



SMID SELECT

Portfolio Comments

June 30, 2023

Distinguishing Features

GIM builds the [SMID Select](#) portfolio from the bottom-up; sector weightings are secondary to stock selection. At quarter-end, the SMID Select portfolio maintained an overweight in Information Technology and Communication Services versus the Russell 2500 Growth benchmark. We decreased the underweight in Biotech this quarter and remain underweight in all other sectors. The strategy has no exposure to Real Estate or Utilities.

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.

2023 so far has been a market which has been very narrow and led by a few extremes. The seven largest companies in the NASDAQ by market cap (Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla, and Meta) are on average up a stunning 89% year-to-date. The remaining 3,521 stocks are up just 5% (source: Furey Research).

Performance & Attribution

The Granahan SMID Select strategy returned +3.9% in the quarter, trailing the +6.4% return of its Russell 2500 Growth benchmark. Strong stock selection in Communication Services, Industrials, and Consumer Staples were positives this quarter. Challenges in Q2 were largely tied to selection in Information Technology 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 **Magnite** (Communication Services, Core Growth), **Kornit Digital** (Industrials, Core Growth), **Chart Industries** (Industrials, Special Situation), **Vita Coco** (Consumer Staples, Core Growth), and **Quanterix** (Health Care, Pioneer).

The largest detractors were **Digital Turbine** (Info Tech, Core Growth), **Enphase Energy** (Info Tech, Core Growth), **indie Semiconductor** (Info Tech, Pioneer), **Grid Dynamics** (Info Tech, Special Situation), and **Castle Biosciences** (Health Care, Pioneer).

Positioning

Unfortunately, for the second quarter in a row, we had a large position that we have been forced to exit because of a major deterioration in the fundamentals. Last quarter it was SVB, this quarter it is Digital Turbine. In both cases, timing was not kind to us. We received a strong positive update from Digital Turbine at a conference in mid-March only to have the company post a very disappointing quarter and outlook when they reported earnings in late May. The company thought it could recognize revenues on a front-end loaded basis for a contract renewal, which was rightfully rejected by auditors. This made us less confident in management and we ultimately sold out of the stock.

You will notice that our Core growth position size is now lower on the account of selling Digital Turbine. In its place, we added to several smaller positions - predominantly Pioneers. This includes several Biotech companies we've been analyzing closely over the last year with the help of our biotech expert, Rich Watson. Additions to **Pliant Therapeutics**, **Prothena Corp**, **MaxCyte** and **bluebird bio** decrease our Biotech underweight versus the benchmark and aims to lower overall portfolio risk.

On a more positive note, many of our top performers this quarter were underperformers last year due to valuations. This reinforces our long-term focus on strong businesses with good fundamentals. We remain intent on adhering to our philosophy and investment process to deliver good absolute and relative investment results over most intermediate and long-term market environments.

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.

Disclosure: The information provided in this commentary should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. The securities discussed do not represent an account's entire portfolio and, in the aggregate, may represent only a small percentage of an account's portfolio holdings.

It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein.