GLOBAL SMALL CAP

Portfolio Comments
September 30, 2023

Distinguishing Features

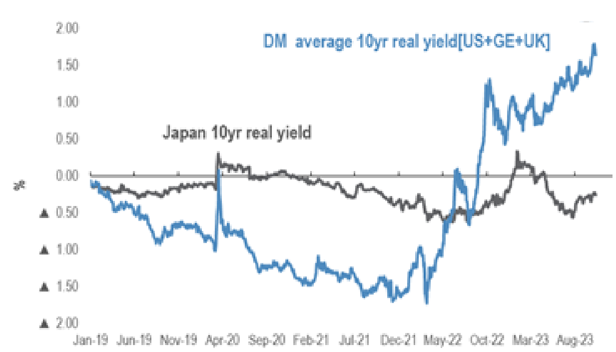
GIM builds the Global Small Cap portfolio from the bottom-up; sector and geographic weightings are secondary to stock selection. The Global Small Cap strategy is overweight Information Technology, Health Care, Communication Services, and Industrials versus the MSCI World Index Small Cap benchmark. The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

Market Environment

All U.S. indices suffered losses this quarter, battered by surging oil prices and the Fed's higher-for-longer rates strategy. The risk of a U.S. government shutdown has been temporarily resolved but could resurface again in mid-November. The manufacturing Purchasing Managers' Index (PMI) across the globe remains in contractionary territory while services PMI's have declined as well. Thus far, we have had resilient consumer spending, but that could change given a plethora of headwinds related to elevated mortgage rates, resumption of student loan payments, higher gasoline prices, a less robust job market, increasing consumer debt, and stubborn inflation. The massive spending and subsidies from Federal governments across the globe could lessen the magnitude of any economic downturn. In the U.S., this spending involves upgrading the nation's roads and bridges, expanding domestic manufacturing of semiconductors, and modernizing the electrical grid.

Overseas, the picture is not dissimilar. In Europe, spending is focused on modernization of government systems and spending on sustainability initiatives, including directly addressing higher energy prices. While good for economic growth, continued government spending could lead to more sustainable inflation. Inflationary trends, including the impact of a stronger dollar, are impacting every corner of the world in different ways. Europe is dealing with higher inflation (~6-7%), particularly in food and energy, given its dependence on Russia and Ukraine. Japan is experiencing elevated prices for goods and services, although not nearly as high as the US and Europe (~3%). After decades of persistent deflationary forces, inflation isn't such a bad thing for Japan as long as it does not spiral out of control. Rates have risen in the US and Europe but not in Japan (see graph). Developed market manufacturing PMIs have been in contractionary territory since January 2023. The deterioration has been more significant in Europe than the US; Japan, Australia, and Canada have held up relatively well. Services PMIs have started to decline as well in most of the large, developed countries. The market environment is as cloudy as ever, but we continue to employ the same disciplined, proven investment process for which Granahan Investment Management is known.

Figure 3: Overseas real yields have risen but Japanese real yield has changed little



Source : Bloomberg Finance L.P., J.P. Morgan Equity Derivatives

Performance Discussion
The Granahan Global Small Cap strategy returned -10.9%, underperforming the MSCI World Small Cap Index return of -4.4%.

The largest detractors for the quarter were **BioLife Solutions** (Health Care, Pioneer), **Topgolf Callaway Brands** (Consumer Discretionary, Core Growth), **S4 Capital** (Communication Services, Pioneer), **Portillo's** (Consumer Discretionary, Core Growth), and **OrthoPediatrics** (Health Care, Core Growth).

The largest contributors for the quarter were **Nutanix** (Info Tech, Pioneer), **Texas Capital Bancshares** (Financials, Special Situation), **Castle Biosciences** (Health Care, Pioneer), **Goosehead Insurance** (Financials, Core Growth), and **SES-imagotag** (Info Tech, Pioneer).

The continuation of a narrow market at the top and a surge in interest rates made for a difficult performance environment for small cap growth mandates, particularly those focused on secular growth. For the Granahan Global Small Cap fund, the rally in Energy and Financials, and the heavy overweight in Technology and Healthcare led to a meaningful negative impact from an allocation perspective. Stock selection compounded the underperformance as long duration growth stocks were out of favor and macroeconomic weakness affected certain areas of the portfolio (e.g., advertising, gaming, consumer, healthcare).

The largest contributors this quarter were:

- **Nutanix (NTNX US)**– Nutanix is a pioneer in the hyperconverged infrastructure market that provides a cloud platform that converges computing, storage, networking, and virtualization for enterprises. Enterprises can efficiently manage their technology investments across a hybrid or multi-cloud infrastructure. Investors have gained increased confidence in the company's ability to deliver sustainable revenue growth and higher levels of profitability.

- **Texas Capital Bancshares (TCBI US)** – Texas Capital rebounded during the quarter as fears about a regional bank crisis eased. Texas Capital stands out relative to other banks given its strong capital and liquidity while the stock remains compelling, trading around tangible book value. We expect the company's ongoing strategic plan of significantly improving profitability to serve as a catalyst for the stock.

- **Castle Biosciences (CSTL US)** – A top detractor last 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, CSTL rebounded as investor concerns eased regarding the reimbursement outlook facing both the company and industry.

The largest detractors this quarter were:

- **Biolife Solutions (BLFS US)** – Biolife Solutions' key product is a preservation media used to develop and transport next-generation cell and gene therapies. The company has the dominant market position in this key enabling technology; however, large customers undergoing destocking due to macro conditions will negatively impact growth for the balance of the year.

