



## SMALL CAP CORE GROWTH

### Portfolio Comments

June 30, 2023

#### Commentary

Stocks rebounded in the second quarter of 2023 with a debt ceiling resolution, a pause in rate increases by the Fed, and deep recession fears somewhat subsiding. The Granahan [Small Cap Core Growth](#) strategy returned 6.3% this quarter, modestly lagging the Russell 2000 Growth Index, which was up 7.0%. Year-to-date, the strategy is up 11.3%, and the Russell 2000 Growth Index is up 13.6%.

Three Core Growth technology companies, Digital Turbine, Super Micro Computer, and WNS, negatively impacted performance this period. **Digital Turbine** reported a weak quarter, citing a lack of mobile device growth and feeble digital ad spending. We are eliminating the position. **Super Micro** makes application servers with Nvidia's GPU chips that are used for AI applications. The stock has been a strong performer, and because we are underweighting the index, it shows as a penalty to performance. **WNS** is a leading global business process management (BPM) company. The stock came under pressure due to perceived risks associated with ChatGPT replacing its customer experience services. We have added to the position of this well-managed company. Two Healthcare Pioneers, Castle Biosciences and Pliant Therapeutics, were also detractors to performance this quarter. **Castle Biosciences** is a diagnostics company improving health through innovative tests that guide care decisions for patients with cancer. The company has a portfolio of tests for skin cancers, Barrett's esophagus, and mental health conditions. During the quarter, a Medicare contractor ruled against the company providing coverage for a skin cancer test. With this disappointing news, the stock was materially impacted as investors speculated the company's main skin cancer test for melanoma could also be affected. We increased our position in the stock given the weakness, as we feel confident in the significant value Castle's skin cancer tests provide and still expect a positive coverage outcome, making for attractive long-term growth. **Pliant** has been a poor performer since reporting a Phase 2 study for pulmonary fibrosis that fell short of street expectations. We believe the drug will become an important treatment for a disease with high unmet needs and have taken advantage of the stock weakness to add to the position.

Like the laggards, the positive contributors to performance were dominated by Core Growth: two in Technology (Magnite and Pure Storage) and one in Industrials (Kornit). **Magnite** rebounded this quarter as earnings were strong across the board, and guidance for the year was better than expected. Their digital advertising technology solution has been taking share of the connected TV market, which is a higher margin business. When the stock was down last quarter, we were buyers; now we are trimming due to position size. **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% on investor enthusiasm for the company's new Apollo direct-to-garment printer. We had added to the position early in the quarter, in part due to our optimism about the Apollo, and have since cut it back after the big move in the stock. **Pure Storage** is a share gainer in the software-defined, all-flash array storage solution market. The company is seeing a continued acceleration in sales of its software and storage-as-a-service offerings, with new products that help clients with cloud migration and increasing AI workloads. Growing subscription services support a higher level of recurring revenues with an increasing margin profile. Given the position size, we are trimming. Two Healthcare Pioneers were strong this quarter: **Immunogen** and **Quanterix**. Immunogen's ovarian cancer drug, Elahere, succeeded in a large clinical study that will drive accelerating commercial uptake. We trimmed on strength but maintain a meaningful position given the company's attractive growth profile. Quanterix provides



equipment that helps detect disease much earlier than traditional methods used today through blood-based protein analysis. The company's primary focus is on neurological diseases. During the quarter, strong data from larger biotech companies developing Alzheimer's drugs highlighted the potential for QTRX's technology to be used in additional drug trials and potentially for a diagnostic to test for Alzheimer's, driving the stock higher. Despite the excitement we have about the long-term opportunity, we did trim our position.

For the year-to-date, our largest detractor was **Silicon Valley Bank** (Core Growth), and **Texas Capital Bancshares** (Special Situation) in Financials. Digital Turbine, Castle Biosciences, along with **Azenta**, a Healthcare Pioneer, round out the laggards.

Positives for the six-month period include four Pioneers: **Si-Bone**, **Immunogen**, and **Quanterix** in Healthcare, and **indie Semiconductor** in Technology. **Vita Coco** (Consumer Discretionary, Core Growth) completes the top five winners.

### Attribution

Overall stock selection for the quarter was weak. Our largest overweights in Technology and Healthcare helped to offset the weakness, as well as underweighting in Consumer Discretionary, Energy, and Basic Materials. Industrials performed in line with the Index, but because of the underweight, it was a performance detractor. Underweighted Consumer Staples and Utilities had positive stock selection, which contributed nicely to performance. Pioneers led the way this quarter, followed by Core Growth, and lagged by our lowest weighting Special Situations.

For the year-to-date, the largest detractor to performance was Financials, with our holding in Silicon Valley Bank. Consumer Discretionary has been strong in the Index, and we are underweight, as well as feeling the impact of declines in Etsy and Chicken Soup for the Soul, both of which we are trimming. Performance in Industrials was comparable to the Index, but our underweight hurt. Healthcare stocks performed slightly less well than the Index, and we are overweight in this sector. Telecommunication stock selection was also a detractor. Underweights in Energy, Consumer Staples, Basic Materials, and Utilities were positive impacts on performance paired with good stock selection. Technology's overweight helped as well. For the six months, the contribution to performance was greatest from Core Growth because of its larger weight. Pioneers performed the best, and Special Situations lagged.

### Weightings

Since the beginning of the year and last quarter, our Financials and Industrials weightings have increased by 1% each, while our Technology weighting has decreased by 2%, largely from the elimination of Digital Turbine and trimming Power Integrations and Pure Storage. The Russell 2000 Growth Index was rebalanced with a 2.5% reduction in the Energy weighting and a 2% increase in Health Care, Industrials, and Technology. We are overweight in Technology and Health Care and underweight in Consumer Discretionary, Staples, Industrials, and Energy.

Pioneers have been steadily rising since the end of the year and are up 2% to 35% since last quarter, largely due to strength in the Biotechs and indie Semiconductor. The Core Growth weight is down 3% from last quarter to 47%, and Special Situations are flat at 15%.

### Themes

Prothena, MoonLake, and Apellis are all clinical-stage biotechnology companies in the portfolio with promising science, developing treatments for autoimmune and inflammatory diseases. **Prothena** has a broad pipeline of monoclonal antibodies for several diseases, including Alzheimer's and Parkinson's disease.



**MoonLake** is developing an antibody that targets a specific immune pathway known as IL-17. Their lead product, Sonelokimab, is in clinical trials for the treatment of psoriatic arthritis and other severe inflammatory skin conditions. **Apellis's** Syfovre recently became the first approved treatment for an inflammatory ocular condition known as geographic atrophy. The company has several other drugs at various stages of development targeting high unmet medical needs.

Newer names in the technology sector of the portfolio, Confluent, JFrog, and HashiCorp, provide software solutions that enable cloud infrastructures for enterprises. They are based on open-source architectures with a multi-cloud approach. **HashiCorp** is the leader in configuring and securing technology environments across cloud platforms. **JFrog's** Artifactory continuously deploys and manages applications in the cloud. **Confluent** is the standard in real-time data streaming across platforms. These companies form the central nervous systems to distribute applications and data across cloud infrastructures. Multi-cloud infrastructure is especially critical for workloads that involve large amounts of data, including machine learning and large language models.

## Macro

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.

## 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.

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