MICROCAP GROWTH
Portfolio Comments
June 30, 2023

Distinguishing Features
GIM builds the Microcap Growth portfolio from the bottom-up; sector weightings are secondary to stock selection. Microcap Growth strategy maintained an overweight in Health Care, Technology and Consumer Discretionary. The portfolio is equal weight to the benchmark in Telecommunications, and we are underweight in all other sectors. The portfolio has no exposure to Utilities, Energy, Basic Materials or Real Estate.

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.

Secular forces including “greenflation”, labor shortages and deglobalization are drivers for upward inflationary pressure. However, inflation is coming down cyclically in the wake of the Fed’s unprecedented monetary tightening; something not seen since the 1930s, 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 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). Also, technology and competition apply downward inflationary pressures.

Performance Discussion
The Granahan Microcap Growth strategy returned +2.8%, lagging the Russell Microcap Growth Index return of +6.4%.

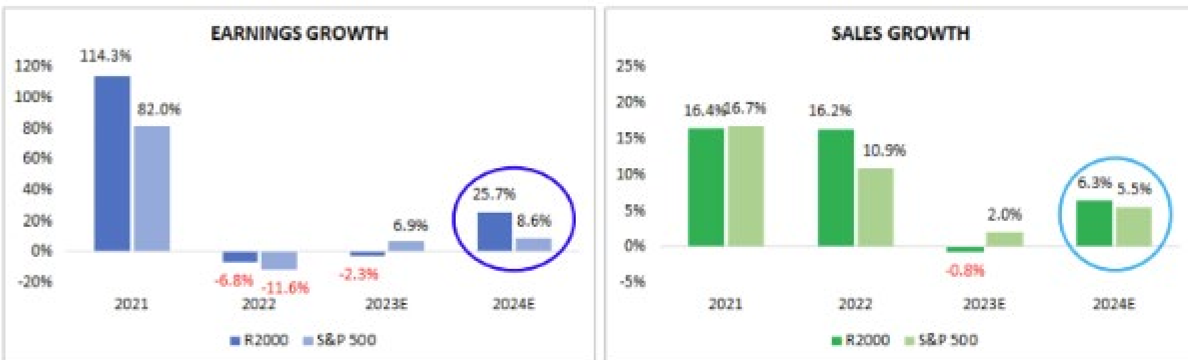
The strategy’s best performing stocks for the quarter were **LifeMD** (Health Care, Pioneer), **SI-BONE** (Health Care, Pioneer), **Harvard Bioscience** (Health Care, Special Situation), **ImmunoGen** (Health Care, Pioneer), and **MoonLake Immunotherapeutics** (Health Care, Pioneer).

The largest detractors for the quarter were **EverQuote** (Technology, Pioneer), **SoundThinking** (Industrials, Pioneer), **Castle Biosciences** (Health Care, Pioneer), **Beauty Health** (Consumer Discretionary, Core Growth), and **Pliant Therapeutics** (Health Care, Pioneer).

In terms of our Lifecycles, Core Growth, Pioneers, and Special Situations all lagged the benchmark this quarter.

Positioning

According to Furey Research, the 2023 earnings estimate for the Russell 2000 benchmark stood at over $85.00 at this time last year and has now declined almost 25% to $65.00. Reported revenue growth in 2022 was just over 16% for the Russell 2000 and the current expectation for 2023 is for a decline of almost 1%. While the revenue and earnings growth rates have declined meaningfully over the past year, there are some signs of stabilization in recent months. We expect there to be continued volatility in the revenue and earnings projections for 2024 but maintain a portfolio with projected revenue and earnings growth well in excess of the overall small cap market.



Source: Furey Research Partners and FactSet. Based upon our capitalized loss earnings model. Data as of 6/29/23.

The banking crisis and surge in Artificial Intelligence have led to extreme valuation differentials between large cap and small cap stocks this year. Apple by itself is now worth more than every stock in the Russell 2000 benchmark combined. This level of divergence was last seen at the height of the pandemic. While we cannot predict the economic outlook with certainty, we do recognize the disconnect in the valuation of small capitalization stocks from fundamentals. The degree of bifurcation matches what was seen during the onset of the pandemic and we believe is not tied to a large difference in underlying fundamentals. The current dislocation is creating attractive investment opportunities and we are positioning accordingly.

During 1H23, we have seen some of this expectation play out within the portfolio. Harvard Bioscience responded to strong results as the company has demonstrated early signs of success in its restructuring plan. ImmunoGen received FDA approval for its lead asset for ovarian cancer. Green Brick Partners reported a much stronger than expected earnings report given robust demand for housing in the Dallas Fort Worth area. All these stocks have been strong performers and positioning in the strongest small cap stocks should result in attractive investment 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.