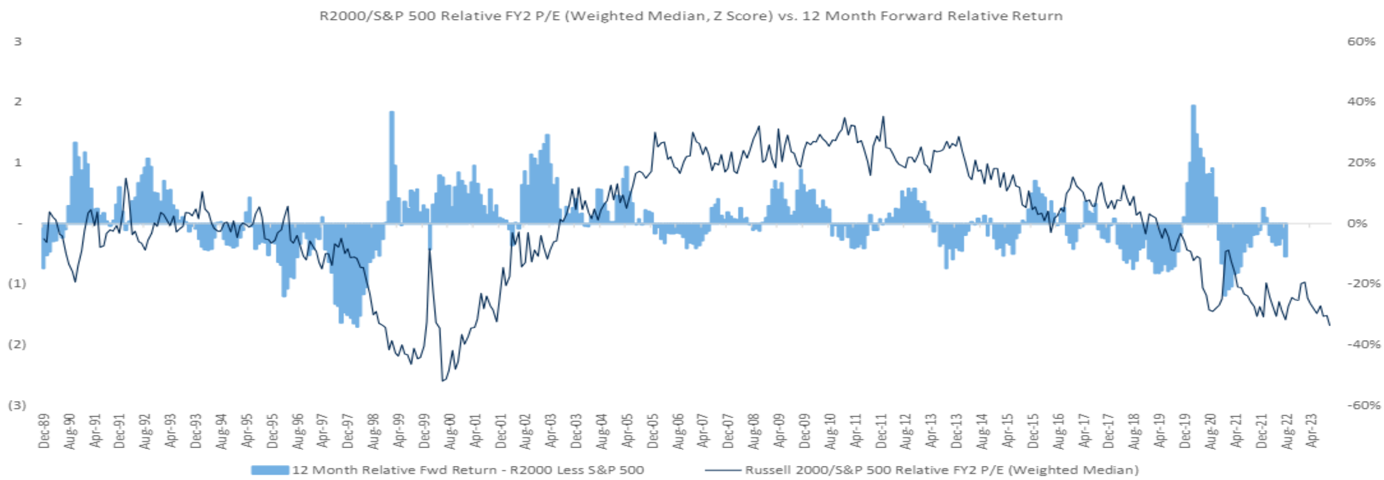
- **TopGolf Callaway (MODG US)**– Topgolf Callaway is a leading golf equipment, apparel, and entertainment company with a portfolio of global brands that include TopGolf, Callaway Golf, TravisMathew, and Toptracer. We believe MODG is well-positioned to capitalize on the fundamental change in the sport of golf as off-course golfers expand the addressable market. The stock was weak due to concerns about the growth outlook for TopGolf given some slowing trends expected for the balance of the year. Some corporate-event and weather-related softness are masking the long-term outlook for the company.
- **S4 Capital (SFOR LN)** – S4's rapid growth over the last few years has created growing pains and the demand from S4's technology customers has not held up as we expected. However, the long-term thesis, tied to a continued shift of advertising spend to digital, market share gains relative to the ad holding companies, and the digital transformation trend, remain intact. The stock is now trading at a discount to inferior legacy ad agencies, despite what we believe is a significantly better growth profile.

Positioning
While the economy aims to normalize and absorb the impact of higher interest rates, we would not be surprised to see deceleration become more visible over the coming months. It remains to be seen whether the United States and other developed markets can avoid a significant downturn. We believe the risk/reward dynamic is increasingly favorable, particularly when viewed with an eye toward the long-term, but a catalyst that changes market sentiment (e.g., rate peak, signs of a soft landing) would be helpful. At Granahan, we remain disciplined and focused on our processes, evaluating companies based on growth opportunities and profitability improvements over years, not quarters. We manage position sizes with an eye towards near-term risks. Our team is continuing to find compelling opportunities - many of which involve companies with positive estimate revisions or whose resilience and durability is being questioned due to transitory factors.

Case in point, we recently added **Boot Barn** to the portfolio. Boot Barn is the leading retailer of western wear. The company has a dominant position in an otherwise fragmented industry. Boot Barn is five times larger than its closest competitor and continues to grow the store count 10-15% per year. The company's market position and increasing mix of private labels allows for leverage against the national brands. The stock, which has historically traded at ~18x P/E, is currently trading at 13x for a 20%+ earnings grower. **Nuvei** is another company that we added to the portfolio during the quarter. A differentiated Canadian provider of payment solutions, particularly to markets with complex requirements, Nuvei has rerated lower partly due to lowered guidance tied to macroeconomic weakness. We see tremendous value for a company with a Rule of 50-type profile (i.e., 15-20% revenue growth + 35% EBITDA margin) that is now trading at less than 8x P/E.

The outperformance of large caps versus small continued in the third quarter (see graph below) but there are signs that this dynamic is coming to an end. However, a reversal is not likely until we get more clarity on the economic situation. Regardless of whether a recession materializes, we believe the setup for small cap growth stocks over the medium and long-term is compelling.

Small Caps Still Deeply Undervalued vs. Large Caps, Have Broken Below Recent Lows



Source: RBC US Equity Strategy, Russell, S&P Capital IQ/ClariFi, CIQ estimates, IBES estimates. As of October 5, 2023.

Outlook

Valuation on our portfolio has come down. In many cases – but not all - reported earnings have been better than expected and US/Canada multiples remain higher than overseas markets, with the exception of Australia. It is almost always the case that misses are hurt disproportionately versus the gains that stocks realize when they beat expectations. Response to earnings was extreme in this regard. There were modest positive moves in stocks on very strong earnings and brutal stock moves downward on misses. We even saw a number of stocks report strong earnings, only to go down in their wake. While there are more headwinds to growth broadly, the companies in the GIM portfolios are ones we believe can sustain strong secular growth.