given the weakness. We remain confident in the significant value Castle's skin cancer tests provide and still expect an attractive long-term growth outlook.

- **Altus Group (AIF CN)** – Disappointing bookings in Q2 stoked fear of a weakening commercial real estate market, especially considering recent bank failures. We agree with the company that the weak bookings announcement is likely a temporary reaction to the banking issues and does not change our long-term view of the growth opportunity.

Positioning

While the performance of the benchmark has been very narrow (i.e., largest companies in the benchmark meaningfully outperforming), we remain disciplined in finding and owning our type of stocks: secular growth companies with superior business models, advantaged competitive positions, and strong long-term growth opportunities.

The AI craze this quarter has led to negative sentiment on a few of our core holdings, but we believe this will pass and focus will shift back to fundamentals. We have spent a great deal of time on AI; time with company managements, AI industry experts, articles about the impact of AI, and internally discussing and debating with the investment team at Granahan. Regardless of whether AI creates more risks or opportunities, we know that AI technology will not change everything overnight. It will take time and many of these same companies that sold off meaningfully are the ones that have been investing and preparing for this dynamic for years. In most cases, we see AI as we saw other technologies historically – another tool to drive efficiency and productivity rather than instantly replacing humans.

Portions of the portfolio have been impacted by slower economic growth this year. The magnitude of an uncertain macro environment is difficult to gauge and even tougher to time, so we remain steadfast in our investment process and continue to view companies through a long-term lens. The stock market discounts risk remarkably fast, and any potential recession might well be the most anticipated of all time. We are talking with management teams to ensure that any weakness is cyclical and does not represent a change to our long-term growth thesis. Our investment case for stocks focuses on earnings growth rather than assuming significant, if any, multiple expansion. Even if multiples have reset and remain at these levels, we believe our companies' earnings growth can drive positive returns.

Outlook

The banking crisis, fears about recession, and 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 had 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 portfolios, and we are positioning our strategies 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.